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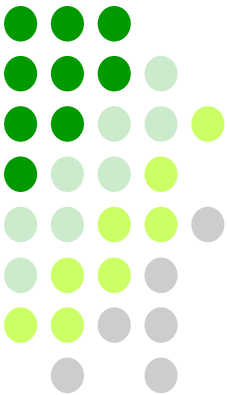

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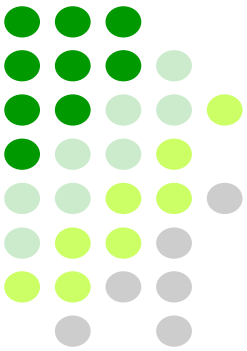

Estate Planning

The Pitfalls of the Section 4(q) Deduction

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Introduction

One of the main methods used in practice to reduce estate duty payable[1] at the death of a person is the use of Section 4(q) of the Estate Duty Act[2]. Financial Planners tend to use the deduction that is allowed in terms of Section 4(q)[3] by bequeathing the whole or the majority of a person's estate to a surviving spouse of that person. Section 4(q)[4] contains a deduction, from the gross estate, equal to the value of the property included in the estate of a person that accrues to a surviving spouse of that deceased person. The bequests as stated above could potentially lead to a saving of estate duty payable in a deceased person's estate.

Section 4(q)[5] however contains two provisos that can firstly limit and secondly potentially prohibit the deduction allowed if there are certain circumstances present. One of these provisos will especially be important when massing is used by financial planners as an estate planning technique.

This article will attempt to identify some of the potential pitfalls of the use of the section 4(q)[6] deductions and enabling financial planners to consider the complexities that exist when the provisos of section 4(q)[7] are applicable under certain circumstances.

Section 4(q) of the Estate Duty Act 45 of 1955

The allowable deduction reads as follows:

"The net value of any estate shall be determined by making the following deductions *from the total value of all property included therein in accordance with section 3, that is to say –*

(q) so much of the value of any property included in the estate which has not been allowed *as a deduction under the foregoing provisions of this section, as accrues to the surviving spouse of the deceased: Provided that-*

(i) the deduction allowable under the provisions of this paragraph shall be reduced by so much of any amount as the surviving spouse is required in terms of the will of the deceased to dispose of to any other person or trust;

(ii) *no deduction shall be allowed under the provisions of this paragraph in respect of any property which accrues to a trust established by the deceased for the benefit of the surviving*

[1] Section 2 of the Estate Duty Act 45 of 1955, read with the First Schedule of that Act
[2] Act 45 of 1955
[3] Estate Duty Act 45 of 1955
[4] Id
[5] Id
[6] Id
[7] Id

spouse, if the trustee of such trust has a discretion to allocate such property or any income therefrom to any person other than the surviving spouse."[8]

It is thus clear from the above that a bequest of property included in a deceased person's estate to a surviving spouse will be allowed as a deduction to the value of the property so bequeathed. However it is important to note that the deduction contained in section 4(q)9 will not be allowed if the so bequeathed property is allowed as a deduction in any other provision contained in section 4[10]. Take for instance the following example:

James was the owner of a house in England. He received the house by way of inheritance from his uncle two years ago after James became ordinarily resident in South Africa for the first time. James has passed since and bequeathed the house in London to his wife Sophia. It is clear from the above facts that James's foreign property in England will qualify for the section 4(e)[11] deduction and therefore will not be deductible in terms of section 4(q)[12]. The other deductions contained in section 4[13] must be applied first where those assets are also bequeathed to a surviving spouse and then the balance, if any, can be used for the section 4(q)[14] deduction.

A further point of paramount importance when dealing with the section 4(q)[15] deduction is who will qualify as a surviving "spouse". As this falls outside the topic and purpose of this article financial planners is advised to meticulously study the definition of a "spouse" contained in the Estate Duty Act[16] to make sure that a person indeed qualifies as a "spouse" for the purposes of the act before using the section 4(q)[17] deduction as an estate planning technique.

Section 4(q) – The first proviso

The first proviso[18] determines that the deduction must be reduced by so much of any amount as the surviving spouse is required to dispose of to any other person or trust in terms of the will of the deceased. Revenue's current view is that the first proviso will be applicable in all cases where a surviving spouse is required in terms of the will of a deceased to dispose of any amount and that the first proviso is not limited to property included in the deceased's estate.[19]

This would entail that where a surviving spouse is required to pay a bequest price to any other person or trust the first proviso would have to be taken into consideration for determining the deduction allowed in section 4(q).

[8] Section 4(q) of the Estate Duty Act 45 of 1955
[9] Estate Duty Act 45 of 1955
[10] Id
[11] Id
[12] Id
[13] Id
[14] Id
[15] Id
[16] Section 1 of the Estate Duty Act 45 of 1955
[17] Estate Duty Act 45 of 1955
[18] Section 4(q)(i) of the Estate Duty Act 45 of 1955
[19] DM Davis, C Beneke & RD Jooste, Estate Planning at 2-26 (Service Issue 51 2018)

Another example of where the first proviso will be applicable is when massing occurs. Massing occurs when two persons under a joint will "mass" their separate estates in whole or in part and appoint common heirs.[20] The effect of massing is that a massed estate is formed out of two separate estates of a person who died and a person who is alive. When persons are married in community of property massing is often used as an estate planning technique to distribute the massed estate to other persons subject to the surviving spouse enjoying a limited right over the whole or part of the massed estate. The limited right that is awarded to the surviving spouse, in exchange for the giving up of their rights of ownership in their own estates, will qualify as property that accrues to the surviving spouse as needed for a section 4(q) deduction. The crux of the matter lies in the fact that the surviving spouse disposes of an amount (his/her one-half share of the joint estate) in terms of the will of the deceased to another person. Therefore the first proviso of section 4(q)[21] will be applicable when calculating the deduction allowable under this section if massing occurs. The above can be best explained by way of examples.

Example 1 – The first proviso

Thando is the owner of a commercial building. On the day that Thando died the fair market value of the commercial building was R 6 million. Thando bequeathed the commercial building to his spouse Mary subject to the condition that Mary pays a bequest price of half of the fair market value of the commercial property at date of his death to his son, Peter. The section 4(q) deduction is calculated as follows:

- Fair market value of commercial building – R 6 000 000
  Less: Value of bequest price to son – R 3 000 000
  Value of Section 4(q) deduction – R 3 000 000

Example 2 – The first proviso

Jan and Marie are married in community of property. They have two children, Hendrik who is 29 years old and Sarie who is 25 years old. The assets are as follows:

Primary residence	– R 4 000 000
House at the sea	– R 3 000 000
Members interest in JMHS CC	– R 900 000
Listed shares	– R 200 000
Personal use assets	– R 600 000
Policy on Jan's life to estate	– R 2 600 000

Jan and Marie have concluded a joint will which reads as follows:

[20] M Botha et al, The South African Financial Planning Handbook at 808 (2018)
[21] Section 4(q)(i) of the Estate Duty Act 45 of 1955

On the death of the testator the estates of the testator and the testatrix are to be massed and shall devolve as follows:

The immovable property to their son Hendrik, subject to a lifelong usufruct to the testatrix over the immovable property.

(1) The personal use assets to the testatrix.

(2) The residue of the massed estate to their daughter Sarie.

Jan died in April 2018 and Marie will be 46 years old at her next birthday. The expenses with regards to the administration (including the Master's fee and the executor's fee) of Jan's estate are R 461 470. Please note that any possible CGT implications are ignored for the purposes of this example. The section 4(q) deduction is calculated as follows:

Step 1: Assets that accrue to Marie as surviving spouse from the deceased estate of Jan–

Usufruct over Jan's one-half of the immovable property	– R 3 385 015[22]
Value of Jan's share of the personal use assets	– R 300 000
Total value of assets from deceased estate	– R 3 685 015

Step 2: Assets that Marie as surviving spouse disposed of –

Marie's one-half share of the bare dominium to their son	– R 114 985[23]
Marie's one-half share of the members interest in JMHS CC	– R 450 000
Marie's one-half share of the listed shares	– R 100 000
Residue to their daughter	- R 1 619 265[24]
Total value of assets disposed of by Marie	- R 2 284 250

Step 3: Thus the section 4(q) deduction available in Jan's estate is:

Total value of assets accrued to Marie from deceased estate	- R 3 685 015
Less: Total value of assets disposed of by Marie	- R 2 284 250
Value of Section 4(q) deduction	- R 1 400 765

The method used above in calculating the section (q) deduction is in line with the method used by Revenue as was expressed in the correspondence between the Commissioner and *The*

[22] Note 1
[23] Note 2
[24] Note 3

Taxpayer[25]. Certain authors are of the view that Revenue misinterpret the meaning of the section.

It is however clear from the examples above that the first proviso can have inimical consequences to the allowable section 4(q) deduction and in the same breath possibly increase the amount of estate duty payable in the deceased's estate.

Note 1

Calculation of Marie's usufruct over Jan's deceased estate's one-half of the immovable property bequeathed to Marie in terms of the massed joint will:

Value of immovable property – (R 4 000 000 + R 3 000 000)/2	= R 3 500 000
Present value of R1 pa for female life of 46 years at next birthday	- 8.05 956
Value of usufruct – [(R 3 500 000 x 12%) x 8.05956	= R 3 385 015

Note 2

Calculation of the value of Marie's one-half of the bare dominium disposed of to her son:

Market value of Marie's one-half of the immovable property	– R 3 500 000
Less: Value of the usufruct over one-half of the immovable property	– R 3 385 015
Value of the bare dominium disposed of by Marie to her son	– R 114 985

Note 3

Calculation of Marie's one-half of the residue of the massed estate disposed of by her to her daughter:

Half of all the property and deemed property of the massed estate	– R 5 650 000
Less: Half of expenses for the administration of Jan's Estate	– R 230 735
Total estate disposed of to Jan's deceased estate	– R 5 419 265
Less: The total legacy to Marie	– R 3 685 015
Less: The legacy to their son	– R 114 985
Value of residue that Marie disposed of to her daughter	– R 1 619 265

Section 4(q) – The second proviso

In terms of the second proviso of section 4(q)[26] there will be no deduction allowed in respect of property that is bequeathed to a trust for the benefit of a surviving spouse in terms of which the

[25] 1992 The Taxpayer 161
[26] Section 4(q)(ii) of the Estate Duty Act 45 of 1955

trustees have a discretion to allocate such property or any income therefrom to any person other than the surviving spouse.

The wording of the second proviso is however not clear. There are contrasting views between authors and academics regarding the interpretation of this proviso.

According to *Davis et al*[27] it appears that the second proviso will cover the situation where the will states that the trustees must pay 50% of the estate income to the surviving spouse and that the balance can be distributed in accordance with the trustee's discretion.[28] *Davis et* al[29] *states that the proviso after all provides* that no section 4(q) deduction will be available if a trustee has a discretion to allocate such property or any income therefrom to any person other than the surviving spouse[30].

Meyerowitz[31] on the other hand is of the opinion that such a strict literal interpretation of the proviso would lead to unfavourable and unfair results[32]. *Meyerowitz* points out that the correct approach is to accept that whenever the surviving spouse's right to income, whether in whole or in part, from a trust cannot be defeated by the exercise of the trustee's discretion, including his discretion as to the allocation of capital, the proviso should not operate to prevent the value of the vested right from being deductible under s 4(q)[33]. This view is accepted by Revenue[34].

Planners should thus take caution when a discretion is given to the trustees to benefit any other person other than the surviving spouse if the goal is to use such a bequest, to a trust, as an allowable deduction for section 4(q) purposes.

Section 4(q) and the recommendations by the Davis Tax Committee

The Davis Tax Committee has made certain recommendations with regard to the current section 4(q) deduction that is allowed in the Estate Duty Act[35]. In layman's terms the Davis Tax Committee has recommend that the section 4(q) deduction be abolished and replaced with a substantially higher primary abatement. [36] It needs to be noted that the above recommendation has not been included in any legislative amendments up to the date of writing this article. Financial planners should therefore focus on the current legislation and only take cognisance of the recommendations.

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[27] DM Davis, C Beneke & RD Jooste, Estate Planning at 2-26 (Service Issue 51 2018)
[28] Id
[29] Id
[30] Id
[31] Meyerowitz, Administration of Estates and Their Taxation, 2010 at 28-15 to 28-16
[32] Id
[33] Id
[34] 1989 The Taxpayer 232
[35] Act 45 of 1955
[36] The Davis Tax Committee, Second Interim Report on Estate Duty at 14

Conclusion

In a time of difficult financial circumstances it is crucial for financial planners to try and effectively plan and manage their client's financial affairs. It is of paramount importance that planners use all of the allowable methods to reduce the tax liability of their clients. One of the most effective methods to save estate duty is by the use of bequests to a surviving spouse and the deduction in section 4(q) of the Estate Duty Act[37].

Financial planners should however be aware of the provisos contained in section 4(q) and the detrimental impact they could have on the use of the deduction in this section. As can be seen in example 1 and 2, the allowable deduction in terms of section 4(q) could be decreased and may lead to an increased amount of estate duty payable in a first dying spouse's estate. Planners should endeavour to make sure that they take note of the provisos contained in section 4(q) of the Estate Duty Act[38] when doing an estate planning for a client and deliver sound advice.

[37] Act 45 of 1955
[38] Act 45 of 1955

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ITC 1387 46 SATC 121

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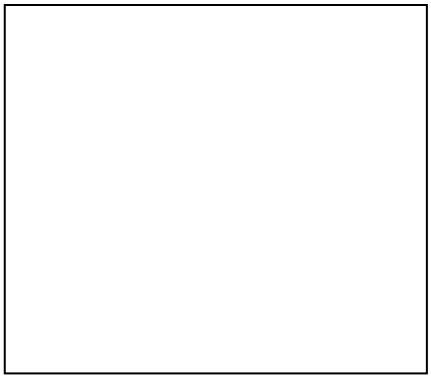
Removal of a Trustee with Specific Reference to the Trust Instrument



Old Mutual Personal Finance: Legal

Introduction

A trust is defined in section*1* of the *Trust Property Control Act*[1] (the Act) as an arrangement by which the ownership in property of one person is, by way of a trust instrument (*e.g*. the trust deed), made over to another person/s (the trustee/s) to be administered or disposed of for the benefit of the person or class of persons (the beneficiaries) as stipulated in the Trust instrument.

A Trustee is defined as a person who acts as a trustee by virtue of an authorization in terms of *s6* of the Act[2].

A trust instrument is defined[3] as a written agreement, testamentary writing or a court order according to which a trust was created.

It follows that a trust functions through its appointed trustees who in their official capacity act together for and on behalf of the trust in line with the trust instrument and the Act. It follows further that the trustees stand in a fiduciary relationship to the beneficiaries. This fiduciary relationship entails that the trustees shall, in the exercise of their powers and duties in relation to the trust, act honestly and in good faith in the interest of the trust and for the benefit of the beneficiaries.

Removal of a Trustee

There are various options available to the Master and other interested parties for the removal of a trustee. The trustee could resign by notice to the Master and the beneficiaries as is provided for in *s21* of the Act[4]. The question that however needs to be answered is what the options are if a trustee is unwilling to resign.

Firstly, one has to look at the provisions in the trust instrument for the removal of a trustee. Secondly, the Court (the High Court) has the power under the common law to remove a trustee. Thirdly, the Master or other interested parties may approach the Court in terms of the Act to remove a trustee. Fourthly, the Master has certain powers in terms of the Act to remove a trustee.

The common law

It is trite that the Court has inherent power to remove a trustee from office at common law[5] The Court will only exercise this power with circumspection. Neither *mala fides* nor even misconduct by the affected trustee are required for the removal of a trustee. The decisive consideration is the welfare of the beneficiaries and the proper administration of the trust and the trust property.

[1] Act No 57 of 1998
[2] Trust Property Control Act No 57 of 1998
[3] Trust Property Control Act No 57 of 1998
[4] Trust Property Control Act No 57 of 1998
[5] Gowar and Another v Gowar and Others 2016 (5) SA 225 (SCA)

Section 20(1) of the Act

This section is to a large extent a confirmation of the common law position. The Court may order the removal of a trustee only if such removal is in the interest of the trust and its beneficiaries.

The court procedure in both these instances can be lengthy and expensive.

Section 20(2) of the Act

This gives the Master the power to remove a trustee under certain specific circumstances:

(a) the trustee has been convicted of an offence of which dishonesty is an element or any other offence for which he has been sentenced to imprisonment without the option of a fine;

(b) the trustee fails to give security or additional security to the satisfaction of the Master within two months of having been requested, or within a further period as allowed by the Master;

(c) the trustee's estate is sequestrated, liquidated or placed under judicial management ;

(d) the trustee has been declared by a competent court to be mentally ill or incapable of managing his own affairs or if he is by virtue of *The Mental Health Act*[6], detained as a patient in an institution or as a State patient ;

(e) the trustee fails to perform satisfactorily any duty imposed upon him , by or under the Act, or to comply with any lawful request of the Master.

The first four grounds could be relatively easy to establish through documentation and affidavits whilst the fifth ground could be more onerous.

The Trust Instrument

As mentioned previously the first option to remove a trustee is generally the trust instrument. Normally the trust deed will set out the circumstances under which a trustee may be removed as well as the procedure to be followed. If this is the case, such process must be followed. If the trust deed is silent on the removal of a trustee, one of the aforementioned procedures may be followed.

The trust deed is a contract and therefore the rules of legal interpretation as expounded by the courts would be applicable.

[6] Act 18 of 1973. It should be born in mind that although Section 20(2) refers to the Mental Health Act, this act has been replaced by the Mental Health Care Act 17 of 2002.

In Du Plessis NO and Others v Van Niekerk and Others[7] the court was called upon to interpret a clause in a trust deed that made provision for the removal of a trustee.

The relevant clause read "The office of a trustee shall be vacated if ...the majority of trustees request a trustee to resign".

Counsel for the applicants, who sought to remove a trustee, argued that the clause is clear and unambiguous and should the majority of trustees request a trustee to resign, no reasons need to be given and such trustee would have no option but to resign. They contended that the Master must amend his records accordingly and does not have any jurisdiction to hear any representations and the court has no say in the matter except to confirm the decision of the majority of trustees.

The judge however found that the clause is ambiguous. The word 'shall' indicates that a peremptory meaning is used, but the word 'request' is irreconcilable with peremptoriness. The use of the word 'request' implies a choice. After considering the relevant circumstances and context as well as the language used, the judge found that in order to give practical, sensible and business-like meaning to the words used, the clause must be interpreted to read that there has to be good cause for such a request.

Secondly the court was prepared to read an implied term into the clause that good cause had to be present for such a request and that there is no valid reason why such an implied clause should not be applicable to all deeds of trust similarly worded.

Thirdly it was held that the trustees cannot take decisions without any reason or for *mala* fide reasons but need to exercise their discretion *arbitrio bono viri, i.e.* based on the discretion of a good person acting reasonably.

Finally the court found that the applicants' resolution to remove a trustee was not taken at a properly constituted meeting and upon proper notice of their intention to the affected trustee.

Conclusion

Persons drafting trust instruments and trustees should take careful notice of the above decision. The authority of the Master and the power of the Court will not readily be ousted by the trust instrument. Affected trustees will always have the right to challenge such decisions by the Master and appeal such decisions made by the Court. This is even more relevant in the case of decisions made by trustees. Trustees can only remove a fellow trustee if so empowered by the trust

[7] 836/2018 ZAFSHC 120

instrument and in circumstances analogous to that set out in the common law or Section 20 of the Act.

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Du Plessis NO and Others v Van Niekerk and Others (836/2018) [2018] ZAFSHC 120 (26 June 2018)

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Under which circumstances does farm land qualify for a 30% deduction in value for purposes of estate duty and CGT?

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Introduction

For purposes of calculating estate duty, farm land registered in the name of the deceased, or registered in the name of a company of which the deceased is a shareholder, is property that is included in the estate of the deceased. The property is included at a value prescribed by Section 5 of the Estate Duty Act.[1]

Since this farm land or shares, as the case may be, is a capital asset, there is a deemed disposal of the asset by the deceased to the deceased's estate for purposes of capital gains tax (CGT). The disposal is deemed to be at the market value of the asset at date of death and the capital gain is thus calculated by deducting the base cost from this value.[2]

In respect of farm land however, the question that often arises is what value is used as the 'market value'. It is not as simple as merely using the value as determined for purposes of including the farm land as property in the deceased estate under the Estate Duty Act[3]. The specific provisions of the Eighth Schedule of the Income Tax Act[4] need to be applied to the case at hand in order to determine what value is to be used for purpose of calculating the capital gains tax.

Calculating estate duty

Estate Duty is levied on the dutiable estate as calculated in accordance with the Estate Duty Act[5]. The value of the dutiable estate is determined by including all property and property deemed to be property[6] in the estate at a value determined in accordance with the Estate Duty Act[7], and deducting from this value all allowable deductions under section 4 and the amount of the abatement as allowed under section 4A of the Estate Duty Act[8].

One of the deductions allowed under Section 4[9] is a debt that is due and payable. Such debts will include any capital gains tax liability (CGT) that arises at death due to the deemed disposal of the capital assets to the deceased's estate[10].

The calculation of CGT therefore directly impacts on the ultimate estate duty liability of the estate. As with all estate related costs, it is critical that the CGT liability of the estate is correctly calculated.

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[1] Act 45 of 1955
[2] Section 9HA of the Income Tax Act 58 of 1962
[3] See footnote 1 supra
[4] Act 58 of 1962
[5] See footnote 1 supra
[6] Section 3 of the Estate Duty Act 45 of 1955
[7] See footnote 1 supra
[8] Id
[9] Id
[10] Section 9HA of the Income Tax Act 58 of 1962

Valuation for purposes of estate duty

Section 5[11] prescribes the method that must be applied to determine the value of the 'property' or 'property deemed to be property' to be included in the estate for purposes of calculating estate duty. The general principle is that property disposed of by the executor of the deceased's estate in the course of the winding up of the estate shall be included at the value realised by such sale[12], and most other property is to be included at the fair market value.

Fair market value is defined in Section 1(1) of the Estate Duty Act[13] as the price that could be obtained if the property was sold on the open market under an arm's length transaction between a willing buyer and seller. It further states that in relation to immovable property on which a *bona fide* farming operation is being carried on, the value to be used is the price that could be obtained from a sale on the open market, less 30% ('the paragraph (b) value').

Farm land on which a *bona fide* farming operation is run is thus included at 70% of the fair market value for purposes of determining the dutiable estate of the deceased.

It must be noted that SARS has confirmed that where the nature of trade of the deceased prior to date of death compromises the letting of the farm, the farm land will not qualify for the paragraph (b) value in the estate of the deceased – the deceased himself needs to have been carrying out the *bona fide* farming operation[14]

Do we use the price realised or market value less 30% if the farmland on which *bona fide* farming operations take place is sold by the executor while the estate is being wound up?

Section 5(1()(a) states that if the property is sold 'in the course of the liquidation of the estate' the value to be included is the price realised by such sale.

In C: SARS v Estate Late HE Streicher[15] the Supreme Court of Appeal confirmed that 'during' the liquidation of the estate is not synonymous with 'in the course of the liquidation' of the estate and it is only when it is necessary for the executor to sell the farm that it will be seen as 'in the course of the liquidation of the estate'.

[11] See footnote 1 supra
[12] Section 5(1)(a) of the Estate Duty Act 45 of 1955
[13] See footnote 1 supra
[14] SARS correspondence dated 12 March 2018 Estate Duty: Guidelines regarding which vouchers must be made available to SARS auditors for the accurate administration of the various acts under SARS' control
[15] 66 SATC 282

In this matter, the deceased bequeathed *bona fide* farm land to her two sons. The sons had no intention of farming and instructed the executor to sell the farm land which he did for full market value. SARS argued that the full market value should be included as property in the deceased's estate. The court, however, allowed the executor to use paragraph (b) value, and not the value realises from the sale of the farm, as the value to be included in the deceased's estate. The court held that since the sale was not necessary for any purpose of the estate, it would not be regarded as a sale 'in the course of the liquidation' of the estate.

We can thus conclude that where the executor is forced to sell the farm land to provide for a liquidity shortfall in the estate, the price realised by such sale will be the value included in the estate since this will be a sale 'in the course of the liquidation of the estate'.

What is the position where farmland on which *bona fide* farming operations take place is held in a company?

To answer this question we need to look at section 5(1)(f)*bis* and section 5(1A).

Section 5(1)(f)*bis*[16] states that, subject to certain condition that fall beyond the scope of this article, shares in a company that are not quoted on a stock exchange are to be included at the value of such shares in the hands of the deceased at his date of death.

Section 5(1A), however, states that where the company referred to in section 5(1)(f)*bis* owns immovable property on which bona fide farming operations are carried on, the value of such shares shall be determined in the manner defined under 'fair market value'. In other words, for purposes of valuing a company that owns farm land on which bona fide farming operations are carried out, the value of the farm to be included in the company's assets will be the market value less 30%.

It is thus clear that shares in a company that only owns *bona fide* farm land will be valued at the fair market value less 30% for purposes of the value of property to be included in the deceased's estate, It is important to note that the 30% deduction in value will only apply to the farmland and not any other assets owned by the company.

Valuation for purposes of CGT

CGT applies to all assets of a person disposed of on or after 1 October 2001 (valuation date), regardless of when the asset was acquired by that person.[17] CGT is levied on the capital gain which is generally speaking the difference between the proceeds and the base cost of the asset.

[16] See footnote 1 supra
[17] SARS Comprehensive Guide to Capital Gains Tax (issue 6)page 307

What constitutes the base cost and methods for determining the base cost are prescribed in the Eighth Schedule[18] and are beyond the scope of this article.

The death of a person gives rise to a deemed disposal of a person's assets for purposes of CGT and the deceased person is treated as having disposed of his or her assets to his or her deceased estate for proceeds equal to the market value of those assets at the date of the person's death[19]

The general principles for determining the 'market value' of an asset for purposes of CGT are contained in paragraph 31 of the Eighth Schedule.[20]

Paragraph 31(1)(f)[21] prescribes that immovable property on which *bona fide* farming operations are carried out may be valued at either the value contemplated in paragraph (b) of the definition of 'fair market value' in section 1 of the Estate Duty Act[22], or the price which could have been obtained upon the sale of the asset between a willing buyer and seller in an arm's length transaction on the open market. As we know, 'fair market value' in relation to *bona fide* farm land, as defined in the Estate Duty Act[23] is the price that could have been realised on the open market less 30%.

The use of the paragraph (b) value for purposes of CGT is, however, limited by paragraph 31(4) in certain circumstances[24] and depends on the valuation method adopted when the farm land was acquired by the deceased. In terms of this paragraph, the paragraph (b) value may not be used where the farming property is disposed of by death, donation or non-arm's length transaction unless:

(a) For farming property owned prior to 1 October 2001, the valuation date value is determined by using the reduced value prescribed by paragraph (b) of the definition of fair market value[25],[26] or

(b) For property acquired on or after 1 October 2001 by way of inheritance, donation or non-arm's length transaction, the property was acquired at the value prescribed by paragraph(b)[27]

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[18] Eighth Schedule of the Income Tac Act 58 of 1962
[19] Section 9HA of the Income Tax Act 58 of 1962
[20] Income Tax Act 58 of 1962
[21] Eighth Schedule Income Tax Act 58 of 1962
[22] See footnote 1 supra
[23] See footnote 1 supra
[24] Eighth Schedule of the Income Tax Act 58 of 1962
[25] Section 1(b) of the Estate Duty Act 45 0f 1955
[26] Note that the definition of 'fair market value' in the Estate Duty Act was amended by Section 1(1)(a) of the Revenue Laws Second Amendment Act 32 of 2005 with effect from 1 February 2006. Prior to this amendment, the definition of 'fair market value' in section 1 of the Estate Duty Act made provision for the use of the Land Bank Value. The amendment was not retrospective and as such, the Land Bank Value and not the 30% reduced market value would need to be used to determine the valuation date value for pre-valuation date farm land
[27] Paragraph (b) of the definition of 'fair market value' in Section 1 of the Estate Duty Act 45 0f 1955

A distinction is drawn between 'pre-valuation date' assets and 'post-valuation date' in determining when the paragraph (b) value can be used.

For farm land acquired before valuation date (1 October 2001) and disposed of by death, donation or non-arm's length transaction, the paragraph (b) method for determining the proceeds can only be used if the Land Bank value[28] was used to determine the value at valuation date.[29]

In respect of farm land acquired after valuation that is disposed of by death, donation or non-arm's length transaction, 31(4)(b) provides that the paragraph (b) method may be used to determine the proceeds if the farm land was acquired at the paragraph (b) value (or Land Bank value if acquired before 1 February 2006).

What if the farmland on which *bona fide* farming operations take place is held in a company?

Shares in a company that owns *bona fide* farmland is not afforded the same treatment for purposes of CGT as it for purpose of estate duty.

The Eighth Schedule of the Income Tax Act[30] does not contain a provision similar to section 5(1A)[31] and as such shares in a company that operates a *bona fide* operation that qualify for the paragraph (b) valuation under the Estate Duty Act[32] are valued under paragraph 31(1)(g), read with paragraph (31)(3) of the Eighth Schedule[33] i.e. the price based on willing buyer, willing seller at arm's length in an open market and not the reduced paragraph(b) value.

These provisions above are best explained by way of examples:

Example 1 – farm land acquired prior to 1 October 2001

Farmer Brown inherited a farm (*bona fide* farm land) from his father in 1980. The Land Bank value on 1 October 2001 was R1 000 000 and the market value was R1 300 000. Farmer Brown died on 1 August 2016 and the property had a market value of R1 500 000.

[28] Section 1 Estate Duty Act 45 of 1955 prior to the enactment of the Revenue Laws Second Amendment Act 32 of 2005
[29] Paragraph 31(4)(a) of the Eighth Schedule of the Income Tax Act 58 of 1962
[30] Act 58 of 1962
[31] See footnote 1 supra
[32] Id
[33] Income Tax Act 58 of 1962

CGT

In order for the executor of Farmer Brown's deceased estate to use the paragraph (b) method for valuation of the proceeds for purposes CGT, the Land Bank value must be used as the base cost.

Proceeds	R1 500 000 – R450 000 (30%)	R1 050 000
Base Cost	Land Bank Value	R1 000 000
Capital Gain		R 50 000

Note that for purposes of estate duty, the *bona fide* agricultural land will be included as property in the deceased's estate at the paragraph (b) valuation of R1 050 000

Example 2 – Farm land inherited after 1 October 2001, paragraph (b) method used on acquisition

If Farmer Brown inherited the same farm from his father in 2008 and the executor of his dad's estate used the paragraph (b) valuation for determining the value of the proceeds of R1 000 000 on the deemed disposal of the farm to the deceased estate. At Farmer Brown's death in August 2016, the paragraph (b) method may be used to determine the proceeds for purposes of CGT since the same method was used to determine the base cost when it was acquired:

Proceeds	R1 500 000 – R450 000 (30%)	R1 050 000
Base Cost	paragraph (b) valuation method	R1 000 000
Capital Gain		R 50 000

Note that for purposes of estate duty, the *bona fide* agricultural land will be included as property in the deceased's estate at the paragraph (b) valuation of R1 050 000

Example 3 – Farm land inherited after 1 October 2001, market value used at date of acquisition

If the executor of Farmer Brown's father used the market value (R1 300 000) to determine the proceeds for calculating the CGT in the deceased estate, Farmer Brown's executor would not be permitted to use the paragraph (b) method for determining the, but would have to use the current market value:

Proceeds	Market Value	R1 500 000
Base Cost	Market value (2008)	R1 300 000
Capital Gain		R 200 000

Note that for purposes of estate duty, the *bona fide* agricultural land will be included as property in the deceased's estate at the paragraph (b) valuation of R1 050 000.

Example 4 – Shares in company that owns farmland inherited by deceased

Farmer Brown inherits shares in Farmland (Pty) Ltd from his father in 2005. The company owns land on which *bona fide* farming operations take place. The value of the shares at date of his father's death was R1 300 000 and the value included in his estate for purposes of estate duty was R910 000. At Farmer Brown's death the shares in the company are worth R1 500 000.

At Farmer Brown's death, the value of the shares to be included as property in his estate for estate duty purposes is:

Market Value	R1 500 000
Less 30%	R 450 000
Value of shares in deceased estate	R1 050 000

The capital gain at Farmer Brown's death is calculated as follows:

Proceeds	Market Value	R1 500 000
Base Cost	Market value (2005)	R1 300 000
Capital Gain		R 200 000

The paragraph (b) value may not be used for purposes of calculating the capital gain.

Conclusion

Calculating the value of *bona fide* farm land, or shares in a company that owns *bona fide* farm land for estate duty purposes is straight forward. One simply deducts 30% from the market value[34] to arrive at the value to be included.

Calculating the CGT that qualifies as a deduction in the deceased estate in respect of a farm owned by an individual is not as simple. The planner first needs to confirm when the asset was acquired by the deceased (pre or post valuation date) and, secondly, at what value it was acquired in order to determine the manner in which the market value of the farm land will be calculated for purposes of calculating the ultimate CGT liability. The planner should also establish whether the farm is owned by the client directly, or whether the client holds shares in a company or close corporation which owns the farm, as the method of calculating the capital gains tax liability may differ.

[34] See footnote 1 supra

The issue again draws our attention to the fact that the attention given to detail in the data gathering process, as the first step in the financial planning process[35], is critical in providing a client with comprehensive advice.

[35] Financial Advisory and Intermediary Services Act.37 of 2002, General Code of Conduct for Authorised Financial Services Providers and Representatives

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The Practical Implications of Terminal Illness Benefits

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Introduction

It is considered beneficial for an insurance policy holder to be able to institute a terminal illness benefit claim on a life insurance policy, should the life assured be diagnosed with a terminal illness. The policy holder will receive an amount equal to the lump sum death benefit, or in certain instances a percentage thereof, whilst the life assured is still alive. The terminal illness benefit allows the policy holder/life assured the opportunity to get their affairs in order prior to death. This article will discuss the nature and operation of a terminal illness benefit as well as the practical implications of a terminal illness benefit.

Terminal illness and critical illness (severe illness/dread disease)

Firstly it is important not to confuse terminal illness benefits with critical illness benefits, as there is a substantial difference between the two forms of insurance/benefits.

A terminal illness benefit is a contractual arrangement between an insurance company and the contracting party, where the insurance company pays to the contacting party a lump sum equal to the life assured sum of a life insurance policy in the event that the life assured is diagnosed with a terminal illness (as defined in the life insurance contract). The terminal illness benefit will automatically end the life insurance benefit. Some insurance companies only allow a portion of the life assured sum to be paid out as lump sum for terminal illness. In circumstances where only a portion of the life assured sum can be claimed, the terminal illness benefit will accordingly reduce the life assured sum and the remainder of the life assured sum will pay out at death of the life assured.

Critical illness cover (also known as “severe illness” or “dread disease”) on the other hand is an insurance product where the insurance company pays out a lump sum to the contracting party in the event that the life assured is diagnosed with a critical illness as defined in the definition of the insurance policy contract. The purpose of critical illness cover is to assist the life assured financially during recovery from a critical illness.

A terminal illness benefit can therefore only be claimed on a life insurance policy and it is not an insurance policy on its own. Critical illness cover is an insurance policy on its own or it can be an accelerated benefit on a death benefit and/or disability benefit. Certainty of death within a certain time period is furthermore not prerequisite for a terminal illness benefit to be paid out.

Life insurance policy contract and the terminal illness benefit

To fully comprehend the terminal illness benefit one needs to understand the structure of a life insurance policy. There are typically two parties to an insurance policy contract, namely the policy holder (or contracting party) and the insurance company (or insurer).[1]

A life insurance policy with a nominated beneficiary is generally construed as a contract in favour of a third party, also known as a *stipulatio alteri*.[2] In short, the life insurance company enters into an agreement with the contracting party in that the insurance company will pay out a benefit to a third party (the beneficiary), at the occurrence of a certain event, in exchange for an initial premium paid by the contracting party to the insurance company.[3]

The life assured is not a party to the insurance policy contract. The life insured is the object of the insurance on whose life the contract is based.[4] In certain instances the policy holder and the life assured and the beneficiary will be the same person and in other instances they may consist of different individuals or even business entities (save for the life insured who will be a natural person for obvious reasons).

The problem that arises is establishing the moment when the beneficiary becomes a party to the insurance policy contract. In practice most life insurance contracts contain a "no rights" clause which stipulates that the beneficiary would not be entitled to any benefit during the lifetime of the life assured.[5] The beneficiary's expectation therefore only becomes a right at the occurrence of the insured event, namely death, and once the beneficiary has accepted the benefit. The acceptance of the benefit by the beneficiary is the action that completes the *stipulatio alteri*.

In Wolmarans and Another v Du Plessis and Others[6] it was found that if the contract does not contain a "no rights" clause, the beneficiary can accept the benefit before the death of the life assured. The beneficiary therefore acquires a right subject to a negative suspensive condition.[7] The right to receive the policy benefits will therefore unconditionally vest in the beneficiary the moment the beneficiary dies and not after his death.[8] It is therefore not necessary for the beneficiary to accept the benefits as it will unconditionally vest in the beneficiary the moment the life assured dies.

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[1] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2017) at page 223
[2] Mooi v South African Mutual Life Assurance Society and Others [2004] 3 BPLR 5519 (TK)
[3] Lake and Others, NO v Reinsurance Corporation Ltd and Others 1985 (1) SA 419 (A)
[4] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2017) at page 225
[5] Warricker and Another NNO v Liberty Life Association of Africa Ltd 2003 96) SA 272 (W)
[6] Wolmarans and Another v Du Plessis and Others 191 (3) SA 703 (T)
[7] D Buys, *When a beneficiary predeceases a life insurance policy holder*, De Rebus 2012
[8] M Botha, W Oosthuizen, *Life insurance and the accrual system: Policies in or out?*, Insurance and Tax Jounal (2009)

The conclusion can therefore be made that, where the policy contract contains a "no rights" clause, the beneficiary merely has a *spes* (an expectation) during the lifetime of the life assured.[9] The beneficiary has no rights to the policy benefits during the lifetime of the life assured and the benefit only becomes due once the beneficiary has accepted the benefit, which in essence can only be done once the life assured dies. The acceptance of the benefit by the beneficiary therefore completes the contract and makes the beneficiary a party to the contract.[10]

The diagnosis of a terminal illness on a life insurance policy does therefore not trigger the insured event, being death, and the beneficiary accordingly does not have any claim to the terminal illness benefits, which is also enforced by the "no rights" clause, which is contained in most life insurance contacts. Most life insurance contracts furthermore stipulate that the terminal illness benefit will only be paid to the contracting party.

The terminal illness benefit claim is therefore a contractual arrangement between the life insurance company and the contracting party, in that the insurance company will pay the life insurance benefit to the contracting party should the life assured be diagnosed with a terminal illness, as defined by the insurance company. The proceeds of the terminal illness benefit will therefore vest in the contracting party. The life insurance benefit will accordingly fall away once the terminal illness benefit is claimed.

Tax implications on a terminal illness benefit

The terminal illness benefit claim will result in a lump sum benefit being paid to the contracting party and in some instances to a third party. It is therefore important to consider the tax applicable to a terminal illness benefit.

1. Income Tax

Section 10(1)(gl) of the Income Tax Act[11] was introduced on 1 March 2015 and reads as follows:

(1) There shall be exempt from normal tax –

(gl)any amount received or accrued in respect of a policy of insurance relating to the death, disablement, illness or unemployment of any person who is insured in terms of that policy of insurance, including the policyholder or an employee of the policyholder in respect of that policy of insurance to the extent to which the benefits in terms of that policy are paid as a result of death, disablement, illness or unemployment other than any policy of which the benefits are paid or payable by a retirement fund;

[9] PPS Insurance Company v Mkhabela (159/2011) [2011] ZASCA 191
[10] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2017) at page 232
[11] Act 58 of 1962

Section 10(1)(gl) therefore exempts from income tax any amount received or accrued in respect of a policy of insurance if the policy relates to the death, disablement, illness or unemployment of any person who is insured in terms of that policy of insurance, including the policy holder, and the benefits are paid as a result of illness.[12]

There will therefore be no income tax payable if the terminal illness benefit is paid out by the insurance company to the contracting party whether the contracting party and the life assured is the same person or not.

Example – contracting party and life assured is not the same person (or entity)

XXX (Pty) Ltd owns a life insurance policy on Mr A's life for business contingency purposes. Mr A is diagnosed with a terminal illness and XXX (Pty) Ltd institutes a terminal illness benefit claim against the insurer for the full death benefit amount. The lump sum benefit will be exempt from income tax in the hands of XXX (Pty) Ltd in terms of section 10(1)(gl).

2. Estate Duty

The Estate Duty Act[13], deals with the taxation of an individual's estate at death. In terms of section 2 of the Estate Duty Act[14], estate duty shall be collected and levied on a person's (who was ordinarily a resident in the Republic of South Africa at the date of death or who was not ordinarily resident, but owned assets in the Republic of South Africa) estate who dies on or after the first day of April 1955. The duty payable is to be known as estate duty.[15]

Section 3(2) of the Estate Duty Act defines what assets form part of a person's estate as at date of death.

Section 3(3) of the Estate Duty Act includes certain deemed property into the estate of the deceased person. Deemed property can be described as property which did not exist as real property at the date of death of the deceased or which did not form as asset of the deceased prior to death. A policy on the life of the deceased is defined in section 3(3)(a) as deemed property.[16]

A terminal illness benefit will therefore vest in the contracting party and accordingly form part of the estate if the contracting party and the life assured is one and the same person. The proceeds of the terminal illness benefit, or of what is left thereof at date of death of the contracting party, will form part of the contracting party's estate for estate duty purposes.

[12] Haupt, Phillip, *Notes on South African Income Tax* (2017) at page 90
[13] Act 45 of 1955
[14] Act 45 of 1955
[15] Haupt, Phillip, *Notes on South African Income Tax* (2017) at page 867
[16] Haupt, Phillip, *Notes on South African Income Tax* (2017) at page 867

Example - contracting party and life assured is the same person

Mr A is the owner of a life insurance policy on his life. Mr A is diagnosed with terminal cancer and successfully institutes a terminal illness benefit claim against an insurance company. He reinvests the proceeds and passes away thereafter. The investment will therefore constitute property in Mr A's estate in term so section 3(2) of the Estate Duty Act.

If the contracting party and the life assured are two different people, the proceeds of the terminal illness benefit will vest in the contracting party and the insurance company will accordingly pay the benefits out to the contacting party. The proceeds of the terminal illness benefit will fall outside the ambit of sections 3(2) of the Estate Duty Act, as it does not fall within the deceased's dutiable estate once the life assured passes away. It will furthermore not form part of deemed property in the deceased's estate in terms of section 3(3) of the Estate Duty Act, as there is no amount due and recoverable under any policy of insurance, which is a domestic policy, upon the life of the deceased on date of death.

Example - contracting party and life assured is not the same person

XXX (Pty) Ltd is the contracting party of a life insurance policy on Mr A's life for business contingency purposes. Mr A is diagnosed with a terminal illness and XXX (Pty) Ltd institutes a terminal illness benefit claim against the insurer for the full death benefit amount. The lump sum terminal illness benefit will not fall in the estate of Mr A, as Mr A is still alive when the benefit pays out. Even though Mr A passes away thereafter, the lump sum benefit will not form part of his estate, due to the fact that it paid out to XXX (Pty) Ltd while Mr A was still alive. At Mr A's death, the benefit will not form part of his property as it is not property owned by him as defined in section 3(2). It will furthermore not be regarded as deemed property, as defined in section 3(3), as there is no amount due and recoverable under any policy of insurance, which is a domestic policy, upon the life of the deceased on date of death.

3. Donations Tax

Donations Tax is a tax on the transfer of assets, which is imposed on person who may want to move assets to different entities or individual in order to avoid income tax or estate duty.[17]

Section 54 of the Income Tax Act[18] provides that donations tax is payable on the value of any property disposed of under a donation by a resident of the Republic of South Africa. The provisions do not apply to non-residents, even if they donate assets within the borders of South Africa.[19]

[17] Haupt, Phillip, *Notes on South African Income Tax* (2017) at page 850
[18] Act 58 of 1962
[19] Haupt, Phillip, *Notes on South African Income Tax* (2017) at page 851

Sections 55 of the Income Tax Act defines a number of words of which the following are applicable for purposes of this article.

"*Donation*": *Any gratuitous disposal of property or any gratuitous waiver or renunciation of a right.*

As discussed above, the proceeds of a terminal illness benefit will vest in the contracting party once the life assured has been diagnosed with a terminal illness, which in terms of the policy contract constitutes a terminal illness.

Some insurance companies allow the benefit to be paid out to a third party, which could be the original beneficiary on the life insurance agreement. However, it is important to note that such a payment is an arrangement between the insurance company and the contracting party and it must not be seen as the insurance company paying out the terminal illness benefit in terms of the original life insurance policy agreement.

The payment of the terminal illness benefit to a third party, on instruction of the contracting party to the insurance company, will lead to a gratuitous disposal property and accordingly donations tax will be payable on the proceeds of the terminal illness benefit. If not a donation, it could lead to the creation of a loan account between the contracting party and the beneficiary.

Other implications on terminal illness benefit Insured and contracting party is the same person

The insurance company will pay proceeds of the terminal illness benefit to the contracting party (also the insured) of the policy and not the nominated beneficiary, which can result in the following advantages/disadvantages:

- ☐ Policy proceeds will pay out free of income tax in terms of section 10(1)(gl) of the Income Tax Act[20]. It will however form part of the client's estate[21] should the life assured pass away, which will result in estate duty and higher executor's fees. If the terminal illness benefit had not been instituted the death benefit would have paid out directly to the beneficiary at the client's death, free of executors fees. The disadvantage, of the death benefit paying out to the nominated beneficiary, is that the proceeds of the life insurance policy will be regarded as deemed property in the deceased estate, which might lead to an increased estate duty liability.[22]
- ☐ It is furthermore important to note that the original beneficiary of the life insurance policy might not inherit the proceeds of the terminal illness benefit, which if claimed, cancels the death benefit.

[20] Act 58 of 1962
[21] Section 3(2) of the Estate Duty Act 45 of 1955
[22] Section 3(3) of Estate Duty Act 45 of 1955

Example

Mr A takes out a life insurance policy on his life with his spouse B as the beneficiary. The purpose of the life insurance policy is to provide capital for B's maintenance in the event of Mr A's death. Mr A, in his will, bequeaths the residue of his estate to his family trust with his children as the income and capital beneficiaries. Mr A becomes terminally ill and institutes a terminal illness benefit claim on his life insurance policy and passes away 2 months later. The proceeds of the life insurance policy, which was originally intended for B's maintenance, will form part of Mr A's estate which will be inherited by Mr A's family trust. There will therefore be no capital available for B's maintenance. This could happen if the spouse isn't the heir of the residue of the estate.

It is therefore important to refer to the will of the contracting party prior to instituting a terminal illness benefit, as the policy proceeds might not end up in the hands of the person for whom in was intended.

- The proceeds of the terminal illness benefit will furthermore be attachable by the creditors of the deceased estate. In Pieterse v Shrosbee NO[23] the Supreme Court of Appeal held that, in the event of the death of an insolvent policyholder, the trustee of that insolvent estate shall not have any claim on the policy proceeds where a policy is payable to a nominated beneficiary and that nominee accepts the benefit.

The policy proceeds would therefore not be attachable by creditors had the policy proceeds paid out directly to the beneficiary.

Insured and contracting party is not the same person

The insurance company will pay the proceeds of the terminal illness benefit to the contracting party (who is not the insured) of the policy, which may result in the following:

- If the purpose of a life insurance policy is to fund a buy and sell agreement, the parties would need to refer to the buy and sell agreement. In most buy and sell agreements the effective date is the date of death of the seller and the policy proceeds would be payable by the contracting party to the estate of the deceased within a certain time period, for example thirty days after receipt of the policy proceeds by the contracting party (also the purchaser). A terminal illness benefit claim can therefore create confusion, due to the fact that the buy and sell agreement determines that the policy proceeds are to be paid to the executor of the seller within a certain time period from date of receipt thereof, but the effective date is only on the date of death of the seller, which will only occur at a later stage.

A terminal illness benefit claim on a life insurance policy which was intended to fund a buy and sell agreement on death, could also have capital gains tax implications for the seller. If the

[23] Pieterse v Shrosbree and Others , Shrosbree v Love and Others (146/02 , 435/03) [2004] ZASCA 129

proceeds of terminal illness benefit is used to purchase the business interest of a person before death, it may result in the seller not being able to utilise the R 300 000 exclusion on capital gains if the seller dies in a year of assessment subsequent to the year of assessment in which the sale took place.[24] The seller will however still be entitled to the annual R40 000 exclusion on the capital gains accruing in a year of assessment other than the year in which he/she dies.[25]

If the proceeds of a life insurance policy funding a buy and sell agreement is not exempt from estate duty in terms of section 3(3)(a)(iA) of the Estate Duty Act[26] and a terminal illness benefit claim is instituted by the contracting party (the purchaser), the proceeds of the terminal illness benefit will be exempt from income tax and there will be no estate duty payable on the proceeds as it will not constitute property or deemed property in the estate of the deceased. The buy and sell agreement will however need to be amended to make provision for the change in circumstances. If the sale of the interest is effected before the death of the deceased in these circumstances, the proceeds paid to the seller before death, in exchange for the transfer of his/her interest in the business, will constitute property in his/her estate.

Conclusion

From the discussion above it is clear that a terminal illness benefit claim can in certain instances be to the advantage of the policy holder, and in other instances the implications can be negative.

It is important to refer to the life policy contract to confirm whether the contract contains a "no rights" clause, and that the proceeds of the terminal illness benefit will indeed pay out to the contracting party. It is furthermore important to confirm that where the terminal illness benefit is payable to a third party, that the payment is made in term of the original stipulatio alteri agreement or whether it is only an arrangement between the contracting party and the insurance company, wherein the proceeds are to paid to a third party, although the contracting party had the vested right.

The policyholder needs to make sure that the he takes all the various factors into consideration prior to instituting a terminal illness benefit claim. The death cover might have been acquired for a specific purpose in the context of the estate plan, and instituting a terminal illness benefit claim on the death benefit might curtail the initial estate plan. It is therefore important to consider all the repercussions prior to instituting a claim for a terminal illness benefit.

[24] Paragraph 5(2) of the Eighth Schedule of the Income Tax Act 58 of 1962
[25] Paragraph 5(1) of the Eighth Schedule of the Income Tax Act 58 of 1962
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Crypto-Currencies and Estate Planning: Planning an Approach

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Introduction

Crypto currencies have become a topical focus for investors and this is largely as a result of the popularity of its brand ambassador, Bitcoin. From an investor perspective Bitcoin's prominence is attributed to the significant gains to be had complemented by its related advantage of "secrecy", i.e. due to its inherent nature the wealth accumulated is generally not declared and hence commonly referred to as secret investments. Whilst the aforementioned at face value appears a win-win situation for any potential investor, the implications from an estate planning perspective can be significant.

The profits from Crypto-currencies is far from assured but death is. Secret investments in this digital asset has the potential to be lost forever if not properly documented, stored and communicated to heirs after one passes away. With the case of mainstream investments, where such investments are held with a financial services provider that is regulated and recognised, the investment can be reconciled with relative ease in the event of death, as there usually is an audit trail highlighting inter alia a record of the transactions, the investment growth or losses etc.

Crypto currencies however are currently not regulated and if you had to die without a record of your digital currency, there is no way of accounting for this in your estate and your heirs could be significantly out of pocket. Unlike bank accounts and other tangible assets to which an executor has assess after death, digital assets typically require a variety of private information to be accessed before the digital asset can be retrieved. Without the right personal information, access is almost impossible especially with the state of the art security measures now implemented for online accessibility to assets.

In an endeavour to address the concerns relating to these so called secret investments, commentators like Michael J. Kearney & Joseph B. Doll [1] suggests the following to ensure that your digital assets are properly recorded.

(1) The majority crypto-currencies use a public-private key system to ensure that transactions are valid and secure. The public key is made public every time the investor buys or sells crypto-currency - only the investor knows the private key. Private keys are essential to verify ownership and access digital assets, and should be recorded.

    It is suggested by Kearney et al[2] that one should create a physical copy of your private key and secure it in a place of safety like a bank safety deposit box which insulates your private key from hacking and may arguably provide the safest means to protect it.

(2) Crypto-currencies are traded on online platforms known as exchanges. These exchanges in turn offer hardware wallets and default digital wallets in which to store your asset. The access is usually granted by username and password. It is important that the username, password,

[1] Michael J. Kearney & Joseph B. Doll in Estate Administration, Estate Planning, Estate Tax, an online publication
[2] *Ibid*

and security question information for exchanges be recorded to retrieve digital assets from exchange wallets.

(3) Certain crypto-currency exchanges also require that investors use two-factor authentication to authenticate their identity when accessing their account and transferring digital assets. Two-factor authentication is typically accomplished via a mobile application that provides a unique code to be entered into the exchange. Investors who use two-factor authentication should also record their username, password, and security question information.

Once crypto-currencies are purchased on an exchange, they are usually automatically stored on that exchange's default wallet where they can be accessed electronically by the investor. Digital wallets, especially those used by exchanges, are susceptible to hacking. As a result there are highly creative and intricate security measures installed by these exchanges.

The investor also has the ability to store information by transferring it to a hardware wallet. Hardware wallets can be purchased online and are generally encrypted flash drives that require a password to facilitate accessing the information therein. The disadvantage of this method is that investors and their heirs may lose their digital assets if their hardware wallet is lost or damaged. Hard copy backups and a record of the information in your Will should ensure proper backup of your information.

Failure to properly record such information and authentication would result in executors and heirs being unable to confirm the existence of such assets that would normally form part of the estate. In addition it is imperative that an executor be in a position to recognise a private key and understand what it is, failing which the information would be useless to an executor.

For a high net worth client a crypto currency investment could be an estate planning technique which could potentially work well while alive and when the asset is unregulated. When the asset is unregulated the asset would not be part of the client's asset inventory and would as a result be secret or untraceable. However, in South Africa there are proposals being put forward that will see the regulation of crypto-currencies, starting with the taxation thereof as confirmed by the Minister of Finance in his 2018 budget speech.[3] Once regulated, digital assets would then be formally regulated assets that can be identified and traced, but until then the onus is on the owner of the digital asset to ensure the asset is not lost without a trace after death.

Even if regulated, access of digital assets would be a near impossibility if the information to access the asset is not available to an executor or an agent of the client. Often estate planning deals with scenarios that foresee circumstances of disability and death. Evaluating the effect of digital assets on these circumstances has become more and more important as everyone gambles on becoming a crypto millionaire.

[3] http://www.treasury.gov.za/documents/national%20budget/2018/speech/speech.pdf

What does it all mean?

Essentially "if I lose the 'keys' to my crypto currency, does it still exist?" It is far reaching to say that the asset would not exist but without the proper "key" and passwords to the digital asset one would unlikely be able to access it. To prevent online fraud and "hacking" the platforms have high level and layered security mechanisms that protect the asset and afford the client the highly favoured anonymity, thus ensuring that the exchanges that offer these services are safe and secure.

Investors that own any kind of crypto currency as an asset should be sure to include the asset in an estate planning conversation. The estate plan on the other hand, which would ideally include a will must clearly describe the assets, indicate where they are held and where to find the access mechanisms to distribute the assets.

Technically, crypto currency is treated like property, so naturally the investor's last will and testament will dictate who inherits this asset. If an investor does not have a will, the Intestate Succession Act[4] will determine which of your heirs are and how distribution will take place.

Legal and financial advisors should actively ask about digital assets in their conversation with clients, as the popularity of these type of assets has increased considerably in recent years.

As a crypto currency owner one should:

(1) Ensure that you have a hard copy (paper back up) of your "keys", exchanges and wallets stored in a physical safe custody facility or your safe; and

(2) Provide loved ones in advance with information on where to obtain access details in case of death or disability; and

(3) Use the services of a third party that offer vault services for those that own a large number of digital assets; and

(4) In the case of high volume ownership of crypto-currencies, co-ownership is encouraged to ensure that the information is not lost on the death or incapacity of one person; and

(5) A client's net worth statement that includes long and short term assets need to now contain the client's digital assets.[5]

[4] Act no 81 of 1987

[5] Michael J. Kearney & Joseph B. Doll in Estate Administration, Estate Planning, Estate Tax an online publication, April 2017. https://www.cstaxtrustestatesblog.com/2018/04/articles/estate-planning/considerations-estate-planning-bitcoin-ethereum-crypto-currencies/

Conclusion

The article has given context to the need to account for and properly document any investments in crypto currencies. Whilst the benefits of not declaring such investments may initialling be appealing this can be short lived in the event of the demise of the investor. It is therefore critical that such investments have an appropriate audit trail that allows an executor access to the same to ensure that heirs are not unduly compromised due to the inaction of the investor.

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Section 4(p) and The Apportionment of Estate Duty

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Introduction

Section 4(p) of the Estate Duty Act[1] (hereinafter referred to as "the Act") is aimed preventing the imposition of double estate duty where the proceeds of a policy have been taken into consideration in determining the value of the deceased's shareholding in a company and the policy proceeds have also been included as deemed property in the deceased's estate.

The section provides for the following deduction from the total value of all property of the deceased: " so much of the value of any property deemed to be property of the deceased by virtue of the provisions of section 3(3) as has not been deducted under any of the other provisions of this section and as the Commissioner is satisfied has been taken into account under the provisions of section 5(1)(f)bis in the determination of the value of any company shares or a member's interest in a close corporation included as property in the estate."

Example 1

The deceased held 50% shareholding in a company and the company took out a policy on the life of the deceased in the amount of R1 million. If the policy proceeds increase the value of the company by R1 million and section 4(p) did not exist, the deceased's estate would increase by R500,000 as a result of the increased business valuation and R1 million as a result of the deeming provisions which includes the policy in his estate. This will amount to double duty being imposed. As a result of section 4(p) an amount of R500,000 will be allowed as a deduction in the calculation of estate duty as it was included in the value of the deceased's shareholding in the business and also in the value of the policy.

Who is liable for the estate duty?

Section 11 of the Act provides as follows:

11. Person liable for duty. *— The person liable for the duty shall be-*

(a) Where duty is levied on property of the deceased which falls under subsection (2) of section three-

(i) As to any property referred to in paragraph (a) or (b) of that subsection, the person to whom any advantage accrues by the death of the deceased; (Author's note: this subsection refers to any fiduciary, usufructuary or other like interest, including a right to any annuity charged upon any property, held by the deceased immediately prior to his death).

(ii) As to any other property, the executor;

(b) where duty is levied upon property which, in accordance with subsection (3) of section three, is deemed to be property of the deceased-

[1] 45 of 1955

(i) *as to property referred to in paragraph (a) of that subsection, the executor: Provided that where the amount due under the policy is recoverable by any person other than the executor, the person liable for duty shall be the person entitled to recover the amount due under the policy;(Author's note:* this subsection refers to a domestic policy upon the life of the deceased excluding any premiums paid by any other person who is entitled to the proceeds of the policy plus 6% interest per annum thereon; or excluding a policy recoverable by the surviving spouse or child of the deceased under a duly registered ante-nuptial or post-nuptial contract; or a policy acquired for purposes of a buy-and-sell agreement and which meets the requirements for exemption, or a policy not effected by or at the instance of the deceased which will not be paid to the deceased or his relatives or dependents or a family company in relation to the deceased)

(ii) *as to any property referred to in paragraph (b) of that subsection, the donee;* (Author's note: this subsection refers to property which was donated by the deceased which was exempt from donations tax and not included as property of the deceased for estate duty purposes).

(iii) *as to any property referred to in paragraph (CA) or (d) of that subsection, the executor.* (Author's note: this subsection refers to an accrual claim in favour of the deceased or property which the deceased was immediately prior to his death competent to dispose of.)*"*

From the above, it is clear that the executor would be liable for payment of any estate duty levied on any property of the deceased which would include the shareholding in the company and the person entitled to receiving the policy proceeds would be liable for payment of the estate duty levied on the policy.

This beckons the question: is it the shareholding in the company which attracts the estate duty, thus making the executor liable for the estate duty or is it the policy which attracts the estate duty, thus placing the liability in the hands of the company (policyholder)?

The company's argument:

The company could argue that section 11 of the Act is only applicable where duty is actually levied and in this instance referring to our example above, the policy is not dutiable as the deduction is applied to the policy. It is the value of the company which is dutiable and thus the liability falls to the executor. Meyerowitz states that " *the value of the deemed property is reduced pro tanto to the extent that is has been taken into account, in determining the value of the shares".*[2] Meyerowitz further states that "*the duty is imposed on the dutiable amount*".[3]

The company's argument could further be strengthened by the fact that the value of the company's shareholding may not necessarily increase in direct proportion to the policy payable yet the deduction would be for the amount of the policy. This is illustrated by way of example in

[2] Meyerowitz on Administration of Estates and Their Taxation, Meyerowitz D, 2010 Edition, Meytax Publishers CC, 28.26, p28-20
[3] Ibid at 28.1, p28-17

Meyerowitz: "For example, where there is an insurance policy for R20,000 but the value of the shares is not enhanced by a similar amount, e.g. because the company, prior to receiving the proceeds had more liabilities than assets, or the method of valuation of the shares was not entirely based on a surplus of assets over liabilities. It is submitted that this should make no difference. The section merely requires the deemed property to have been taken into account in determining the value of the shares."[4] To explore this example further, let us assume that the liabilities of the company exceeded the assets of the company prior to the payment of the policy and after payment of the policy of R20,000 the value of the shareholding increased to R15,000. The company could thus argue that the deduction of R20,000 is being applied to the policy, as it stands to reason that you cannot deduct R20,000 from the company shareholding which is valued at less.

The executor's argument:

The executor of the deceased estate could argue that it is the policy which is increasing the value of the company, which is bringing about the estate duty and since the policy is payable to the company, the company should be liable for the estate duty as section 11(b)(i) clearly states "Provided that where the amount due under the policy is recoverable by any person other than the executor, the person liable for duty shall be the person entitled to recover the amount due under the policy".

What does the legislation say?

If we have a closer look at the legislation, section 4(p) states that "*The net value of an estate shall be determined by making the following deductions from the total value of all property including therein…so much of the value of any property deemed to be property of the deceased… and has been taken into account… in the determination of the value of any company shares or a member's interest in a closed corporation included as property in the estate*"

It is thus clear that the answer is not clearly defined, as the deduction is from the total value of all property which shall include property and deemed property. The net value of the estate is determined by adding property and deemed property less allowable deductions but before deducting the abatement of R3.5 million.[5] The legislation is thus not specific as to whether the deduction is applied to the policy or to the shareholding in the company. The question of who is liable for the payment of the estate duty thus remains unanswered.

A practical comparison of the 2 options:

Section 13(3) of the Act provides for the calculation of the apportioned estate duty "w*henever duty is in terms of section 11(b)(i) payable by more than one person on the value of any property referred to in section 3(3)(a), the amount of duty payable by each such person shall be such*

[4] Ibid at 28.26 p28-20
[5] Section 4A of the Estate Duty Act 45 of 1955

proportion of the total duty attributable to the total value of the said property, as bears to the said total duty the same ratio as so much of the amount which such person is entitled to recover under any policy as is included in the estate under section (3)(3)(a), bears to the total value of the said property".

Example:

Mr A has a 50% shareholding in a company. Mr B, his brother, has a 30% shareholding and Mr C, his cousin has a 20% shareholding. The company takes out a policy of R1 million on the life of Mr A. The policy is not exempt from estate duty. Mr A dies and the policy proceeds are paid to the company. The value of the company prior to the payment of the policy was R10 million and it is now worth R11 million. The individual shareholding has increased as follows:

Before policy proceeds are received	After policy proceeds are received
Mr A: R5,000,000	Mr A: R5,500,000
Mr B: R3,000,000	Mr B: R3,300,000
Mr C: R2,000,000	Mr C: R2,200,000

A simplified calculation of Mr A's estate duty:

Shareholding in company	R5 500 000
Plus policy	R1 000 000
Gross Estate	R6 500 000
Less Section 4p deduction	R500 000
Net Value of Estate	R6 000 000
Less Section 4A abatement	R3 500 000
Dutiable Estate	R2 500 000
Estate duty @ 20%	R500,000

If we accept the argument that the executor is liable for the estate duty liability to the extent that policy proceeds increased the value of shares in the estate of Mr A, the estate duty has to be apportioned and the company will be liable for estate duty as follows:

Liability of company: $\frac{\text{value of life assurance (after Sec 4p deduction)}}{\text{net value of estate}}$ x duty payable[6]

Thus: $\frac{(\text{R1,000 000} - \text{R500 000})}{\text{R6 000 000}}$ x R500 000 $= R41\ 666.67$

The company will thus be liable for estate duty in the amount of R41 666.67.

If we accept the argument that the executor is not liable at all for the estate duty incurred as a result of the policy proceeds, the estate duty has to be apportioned and the company will be liable for estate duty as follows:

Liability of company: $\frac{\text{value of life assurance (do not apply Sec 4p deduction)}}{\text{net value of estate}}$ x duty payable[7]

Thus: $\frac{\text{R1,000 000}}{\text{R6 000 000}}$ x R500 000 $=$ R83 333.33

The company will thus be liable for estate duty in the amount of R83 333.33.

The deemed value of policies owned by third parties will be the value of the proceeds of the policies less premiums paid by such third party plus 6% compound interest.[8] Please note that this was however not taken into account in the above calculation.

Please note further that the section 4p deduction is not applicable to shares listed on a stock exchange that are included as property in the estate of a deceased[9].

Conclusion

This matter of liability for estate duty where the section 4p deduction has been applied can thus clearly be interpreted in two ways.

It is my view that the purpose of section 4(p) is merely to avoid estate duty being imposed twice in respect of the same amount. It is submitted that it was not the intention of the legislator to absolve the person receiving the policy benefits from being liable for the estate duty brought about by the proceeds, and that the executor should thus be able to recover the proportionate

[6] Premiums and Problems Edition 117, 2018, Old Mutual Personal Finance, p E39
[7] Id
[8] Section 5(1)(b) of the Estate Duty Act 45 of 1955
[9] Section 5(1)(f)(bis) of the Estate Duty Act provides that the deduction is applicable "in the case of shares of any company not quoted on any stock exchange…"

duty from the *company*. In my opinion there is no rational argument to treat the company different than any other person receiving the proceeds of a policy on the life of the deceased. If it was another party benefitting from the proceeds as a contracting party or beneficiary (without the proceeds affecting the value of the company) resulting in an increase of estate duty, such party would be liable for the proportionate duty. This beckons the question: Why would one treat the company different in these circumstances? It is after all the company and not the estate that enjoys the benefit of the proceeds. Another argument in support of this view is that if the *proceeds* of a company owned policy does not increase the value of the shares due to the valuation method used, the company, and not the estate, would be liable for the estate duty resulting from the proceeds.

This issue will, *however*, in all probability only be clarified via a legislative amendment or a finding by a Court. Until *then*, clients and financial planners should be aware that there is potentially more than one viable interpretation of section 4(p) and plan accordingly.

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Succession Planning for Family Owned Businesses

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Introduction

Succession is the most important challenge that family owned businesses face[1]. Family businesses comprise of approximately 75% of all the business in the world[2]. In South Africa, family owned businesses are even more popular with around 80% of all registered companies being family owned.[3] These businesses range from large well-known entities such as Remgro[4] and Pick N Pay[5] to smaller entities such as local farming operations. Agri SA states that approximately 95% of commercial farming business are family owned[6]. Succession planning is crucially important to ensure continuation of these types of businesses. Succession is not a single event comprising the passing on the of ownership and management to the next generation, but rather a long term process beginning long before the heirs take over the business[7]. Unfortunately, very few family owned businesses survive the passing of ownership and or leadership from generation to generation.[8] The purpose of this article is to show that holistic and successful financial planning for family owned business is more complex than financial analysis and recommendations and entails an understanding of family dynamics, the perspective of the next generation, the role of the founder and other non-financial aspects.

Challenges

Statistics show that family owned businesses fail at an alarming rate and only a small percentage survive past the first-generation[9]. From the second to the third generation only 14% of transitions are successful.[10] Many family owned businesses are small and do not have the financial strength and staff that larger companies have.[11] A succession plan is vital to ensure a smooth transition from generation to generation. In a recent survey done by PWC only 17% of FOB's indicated that they have some sort of succession plan in place.[12] The reluctance to plan can be attributed to the association of planning with change in that change relates to compromise[13]. A benefit of planning is that it encourages commitment from all parties involved with an end goal in place[14].

[1] Handler 1994:133.
[2] Diederichs 2018: 2.
[3] Venter & Farrington 2009:135.
[4] Founded by Anton Rupert
[5] Founded by Raymond Ackerman
[6] Diederichs 2012: 1.
[7] Handler 1994: 134.
[8] http://www.fabasa.co.za/wp-content/uploads/2018/07/SucceedArt1-1.pdf
[9] Ward 1998: 190.
[10] Diederichs 2012:1.
[11] Ward 1998: 194.
[12] https://www.pwc.co.za/en/publications/family-business-survey.html
[13] Ward 1998: 194
[14] Ward 1994: 194.

André Diederichs, a specialist in the field of financial planning for family-owned businesses, lists the following as succession planning pitfalls to avoid in family-owned businesses in the FABASA[15] Newsletter dated May 2018[16]:

☐ *Keeping succession planning a secret:*

☐ Keeping the plan or process a secret harms transparency and trust in the business. It could have the *effect* that family members or employees leave the business due to uncertainty about their own future rather than motivating them to stay and perform in terms of the succession plan in place.

☐ *Favoritism:*

The first-born, oldest son, only son, person whom is the most popular or person the founder gets along with the best is not necessarily the best choice in choosing a successor. Diederichs recommends to have an objective approach that is fair and to use various sources in identifying the correct individual as successor.

☐ *Fail to review, revise and update your succession plan:*

Life happens and circumstances are bound to change. Once in place, the succession plan must be amended if and when necessary. It is not set in stone and as circumstances change the plan must also change.

☐ *Top performers are the best leaders:*

An individual who exceeds in their current role is likely to catch the eye, but good performance does not ensure good leadership. Diederichs advices to consider the core abilities and skills of an individual and not just performance in their current role. Leaders of family businesses need special skills and those who show stewardship qualities are more likely to succeed.

Possible Solutions

From the above challenges it is clear that strategic planning is fundamental and that failure to plan for the future is a common occurrence. The family must be clear on why they are committed to perpetuating the business, on how the family see themselves and the business in a few years, on whether they want to stay actively involved or be in a more passive role, on whether they want to create spin-off business opportunities for other family members etc.[17]. Researchers and specialists in the field of family owned businesses have created tools and structures that can assist in successful succession which can be summarised as follows:

☐ *Realising* the importance of succession planning:

More often than not succession planning is not seen as part of the long term business strategy. Focus is placed on financial stability and profitability rather than succession. The first step to success is that the founder must realise the importance of such a plan. The plan should be identified long before actual succession and it must be borne in mind that anything can

[15] Family Business Association of South Africa.
[16] FABASA Newsletter 1 May 2018.
17 Ward 1998: 192.

happen at any given time. Life occurrences such as death, retirement, personal projects and divorce will have a big impact on the business.[18]

☐ The *buy*-in of stakeholders:

Relationships with stakeholders are important in any business structure. Stakeholders are invested in the long term success of the family owned business. These stakeholders include other family members, employees, clients, suppliers, accountants, financial advisors, the bank etc. Their buy-in in the individual that takes over is an important factor. The founder might want his eldest son to take over but the son may have poor leadership abilities or lack inter-personal skills needed in the business.

☐ *Governance* structures and governance tools:

Advisory boards and committees play an important role in family-owned business because of the specific nature of emotions in family operations. Sibling rivalry, clashing personalities or the unwillingness of the founder or current leaders to let go of their position are just some examples of emotional challenges connected with family owned businesses[19]. Independent and objective individuals have the ability to look past these emotional factors to help make decisions to ensure business productivity and success. Fairness in the balance between business and the family must be managed and maintained[20]. Another helpful tool is to establish a family business constitution that family members are bound to. The constitution helps create certainty and trust between all members involved.

☐ *Stewardship*:

Stewardship entails the management of another's business or affairs[21]. In the context of family owned businesses this concept has proven to be helpful in succession planning as the leaders of the current business manage the business as if borrowed from the future generation and with their best interest at heart. This will translate in preserving and growing the business not for oneself but for the generations to come. Diederichs summarises this concept as follows: "Family business leaders are true stewards when they believe the businesses they serve are larger than themselves"[22].

Financial Planning Solutions

Financial planners, accountants and attorneys are generally not equipped to deal with the complex nature of family businesses. As financial planners are often entrusted with handling the planning and succession of the business, cognisance of the emotional nature of family owned business must not be overlooked when assisting clients. Discussions around the importance to have a succession plan in place or the details of existing plans in place should be at the core of financial planning, whether it relates to the business or personal estates of clients. The following example illustrates the special nature of the planning process:

[18] Ward 1998: 191.
[19] FABASA 2017 Newsletter.
[20] Diederichs 2011: 74.
[21] https://www.dictionary.com/browse/stewardship
[22] Diederichs 2011: 75.

John (58), a wealthy and respected farmer, is married out of community of property to Jane (56). They have three sons, Jack, Joe and John Jr, and one daughter, Joanne, who have all reached the age of majority. Joanne is permanently living in Australia with her husband and two small children. They have no intention of returning to South Africa as Joanne's husband is a director at a top engineering firm in Australia. John Jr is a first year law student at university and he is still unsure about his future plans. Jack and Joe have both completed their studies and have returned to farm with their father and are both under the impression they will inherit the family owned business. Jack is married to Sandra and they have two small boys. Joe is engaged. The current structure of the business is as follows:

John Dairy Farms CC owns all livestock and farming equipment and carries out all the operational activities of the business. John is the sole member of the CC. The CC has outstanding long term hire purchases and production loans. Four farms are held in the John Johnson Family Trust. The trustees of the trust are John and Jane and they as well as their four children are the capital and income beneficiaries of the trust. There is a R10 000,000 loan account against the trust in favour of John. John and Jane jointly owns a townhouse in Potchefstroom that have been used by the children while studying and John owns a holiday home in Plettenberg Bay. Jane also runs a farm stall with a coffee shop on one of the farms. They have outstanding bonds on the properties. John and Jane have made little provision for retirement although they have around R3 000,000 in investments and shares.

John and Jane's current will states that the surviving spouse will inherit the estate of the first dying of them and on the death of the surviving spouse the children will inherit the estate in equal shares. John is worried that if he should pass away first the sons, and their wives will not allow his wife to stay on the farm or provide an income for her and vice versa. They have never had an estate analysis done before. John is worried about the future of the farms and business. None of the liabilities in the CC or their personal capacity are covered via life insurance policies. John is of the opinion that the loan account in favour of him against the trust is not a problem as it is merely an accounting entry in the financial statements. The family has not discussed succession planning before.

It is clear from the example above that should either parents pass away now there will be a negative impact on the business and the family members. By having essential conversations around succession planning the uncertainty and fear may be eliminated and the successful business continuation can be achieved. For a start a family meeting should be held and a family business constitution and advisory committee set up. Once the intentions and expectations of all family members are clear, John can, for example, decide to transfer his member's interest to Jack and Joe (in life or in his will depending on the most favourable situation for all) and the role of each of them clearly defined. Jack's wife indicated that she would be very interested in taking over the farm stall activities from Jane. They have a good relationship and Jane would like to bequeath the business to her daughter-in-law and this bequest can be done by amending the

will accordingly. Joanne and John Jr, who has not showed any interest in the family business, can inherit the non-business related assets and possible life policies to ensure equal inheritance of all the children of John and Sandra.

The trust deed can be amended (if possible in terms of the trust deed) to remove Joanne and John Jr as beneficiary and in turn they could receive some of the other properties, investments or life cover policies on their parents' death, and open discussions with the members of the family can be beneficial to avoid family disputes after the death of the parents. The sons that will be carrying on the farming operations can be bought in as replacement trustees on the passing of John and Jane (if the trust deed provides for such a replacement in the wills of John and Jane). It would also be advisable to appoint an independent trustee. In a court case[23] the Appeal Court instructed the Master of the High Court to ensure that a clear distinction should be made between control and management of trust assets as opposed to enjoyment of the assets. Where the trustees of the trust are the only beneficiaries of the trust and are also related to each another, it is important that an independent trustee be appointed to ensure that this distinction is made. The trust deed must be clear on the rights of the spouses and children of the sons for the next generation. Because of the provisions in section 7C of the Income Tax Act which deals with low interest/interest free loans, the loan account should not be viewed as a mere accounting entry. It should also be borne in mind that it is an asset in John's estate for estate duty purposes. The loan account can be bequeathed to the trust which will ensure that the provisions of section 7C will not be applicable any more.

Business assurance structures can be put into place such as contingent liability/loan account assurance for business debts as well as possible key person cover for operational expenses on the passing of John related to his key role and years of expertise in the business.

John and Jane's will as well as the documentation pertaining to the CC and trust deed must be in line with the succession plan in place and need to be amended as the plan changes. It is important to ensure the best possible result taking into account the tax implications such as capital gains tax and estate duty.

Conclusion

It is clear from statistics that the success rate of the transfer of family owned business from one generation to the next is not an easy task and it requires special measures and long term planning. Holistic financial planning for family companies is of utmost importance. The emotional aspects of such business structures must not be overlooked as it can be detrimental to the continued existence of a family owned business. Putting a plan into place without taking the family dynamics into account may lead to a futile result. Tools and governance structures such

[23] Land and Agricultural Development Bank of SA v Parker and Others (186/2003) [2004] ZASCA 56; [2004] 4 All SA 261 (SCA) (23 September 2004)

as advisory boards are helpful in remaining objective and fair. A succession plan will give certainty to all involved and serve to motivate the next generation to ensure future success. Legal documents such as the will and trust deed of the parties should always be in line with the succession plan in place. The plan should be revised and amended when needed.

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Executors Fees

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Introduction

Executor's fees is one of a plethora of expenses, which if not adequately provided for could cause liquidity constraints for a deceased estate. Just as the name suggests, these fees are paid to executors as remuneration for their services in liquidating and distributing deceased estates. Executors are entitled to charge fees in respect of all assets of the deceased estate which fall under their custody and control during the liquidation and distribution process.

The Administration of Estates Act[1], states that executor's remuneration must be paid from 'the assets of a deceased estate'. The phrase 'assets of a deceased estate' is not only confined to assets which the deceased actually owned during his life time. The phrase also extends to assets which are deemed to have belonged to the deceased (such as proceeds from certain life insurance policies and payments received in terms of the accrual claim) as well as assets which become payable to the estate by default (such a proceeds from retirement funds were no dependants can be traced). Since executors are afforded such a wide pond from which they can draw their fees, it is important to ensure that sufficient provision for the payment of executor's fees is made during the estate planning stage.

How are the fees determined?

The rate at which executor's fees will be paid by a deceased estate may be predetermined by a testator in his will. However in instances where a person dies intestate or omitted to fix a rate in their will, the amount payable will be determined according to a prescribed tariff. The executor is not bound to wind up the estate at a reduced fee, and it is therefore prudent for the testator to agree the reduced fee with the executor before date of death, and to preferably obtain written confirmation of the reduced fee from the nominated executor.

This ability of an individual to predetermine the rate of executor's fees underscores the importance of having a will. Significant savings may be realised where a lower rate than tariff rate is predetermined and recorded in a will.

The maximum prescribed fee according to the tariff is currently 3.5% of the gross value of the estate, excluding VAT. If the executor is a registered vendor he will be obliged to add VAT to the bill (an effective rate of 4.025% from the 1st of April 2018).

An executor will also be entitled to a further 6% (6.9% inclusive of VAT, where applicable) of any income which accrues to and is collected by the estate after the death of the deceased. This would include for example, any business income which accrues to the estate of a sole proprietor or any dividend income which accrues and is received posthumously by the estate. It is worth

[1] Administration of Estates Act 66 of 1965

noting that this additional rate is levied on the gross income (not the net income) which the executor collects[2].

The Master of the High Court however retains the power to review the amount of fees payable by an estate and may, in special circumstances, either reduce or increase any such remuneration (for example if he is of the opinion that the set fees are unreasonably low in relation to the complexity a particular deceased estate).

Community of property

On the death of a spouse who was married in community of property, the entire joint estate falls under the administration of the executor of the deceased. Although the joint estate is terminated by death, the surviving spouse does not immediately become vested with the ownership of half of each asset. It is the executor's responsibility to first settle all the liabilities of the joint estate[3]. The surviving spouse is therefore only entitled to half of the net balance of the joint estate. It is on this basis that the executor is entitled to levy fees on the value of the entire joint estate.

Massed estates

In the case of massed estates, the executor is required to administer both the deceased and survivor's assets and may as such levy fees in respect of both parties' assets. This applies even if they are married out of community of property.

Marriage in terms of the accrual regime

The executor is obliged to pursue any accrual claim against a surviving spouse for the benefit of heirs. If an accrual claim against such a spouse is successful the executor will be entitled to charge fees on the value of the amount received.

What is excluded from executor's fees?

Life policies

As a general rule, life insurance policies with beneficiaries nominated are not subject to executor's fees since they do not form part of the assets of the estate for purposes of winding up the estate. The proceeds of these policies are paid directly from the life assurance company to the nominated beneficiaries.

However, if, for any reason, a beneficiary cannot/does not accept the benefit under a life policy, the policy proceeds will be paid to the deceased estate by default. An example of such a situation is where a nominated beneficiary predeceases the contracting party and the latter

[2] The Law and Practice of Administration of Estate and Estate Duty, D. Meyerowitz, 6th Edition, June 1998.
[3] The Law and Practice of Administration of Estate and Estate Duty, D. Meyerowitz, 6th Edition, June 1998.

forgets to amend the beneficiary nomination. On the death of the life assured, the beneficiary nomination will fail and the policy proceeds paid to the estate of the contracting party.

Endowment policies also present a unique challenge where the contracting party and the life assured are two different people. If the contracting party dies before the life assured the policy proceeds will not be paid out to the nominated beneficiary (since the life assured would still be alive). The surrender value of the policy will however be an asset of the estate and the executor will be entitled to levy executor's fees on this value.

Retirement fund benefits

Proceeds from retirement funds are also usually distributed directly to beneficiaries or dependents and do not form part of the assets of the estate. The procedure for the distribution of these proceeds is governed by the Pension Funds Act[4], which gives fund trustees wide ranging powers to identify beneficiaries/dependents and apportion benefits. The benefits from retirement funds will however be paid to the estate by default and into the control of the executor if the trustees cannot, after the prescribed period, trace any dependants and no beneficiaries were nominations were made by the deceased[5]. In such an instance, the executor will be allowed to charge a fee on the benefits paid to the estate.

Conclusion

The argument for executor's fees is not without merit. The office of executor is a very demanding and highly perilous fiduciary office which is fraught with many dangers. The practice standards are high and executors may be held personally liable for any losses resulting from their transgressions during the winding up period. It follows therefore that executors should be adequately remunerated for their services. Any estate planning process should therefore consider ways to adequately provide for the payment of executor's remuneration. Failure to make such provision could cripple an estate, resulting in unintended consequences such as the detrimental sale of estate assets.

[4] Pensions Fund Act, 24 of 1956
[5] The South African Financial Planning Handbook, 2017, M. Botha, L. Rossini, W. Geach, B. Goodall, L. Du Preez, Lexis Nexis, 2017.

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Treatment of Foreign Property for Estate Duty Purposes

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Introduction

South African residents as a general rule pay income tax on their worldwide taxable income. In keeping with this foundational principle, the tentacles of estate duty have an equal global reach. Estate duty is accordingly levied on the property of any person who was ordinarily resident in South Africa at the date of his/ her death, irrespective of where in the world such property is situated. It is worth noting that non- residents may also be subject to estate duty on their South African assets. This aspect will however not be discussed in this article.

Ordinarily resident

Although the Estate Duty Act (the act) does not specifically define the phrase 'ordinarily resident', the case law has over the years provided some guidance. The widely held and accepted view is that a person is ordinarily resident 'in the country of his most fixed or settled residence'[1]. This is the country to which he would 'naturally and as a matter of course return from his wanderings'. A natural person may therefore be ordinarily resident in South Africa even if that person was not physically present in South Africa during the relevant year of assessment.

Once it is determined that a deceased person was ordinarily resident in South Africa at the time of his, estate duty will be levied on their worldwide assets.

Relief: Section 4(e)

However, not all the offshore property belonging to residents is subject to estate duty. Section 4(e)[2] of the estate duty act mitigates this position by affording special relief in the form of a deduction in respect of foreign assets held by a deceased who was ordinarily resident in South Africa.

This deduction is available in respect of properties situated outside South Africa which were acquired by the deceased before he became ordinarily resident for the first time. The deduction also applies to property the deceased acquired after he became ordinarily resident, by way of donation or inheritance from a person who was not ordinarily resident at the date of the donation or date of death. [3]

The relief also applies in instances where the deceased disposed of the original property and acquired any other property from the proceeds of the disposal, or purchased another property out of any income from the original property.

[1] Cohen V CIR 1946 AD 174.
[2] Act 45 of 1955
[3] The South African Financial Planning Handbook, 2017, M. Botha, L. Rossini, W. Geach, B. Goodall, L. Du Preez, Lexis Nexis 2017.

It should be noted however that the deduction only applies to property which is situated outside of South Africa at the time of death. Any property which was acquired by a deceased person before he became a resident but was subsequently brought to South Africa will be fully dutiable.

Property which was, at the time of acquisition, situated in in South Africa and at the time of death is situated outside the country will also not qualify for this relief.

Life insurance policies

In terms of Section 3(3)(a) of the estate duty act, only the proceeds of domestic policies on the life of a deceased person are included in his estate as deemed property.

A domestic policy is defined as any life policy, issued and payable in South Africa. The definition of domestic policies also extends to life policy issued outside the country which have, at the request of the owner, subsequently been made payable in the South Africa. Conversely, life policies which are issued outside the country but which, at the request of the owner, have been made payable at a place in another country are not domestic policies.

Non-domestic policies

Section 3(3)(a) only deals with domestic policies. Meyerowitz states that if a policy is not a domestic policy and the proceeds are payable to a deceased who was ordinarily resident, they are dutiable, not as deemed property, but as property of his estate.

Meyerowitz further contends that if the proceeds are payable to a third party, through a beneficiary nomination, and the deceased during his lifetime had the right to change the beneficiary nomination, the proceeds may be included as deemed property.[4] This is because Section 3(3)(d) of the estate duty act, includes as deemed property, any property of which the deceased was immediately prior to his death competent to dispose for his own benefit or the benefit of his estate.[5]

Foreign death duties

Section 16(c) of the estate duty act provides relief against double taxation in respect of a person's foreign assets. This provision states that any amount of death taxes which have been paid to any other country in respect of any property situated outside South Africa (and is included in the estate of any person who was ordinarily resident in South Africa) may be deducted from any estate duty payable on the same property in South Africa.

[4] The Law and Practice of Administration of Estates and Estate Duty, D. Meyerowitz at 27.31
[5] The Law and Practice of Administration of Estates and Estate Duty, D. Meyerowitz at 27.31

The deduction under this paragraph cannot however be more than the estate duty imposed on the property in South Africa. This means that the foreign death duties attributable to that property as well as the estate duty payable in South Africa must both be ascertained and only the lesser of the two amounts is deductible.

Example

Mr. C, who was ordinarily resident in South Africa, owned an industrial property in UK. On his death, the revenue authorities in UK imposed an inheritance tax equivalent to R400 000 on the property. The estate duty attributable to the same property in South Africa was R200 000. The deduction available to Mr. C's estate will therefore be limited to R200 000. This means that the estate will only be liable to pay a total amount of R400 000 (to the UK authorities) in respect of the building.

Double death agreements

Section 16 is however subject to a double death duty agreement which may exist between South Africa and any foreign country. The aim of these agreements is to determine which country has the primary taxing rights where a person is a resident of one country and the assets are situated in another country. Generally speaking, the country where the asset is situated has the exclusive right to levy estate duty. These agreement should not be confused with the double taxation agreements which South Africa enters into with other countries in respect of normal income tax[6].

Currently South Africa only has double duty agreements with Botswana, Lesotho, Swaziland, the United Kingdom, the United States of America and Zimbabwe.

Example

United Kingdom

Article 5 of the agreement, states as a general rule that only the country in which the deceased was domiciled will have the rights to levy tax on the property of the deceased which is situated within its jurisdiction. (Unless the deceased was domiciled in the other country within 10 years immediately preceding the death).

If for any reason (other than an allowable exemption or specific deduction), the tax which is payable in the country which is entitled to levy tax, is not paid then the other country will be free to tax that property.

Immovable property, including livestock and equipment used in agriculture, may however be taxed in the country in which it is situated.

[6] Notes of South African Income Tax, Thirty- Third Edition, Philip Haupt, H&H Publications, 2014

Assets forming part of the business property of a permanent establishment of an enterprise may be taxed in the country in which the permanent establishment is situated. Permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on (for example, a place of management, factory or at a branch)

Property consisting of shares, stock, and debenture stock issued by companies incorporated in one of the states and rights of unit holders in any unit trust scheme where the register of unit holders is kept in one of the states may be taxed by that state.

If the deceased owned any property which is not considered as property in one country but is considered as property in the other country, then the latter country will have the rights to tax that property.

Conclusion

Given the far multijurisdictional reach of estate duty it is recommended that to avoid incurring unexpected and unnecessary taxes arising on death, South African investors who have invested offshore should always take these assets into account in their estate planning.

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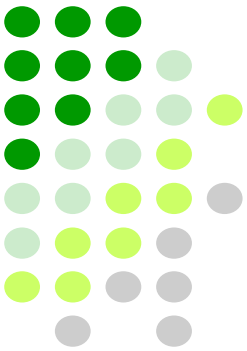

Business Assurance

The Unilateral Buy and Sell Agreement and Estate Duty

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Introduction

When a person becomes a business owner an important question to ask is: "What will happen to my business interest should I die or become permanently disabled?"

When a person dies, his business interest will form part of the property in his[1] estate for estate duty purposes.[2] If a person becomes disabled his business interest can either be kept or sold to another person. If there is more than one owner[3] of a business entity the co-owners can agree that, should one of them die or become permanently disabled, the other owners will buy the business interest from the estate of the deceased owner or from the disabled owner. This agreement between the owners of a business entity will normally be in writing as proof of their intentions.

This written agreement between the owners of a business entity is called a buy and sell agreement. A buy and sell agreement can be described as a specific type of contract between the co-owners of a business entity that provides for the sale of an owner's business interest upon the happening of a specified event (usually the death or permanent disability of one of the owners). Thus the owners of the business entity become parties to the buy and sell agreement. This means that there is an undertaking by the parties that the survivors will purchase the interest of the first dying party, with a corresponding undertaking that the first-dying party will sell such interest to the surviving parties in terms of the contract.

The buy and sell agreement is a well-established and widely used business concept. This article will provide a broad overview of the different types of buy and sell agreements with specific focus on the one-side or unilateral buy and sell agreement, as well as the estate duty consequences of each.

The reciprocal buy and sell agreement

Where there is more than one business owner, the buy and sell agreement usually provides that, upon the death or permanent disability of one party, the other parties are obliged to purchase the affected party's share in the business at a predetermined or determinable price[4]. The purchase price is commonly equal to the fair market value of the business as at date of death of the first dying party, and the method of valuation can be stipulated in the buy and sell agreement[5].

[1] Reference to the male gender includes the female gender, and *vice versa*.
[2] Section 3(2) of the Estate Duty Act 45 of 1955.
[3] "Owner" and "business" in this context refers to (and is used as synonyms of) either a partner in a partnership, member of a close corporation or shareholder in a company, as the case may be.
[4] Old Mutual Premiums & Problems. Edition 116: 2018 at page D41.
[5] Old Mutual Premiums & Problems. Edition 116: 2018 at page D41.

The purchase price is typically funded by way of an insurance policy. This means that the parties take out life insurance (and/or disability insurance) policies on each other's lives. Should one of the events that triggers the sale take place (death/disability), the proceeds of the policy/ies are used to buy the business interest from the affected party/the estate of the affected party as stipulated in the agreement.

The unaffected parties then pay the purchase price to the affected party or his deceased estate and receives the business interest in return, either from the affected party or his executor. The purchase price can be used by the disabled party to provide for his future needs, or will be distributed by the deceased party's executor in terms of the will. This type of buy and sell agreement is generally referred to as a reciprocal buy and sell agreement.

Example:

In company ABC there are 4 shareholders. Each of these shareholders hold 25% shares in the company. The shareholders agreed that, should one of them die or become disabled, the other shareholders will buy the shareholding from the deceased/disabled shareholder. They concluded the agreement in writing. In terms of this contract, if A should die or become disabled first, B, C and D will be obligated to buy the shareholding of A at the fair market value of the shares as at date of death or disability. A (or his executor) will be obligated in terms of this contract to sell his shares to B, C and D on disability (or death). The same will happen if B should die first (in such an instance A, C and D will be the purchasers) etc. The obligation to buy and sell is reciprocal/applicable to all the shareholders.

The main reasons for/advantages of having a buy and sell agreement in place are:

- It prevents a forced partnership with heirs, for example the spouse of a former co-owner;
- It provides certainty on the future of a business interest should the owner die or become disabled;
- An equitable purchase price or valuation method can be determined, eliminating disputes between heirs/executors and co-owners;
- The remaining owners can continue to run the business without interruptions;
- Using life assurance proceeds is a relatively inexpensive way of funding the purchase price;
- Life insurance also ensures that the purchase price is immediately available and there is no need for loans and the payment of financing charges;
- Life insurance can be an effective tool in business succession planning;
- If certain requirements are met, the policy proceeds will be exempt from estate duty;
- The purchase price that is paid in cash to the estate, will improve the liquidity position in the estate and can thus contribute to effective estate planning.

One of the main advantages of funding a buy and sell agreement with life assurance is that if there is compliance with Section 3(3)(a)(iA) of the Estate Duty Act 45 of 1955 ("the Act"), the

proceeds will not be a deemed asset in the estate of the deceased party. In terms of Section 3(3)(a) of the Act, any "domestic" policy on the life of a deceased is regarded as "deemed property" in the estate of such deceased, regardless of whether the proceeds are payable to the estate or some other person (for example a nominated beneficiary).[6] Normally, this would mean that the proceeds of policies that fund buy and sell agreements will be subject to estate duty and thus increase the estate duty liability in the estate (or the amount payable by the policy owner, as the case may be). However, Section 3(3)(a)(iA) of the Act stipulates one of the few exceptions to this rule.

Section 3(3)(a)(iA) provides that if :

- the policy was taken out or acquired by a person who on the date of death of the deceased was a partner of the deceased, or held any share or like interest in a company in which the deceased also at date of death held a share or like interest; and
- the purpose for taking out/acquiring the policy was to enable that person to acquire the whole or part of the deceased's interest in the partnership or share or like interest and any claim by the deceased against that company; and
- if no premium on the policy was paid or borne by the deceased, the proceeds will not be deemed property in the estate of the deceased.

This exclusion from being deemed property in the estate provides an added advantage of funding buy and sell agreements with life assurance, as it effectively increases the deceased estate with the full value of the policy (which would have been deemed property and possibly estate dutiable), without placing any extra estate duty or burden on the deceased estate.

The one-sided buy and sell agreement

Where the obligation to purchase is not reciprocal, but only one owner undertakes to purchase the business interest, it is known as a one-sided or unilateral buy and sell agreement. In this instance, only one owner's life may/will be insured and only that owner will have the obligation to sell upon the happening of the specified event/s.

This type of unilateral buy and sell agreement can be beneficial in the following scenario:

Example 1:

A and B are shareholders in Company C, with a market value of R10 000 000. A owns 70% shareholding and B owns 30% shareholding. Generally speaking, owner A already has the controlling interest. A may wish to leave a part of his interest to his heir/s. B however, is against going into business with a new partner having a controlling interest.

[6] SARS External Guide: Estate Duty Implications on Buy-and-Sell Arrangements, where shares are held in trusts: Page 2 Par 5

A and B can therefore enter into a unilateral buy and sell agreement, in terms whereof which B undertakes to buy 50% of A's shareholding upon A's death or disability, with A's only obligation in turn to sell the interest.

To fund the purchase price, B will take out a life insurance policy on the life of A in the amount of R3 500 000[7] and pay the premiums. This way, both parties get their wish. Owner A may leave the remainder of his 35%[8] shareholding to an heir in his Will, and B will have the controlling interest of 65%[9] shareholding should A pass away or become disabled.

In this example, even though the agreement is one-sided and only a part of the business interest is the subject of the contract, if A and B use life assurance to fund the purchase price should A die, the proceeds will be exempt from estate duty, as there has been compliance with Section 3(3)(a)(iA) of the Act: A and B are both **owners** in the business at date of A's death; the **purpose** of the policy is to acquire the whole **or part of** B's interest in the business and A will not pay any **premium** on the policy.

Example 2:

Another example of a unilateral buy and sell agreement is where a sole owner (sole proprietor/only member/only shareholder) identifies a key employee or family member that wishes to take over the business upon the owner's death/disability.

This type of one-sided buy and sell agreement can be especially beneficial where a family business is involved:

Father F owns 100% shareholding in Family Company A (business value R10 000 000).

Father F has two children, daughter B and son C. Daughter B is substantially involved in the running of the business. Son C has other interests, but is equally ambitious.

F and B can enter into a one-sided buy and sell agreement, in which B undertakes to purchase F's entire shareholding should he die or become disabled. B takes out life assurance on F's life to fund the agreement. This way, upon F's death/disability, B becomes the sole shareholder of the Company and F has the financial means to benefit son C in his Will. It's a win-win situation. The purchase price will also provide for additional liquidity in the estate of F.

In this scenario, however, the proceeds will not be free from estate duty, as B is **not a co-owner** in the business at date of death of F, even though all the other requirements of Section 3(3)(a)(iA) are met. It will be recommended that the value of the life cover under the policy be increased to provide for estate duty, calculated as follows:

[7] R10 000 000 X 70% X 50%
[8] 70% X 50%
[9] 30% + 35%

Value of business interest: R10 000 000

Cover required including estate duty:

$$= \frac{\text{Initial cover required}}{1 - \text{Estate duty Rate}^{10}}$$

$$= \frac{10\,000\,000}{1 - 0.20}$$

= R12 500 000

The estate duty implication can, however, be avoided by making B a shareholder in the company. F can donate or sell even a very small percentage shareholding to B during his lifetime. As soon as B is a shareholder (and stays that way until F's date of death), the proceeds on the policy funding the agreement will be excluded from deemed property in terms of Section 3(3)(a)(iA) of the Act. It can be argued that this will be the case even if the agreement was concluded and the policy taken out before B became a shareholder. The requirement is only that the policy must have been taken out by a person who was the partner/co-member/co-shareholder of the deceased as **at date of his death**.

Example 3:

A third example of a one-sided buy and sell agreement is where the owner (X) of a similar business wishes to purchase the owner's (Y) business interest at his death. Once again, as X is **not a partner**/co-member/co-shareholder, the policy proceeds will not be free from estate duty and provision will have to be made therefor.

The exclusion will apply, however, in the scenario where natural person N and private company P own the shares in company Z and company P takes out a policy on N's life to enable company P to purchase N's interest in company Z when N dies.[11] A company is regarded as a "**person**" for purposes of Section 3(3)(a)(iA) of the Act;[12] company P is a **co-shareholder** of N in company Z on the date of N's death, the **purpose** of the policy is to acquire N's shares upon his death, and company P will pay all the **premiums** under the policy. Thus all the requirements of Section 3(3)(a)(iA) of the Act are met and the policy will be excluded from deemed property.

However, in the inverse scenario, if N wishes to purchase company P's shareholding in company Z upon the death of (for example) one of company P's directors, the policy will not be excluded. In this instance, N and company P will enter into the one-sided buy and sell agreement. Company P will nominate a person to be the life covered under the policy funding the

[10] For purposes of this example it t is assumed that the dutiable estate will not exceed R30million
[11] SARS External Guide: Estate Duty Implications on Buy-and-Sell Arrangements, where shares are held in trusts: Page 3 par 6.3
[12] SARS External Guide: Estate Duty Implications on Buy-and-Sell Arrangements, where shares are held in trusts: Page 3 par 6.3

agreement. The life covered will usually be a director or shareholder. Should this nominated life covered (NLC) then pass away (or become permanently disabled) the individual (N) will purchase company P's interest with the proceeds of the policy on the life of the NLC. Even though the agreement is between co-owners (N and company P) and the purpose is to purchase the shares held by them, the requirements of Section 3(3)(a)(iA) of the Act are not met as the NLC as life covered is not a shareholder in company Z at his date of death, and the policy will be included as deemed property in the estate of the NLC.

The advantages of having a one-sided buy and sell agreement in place largely overlaps with that of a reciprocal buy and sell agreement. Even though estate duty will be payable on a policy funding a one-sided agreement in appropriate instances, it could be argued that the advantages far outweigh the cost. It can provide much needed liquidity in the estate of a father wishing to benefit all his children equally, or of a husband who wishes his wife to inherit cash for her maintenance rather than a business interest, or prevent heirs from disputing their entitlement to estate assets, to name a few examples.

Conclusion

If the life policies funding the purchase price are structured correctly, the one-sided buy and sell agreement can be a very effective tool in business succession planning, without any negative estate duty consequences for the estate of the deceased party. The advantages of this type of arrangement is often overlooked in favour of more complicated or costly alternatives. It must be borne in mind that business planning must always be done in conjunction with estate planning to make sure that the one complements the other and that the necessary needs of the client are catered for.

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The Importance of a Correctly Structured Buy and Sell Agreement

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Introduction

A buy and sell agreement is a legally drafted agreement made by the members, shareholders or partners (in this article I will be referring to shareholders) of a business obligating each shareholder to sell his/her interest in the business to the surviving shareholders on death.[1] The agreement also obliges the remaining surviving shareholders to purchase the deceased shareholder's interest. It is very important to realise the significant impact that such a structure has on the continuity of the business and that it plays a vital role in the business succession plan.

This article will illustrate the importance of a client having a correctly structured buy and sell agreement and also allude to a few mistakes that some buy and sell agreements may contain.

❑ The risks of not having a buy and sell agreement

- o The remaining owners may not have sufficient cash available to buy the deceased's business interest.
- o The heirs do not have the security that they will be paid a fair price for the deceased's business interest, which may result in a forced sale.
- o The remaining business owners may not have immediate and clear ownership of the business and negotiating with heirs or delays relating to winding up of the estate might complicate matters.
- o In funding the purchase of the deceased's interest, the capital resources of the business might be drained, jeopardising the continuation of business.

❑ The benefits for the shareholders of the business to have a buy and sell agreement in place

- o The continuity of the business is ensured.
- o No outsiders will be involved in the business and they can continue unhindered.
- o The funds are available to ensure that the transaction can be concluded timeously.

❑ The benefits for the dependants of the co-owner where there is a buy and sell agreement in place

[1] *The South African Financial Planning Handbook* 2018, M Botha, L Du Plessis & W Geach page 1 045.

- They will inherit a capital amount instead of an interest in a business they have no knowledge of.
- The capital received can be invested to replace the loss of income experienced.
- The capital can assist with the overall estate planning of the co-owners and their families.

❑ Rights and obligations created in a buy and sell agreement

- **The right to purchase –** The agreement provides the surviving shareholder(s) the right to purchase the deceased or disabled shareholder's interest in the business.
- **The obligation to pay the agreed purchase price –** The agreement creates an obligation on the surviving shareholder(s) to pay an amount, as determined in the agreement, for the deceased or disabled shareholder's interest in the business.
- **The obligation to sell –** There is an obligation on the owner (estate) of the interest on date of death to sell the interest in the business.
- **The right to receive a purchase price –** The agreement creates and a right for the deceased/disabled shareholder (or his/her estate) to receive an amount, as determined in the agreement, for the sale of such shareholder's interest in the business.

❑ The Estate Duty Act[2]

The Estate Duty Act outlines when life insurance policies that are used to fund buy and sell agreements are dutiable.

❑ Section 3(1) and 3(3) of the Estate Duty Act provide as follows:

3. What constitutes an estate?

(1) For the purposes of this Act the estate of any person shall consist of all property of that person as at the date of his death and of all property which in accordance with this Act is deemed to be property of that person at that date.

(3) Property which is deemed to be property of the deceased includes—

a) so much of any amount due and recoverable under any policy of insurance which is a 'domestic policy', upon the life of the deceased as exceeds the aggregate amount of any premiums or consideration proved to the satisfaction of the Commissioner to

[2] Estate Duty Act 45 of 1955

have been paid by any person who is entitled to the amount due under the policy, together with interest at six per cent per annum calculated upon such premiums or consideration from the date of payment to the date of death: Provided that the foregoing provisions of this paragraph shall not apply in respect of any amount due and recoverable under a policy of insurance, if—

(iA) the Commissioner is satisfied that the policy was taken out or acquired by a person who on the date of death of the deceased was a partner of the deceased, or held any share or like interest in a company in which the deceased on that date held any share or like interest, for the purpose of enabling that person to acquire the whole or part of—

(aa) the deceased's interest in the partnership concerned; or

(bb) the deceased's share or like interest in that company and any claim by the deceased against that company, and that no premium on the policy was paid or borne by the deceased;

(ii) except where the provisions of paragraph (i) or (iA) of this proviso apply, the Commissioner is satisfied and remains satisfied that such policy was not effected by or at the instance of the deceased, that no premium on such policy was paid or borne by the deceased, that no amount due or recoverable under such policy has been or will be paid into the estate of the deceased and that no such amount has been or will be paid to, or utilized for the benefit of, any relative of the deceased or any person who was wholly or partly dependent for his maintenance upon the de ceased or any company which was at any time a family company in relation to the deceased;

❑ Estate duty Requirements explained

ESTATE DUTY REQUIREMENTS EXPLAINED IN TERMS OF BUY AND SELL AGREEMENTS[3]
1. The Policy must be acquired by a person. There is no definition of "person" in the Estate Duty Act. The definition of person in the Interpretation Act 33 of 1957[4] lists persons as follows; ❑ Divisional council, municipal council, village management board or like authority; ❑ Any company incorporated or registered as such under any law; ❑ Any body of persons corporate or incorporate. Therefore based on the above if the applicant is not a person the exemption contained in the Estate Duty Act will be lost and the policy will be subject to Estate Duty. A trust is not included in the above definition, therefore a trust is not regarded as a person for estate duty purposes.[5] Clarification of this is found in the case of CIR V Mac Nellies Estate, the Commissioner of Inland Revenue found that although a trust is not a person, the assets of a trust vest in the Trustees of the Trust who are "persons" albeit that they hold the assets of a trust in a fiduciary capacity. The Commissioner found that the exclusion from "property which is deemed to be property" provided for in Section 3(3) (a) (iA) applies where the policy is taken out or acquired by a Trustee of a Trust in capacity as a Trustee.[6] Care should be taken if there is a trust involved the above exemption contained in Section 3(3) (a) (iA) only applied where the policy is taken out or acquired by a trustee of a trust, the ruling does not apply where a natural person takes out a policy on the life of a trustee.
2. The person taking out/acquiring the policy must on date of death of the deceased be a partner of the deceased or hold any shares or a like interest in a company in which the

[3] SARS External Guide, The estate duty implications of buy and sell Arrangements where shares are held in trusts, dated 1 October 2012, page 5
[4] Interpretation Act 33 of 1957
[5] *Cir V MacNeillies Estate 1961 (3) SA 883 (A)*
[6] *Phillip Frame Will Trust v CIR 1991 (2) SA 340 (W), 53 SATC166*

deceased on that date also hold shares or a like interest in the business. In this regard the following aspect is important:

- ❑ The deceased must have held shares or a similar interest in the business at date of death;
- ❑ A company, close corporation or trust that holds the shares in the business does not satisfy this requirement – simply put a company/close corporation or trust does not have a life to insure and will thus have to nominate a person (e.g. a director or trustee) to be insured, and this insured person will not hold an interest in the business (the company, close corporation or trust will hold such interest) as required in the Estate Duty Act.

Where a valid insurance contract exists at the date of the deceased's death, the business relationship between the individuals must also still be in existence. If the relationship no longer exists, the policy proceeds will be a deemed asset in the estate of the deceased for estate duty purposes.

3. The policy must be taken out/acquired for the purpose of enabling that person to acquire the whole or part of;

- ❑ The deceased's interest in the partnership or'
- ❑ The deceased's share, or like interest in that company and any claims by the deceased against that company

If the policy was taken out or acquired for a purpose other than for a buy and sell arrangement the exemption above will be lost and the policy will be estate dutiable.

An example of where a policy was taken out for purposes other than to acquire the whole or part of the deceased interests is, where the business is overvalued and a life insurance policy is taken out for more than what the business is worth. Therefore the owner of the policy will be receiving more than the value of the interest to be purchased.[7] If the difference in the proceeds of the policy and the valuation of the business interest at date of death is substantial, the Commissioner may exercise his discretion by not allowing the exclusion. The grounds for disallowance in this case will be "the intention of the parties". If the difference

[7] SARS External Guide, The estate duty implications of buy and sell Arrangements where shares are held in trusts, dated 1 October 2012, page 4

can be verified for instance by a general drop in the business that occurred shortly before the death of the shareholder the intention of the parties will be taken into account.[8]

Another example is where there is a loan amount owing to the deceased of R1 million and the business interest is valued at R2 million. If the purpose of the policy taken out by the co-owners of the business was only to settle the loan account on death of the deceased, the policy proceeds will not qualify for the estate duty exclusion.

4. No premium on the policy was paid or borne by the deceased, directly or indirectly.

- The life assured on the policy funding the buy and sell agreement may not pay any premium on the policy of insurance on his life. It is important to note that where the business pays the premiums of the policy funding the buy and sell agreement, the premiums paid must be allocated to the loan account of the contracting party.

Example 1.

A, B and C are shareholders in Company X. They have a buy and sell agreement in place, funded by pure-risk life cover. Shareholder C leaves the business and sells his shares to D. What are the implications on the policies funding the buy and sell agreement?

A new buy and sell agreement must be concluded between the remaining shareholders and the new shareholder, i.e. between A, B and D.

The policy on C's life can be ceded to him. The policy will not be subject to capital gains tax if it is paid to C's estate or to a beneficiary on C's death.

A new policy will be taken out on D's life. A and B will be the owners and beneficiaries. C may, depending on the structure and terms of the buy and sell agreement, cede his ownership of the policies on the lives of A and B to D. Although D is not an original

[8] SARS External Guide, The estate duty implications of buy and sell Arrangements where shares are held in trusts, dated 1 October 2012, page 4

beneficial owner, and this is clearly now a second hand policy, there will be no CGT payable on the proceeds as a result of the exclusion.[9]

Example 2

X, Y and Z are shareholders in a business. X and Y's shares are held in their separate share trusts. Z holds his shares in his own name. They have a buy and sell agreement in place, funded via pure-risk life assurance policies. Z transfers his shares to a trust as well.

What is the impact on their buy and sell agreement?

A new buy and sell agreement must be concluded between X, Y and the trust to reflect the new ownership of the company.

The policy on Z's life will not be affected as there is no change in ownership on that policy.

The policies on the lives of X and Y owned by Z will be ceded to Z's trust via cession. The cession won't result in CGT being levied on the proceeds as the policy is a risk only policy and this is now specifically excluded.[10] The policy on the life of Z will however not meet the requirements for the estate duty exclusion anymore for the reasons discussed above, and provision may need to be made for additional cover in respect of estate duty.

All four of the above requirements must be met. If any of the above requirements are not adhered to, the estate duty exemption contained in section 3(3) (a) (iA) of the estate duty act will not be applicable and the policy will be estate dutiable. If any of the above requirements are not met, the policy will be deemed property in the deceased estate in terms of Section 3(3) of the Estate Duty Act. Proceeds of domestic policies of insurance on the life of the deceased is included as deemed property of the deceased in his/her estate. If the proceeds of the life policy are not exempt estate duty becomes payable by the beneficiary or recipient of the policy.[11]

[9] Paragraph 55 (1)(c)(i) (ii) and (e) of the Eighth schedule of the Income Tax Act 58 of 1962. Please note that paragraph 55(e) is only applicable in respect of pure risk policies with no cash value.
[10] Paragraph 55(1)(e) of the Eighth schedule of the Income Tax Act.
[11] Section 11 of the Estate duty Act 45 of 1955

If the policy does not meet these requirements, the person deriving a benefit from the insurance policy will be liable to pay the proportionate estate duty resulting from the life insurance policy as provided for in section 11 of the Estate Duty Act. Section 11(b)(i) of the Estate Duty Act provides as follows:

11. Person liable for duty "The person liable for the duty shall be –

(b) where duty is levied on property which, in accordance with subsection (3) of section three, is deemed to be property of the deceased--

(i)as to property referred to in paragraph (a) of that subsection, the executor: Provided that where the amount due under the policy is recoverable by any person other than the executor, the person liable for the duty shall be the person entitled to recover the amount due under the policy;

How to structure a buy and sell agreement.

Andrew, Clive, Malcolm and Julia formed a company, Be Fit (Pty) Ltd. The value of the business is R6, 000 000.00. The shareholding is as follows;

Shareholders	**Shareholding%**	**Value of Share**
Andrew	40%	R2,400 000.00
Clive	25%	R1,500 000.00
Malcolm	20%	R1,200 000.00
Julia	15%	R900 000.00

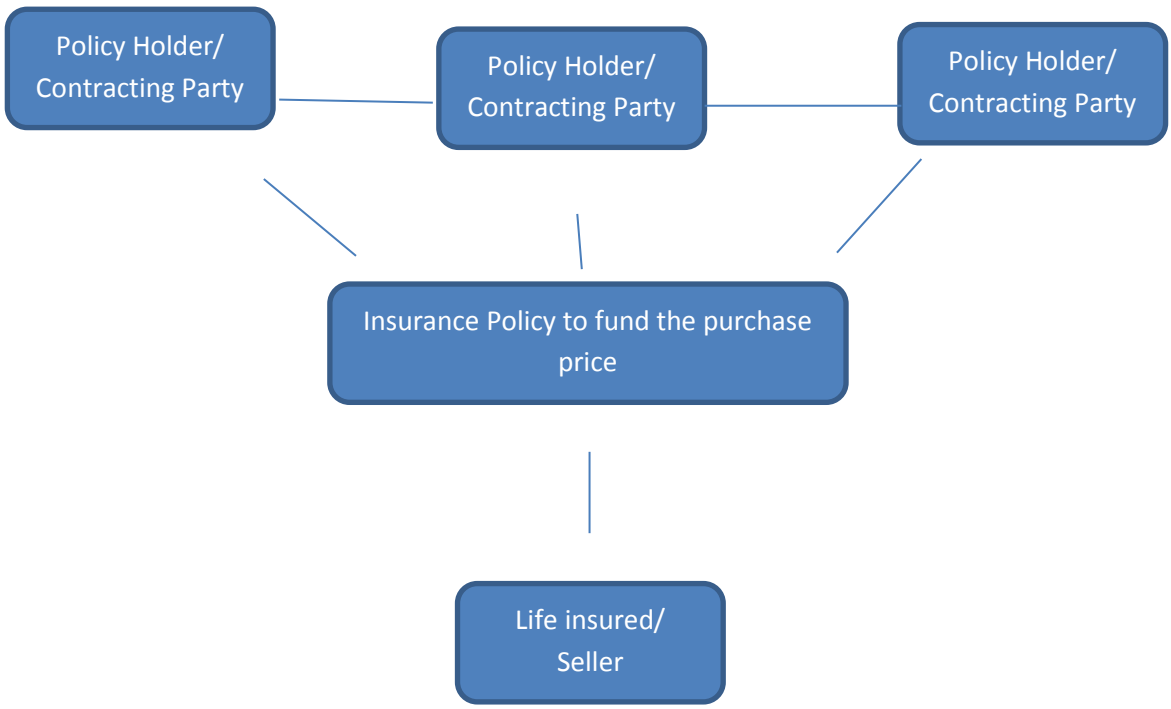
The shareholders wish to enter into a buy and sell arrangement to make sure that the business will continue upon one or more shareholder's death and disability. They want to make sure the remaining shareholders can continue with the business unhindered and that an amount equal to the market value of the shares is paid to the a disabled shareholder or the estate of a deceased shareholder.

The arrangement will be funded by way of life cover that the parties take out on each other's lives. This will ensure that there are sufficient funds available to pay the purchase price. At the same time the shareholders will enter into a buy and sell agreement which will create the

obligation to sell on the deceased or disabled shareholder and the obligation to buy on the remaining shareholders.

The agreement will furthermore provide the method used to determine the purchase price – which will provide peace of mind to all shareholders as it will limit possible disputes when the event happens, and will also make it possible for each shareholder to plan sufficiently for death or disability.

- A Traditional buy-and-sell policy



The traditional structure entails that each shareholder has one policy on his/her life with the remaining shareholders being the co-owners of that policy. The life of each shareholder is insured for an amount equal to the value of their interest in the business. The contracting parties for the life insurance policy are thus the other shareholders.

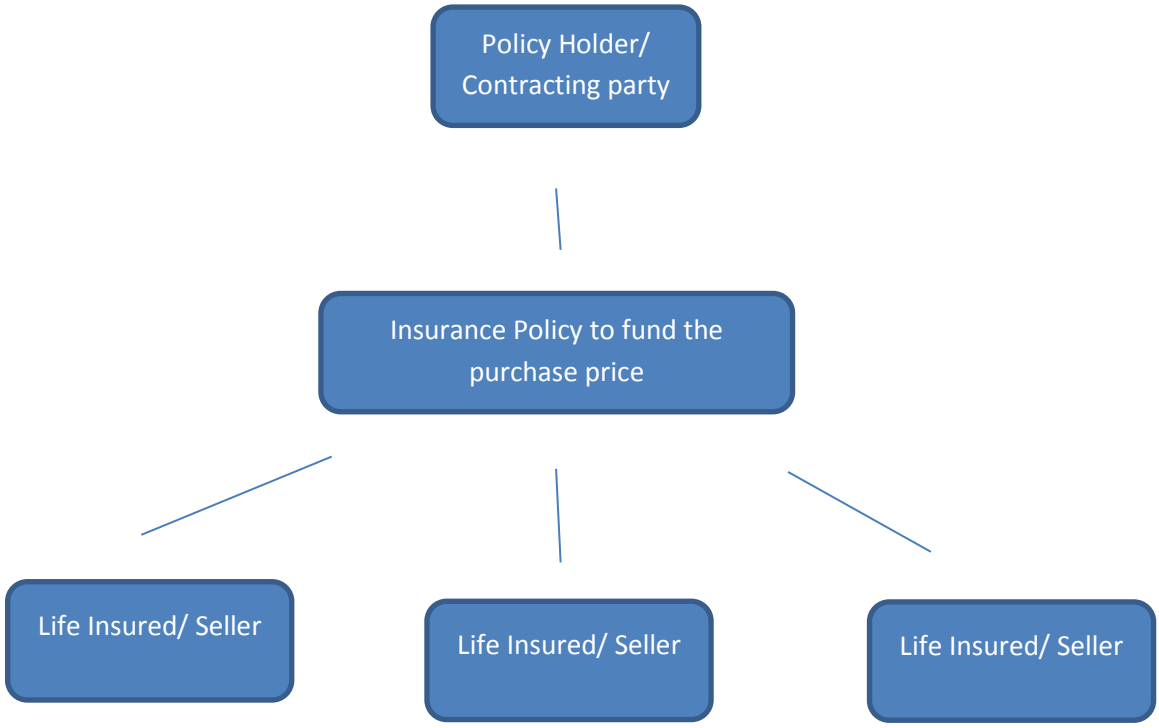
Based on the above example the ownership of the policy will be structured as follows;

Life Insured Deceased/Disabled Party	**Policy holders and ownership**		**Sum Insured**
Andrew	Clive Malcolm Julia	25/60 =42% 20/60 = 33% 15/60 = 25%	R2,400 000.00
Clive	Andrew Malcolm Julia	40/75= 53% 20/75= 27% 15/75= 20%	R1,500 000.00
Malcolm	Clive Andrew Julia	25/80 = 31% 40/80= 50% 15/80 = 19%	R1,200 000.00
Julia	Andrew Clive Malcolm	40/85= 47% 25/85=29% 20/85=24%	R900 000.00

Note – the ownership of the policy is calculated by using the following formula: % Ownership = Shareholding of policyholder / (100 – shareholding of life insured

Each of the policyholders above should pay the premiums on the policies that they own. The premiums are accounted for in such a manner that each policy holder pays the proportionate premiums equal to his/her policy ownership.

- The alternative way of structuring a buy and sell agreement



The above method of structuring the policies funding this agreement would be to have three policies each with only one contracting party, but with three life assured persons on each policy. More than one person's life can be insured. The alternative structure entails that each shareholder owns one policy on the lives of all the other shareholders. The advantage of structuring the agreement using this method is that each one of the parties own one policy and pays one premium.

Based on the above example the ownership of the policy will be structured as follows;

Policy Holder	**Lives Insured**	**Sum insured on the policy**
Andrew	Clive	40/75 = 53% x R1,500 000.00 = R795,000.00
	Malcolm	40/80 = 50% x R1,200 000.00 = R600 000.00
	Julia	40/85 = 47% x R900 000.00= R423 000.00
Clive	Andrew	25/60=42% x R2,400 000.00 = R1,008 000.00
	Malcolm	25/80=31% X R1,200 000.00 = R372 000.00
	Julia	25/85=29% x R900 000.00 =R261,000.00
Malcolm	Andrew	20/60=33%x R2,400 000.00=R792,000.00
	Clive	20/75=27% xR1,500 000.00=R405,000.00
	Julia	20/85=24% x R900 000.00= R216,000.00
Julia	Andrew	15/60=25% x R2,400 000.00=R600,000.00

	Clive Malcolm	15/75=20% x R1,500 000.00= R300,000.00 15/80=19% x R1,200 000.00= R228,000.00

Note – the ownership of the policy is calculated by using the following formula: % Sum insured = (Shareholding of life insured / (100 – shareholding of policyholder)) x sum insured required

Each of the policyholders should pay the premiums on the policies that they own. In the case of the alternative structure the premium is simple, as each policyholder pays the total premium on the policy he/she owns.

Traditional structure vs Alternative structure;

- The traditional structure leads to errors in calculation of premiums allocated to each policyholder, as the policy holder will pay premiums in accordance with their shareholding. The alternative structure eliminates this possibility as each policyholder is liable for the premiums due to the policy that they own. Therefore from an administrative point of view the alternative method is simpler.
- When one of the business owners decides to leave the business the traditional structure will result in various cession documents that can become quite cumbersome if there are many shareholders in the business. A positive associated with the traditional structure is that the leaving business owner can elect to retain the policy on his/her life by taking cession of the policy from the remaining shareholders. The capital gains tax implications (where applicable) as stated above will however need to be borne in mind.

When one of the shareholders decide to leave the business the alternative buy-and-sell structure can be adapted easily. Each business owner that is a policyholder will remove the shareholder leaving the business as a life insured on the policy.

- **Mistakes found in buy and sell agreements;**
  - **No buy and sell agreement drafted or an unsigned agreement;**

    The main purpose of a buy and sell agreement is to provide the business with a succession plan in the event of the death or permanent disability of one of its shareholders. The buy and sell provides the surviving shareholders with liquidity to purchase the interest of the deceased or disabled shareholder.

If there is no agreement in place or if it is unsigned there is no obligation on the shareholders to buy or sell the shares in the business in the event of death and/or disability. A further danger with an unsigned buy and sell agreement is that there is no method stipulated as to how the shareholder's interest in the business is valued or an agreement on the price to be paid. Without the agreement any unresolved dispute will have to be determined by the courts and this can be a costly and time consuming exercising, thus not benefiting any party.

Another danger to an unsigned buy and sell agreement or if there is no agreement to this effect in place, is that the policy proceeds may fall foul of the estate duty exemption found in section 3(3) (a) (i) of the Estate Duty Act, as there will be no proof that the life insurance policy was taken out for the purpose of acquiring the shares of the deceased shareholder.[12]

- **The Company pays the premiums**

A company is allowed to pay the premiums of a policy funding a buy and sell agreement. It must however be borne in mind that the individual shareholders own the insurance policy and the company only pays the premiums on the behalf of the individual. The individual should therefore have a debit loan account in favour of the company in respect of the premiums that the company paid.

There are also other options available where the business facilitates the payment of the premiums. This is allowable as long as the premiums are accounted for properly. The options in this regard include:

- The premium is added to the salary of the policyholder as a fringe benefit.[13]
- The premium is written off against a credit loan account against the company that is owed to the policyholder.

- **The buy and sell agreement does not cater for disability**.

What happens to the business in the event of the shareholder's disability? This is a question that should be posed to the clients when consulting with them with regards to their business succession plan. It is also important that shareholders accept and understand that in the event of disability of a shareholder, such a person will be obligated to sell his/her shares to the remaining shareholders. The definition of disability should be defined in the buy and sell agreement and aligned to the definition of disability in terms of the provisions of the policy.

[12] Section 3(3) of the Estate Duty 45 of 1955
[13] S11 (w)(1) Income Tax Act 58 of 1962

- **Under valuing or over valuing of the company**

  A business valuation is required for a correctly structured buy and sell agreement and this should be reviewed on an annual basis. It is important that a qualified individual is tasked with the obligation to provide the company with a business valuation.

  If the shares are overvalued and the purchaser pays more for the shares from the deceased estate or from the disabled shareholder, the purchaser may be regarded to be making a donation and as the donor the purchaser could pay donations tax. SARS could also disallow the estate duty exemption in respect of the policy proceeds as it could be argued that the sole purpose of the policy is not to fund a legitimate buy and sell agreement.

  If the shares are insured for less than its market value, for example where the parties to a buy and sell are not able to afford the insurance premium, it will result in a shortfall on the side of the purchaser. The purchaser will thus not have the necessary funds available to purchase the shares from the deceased estate. It must also be borne in mind that the executor of the deceased estate will include the market value of the shareholding for estate duty purposes.

Conclusion

A correctly structured buy and sell agreement is an eloquent way to effect the succession planning of a business and it will ensure the continuation of a business should one of the co-owners in the business die or become disabled. Care should be taken when structuring a buy and sell agreement, and cognisance should be taken of the pitfalls discussed in the article as it could frustrate the purpose of a buy and sell arrangement.

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General

Charitable Trust as a PBO

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Introduction

Trusts are used for various purposes and are often set up to undertake charitable endeavours. When setting up a charitable trust the ordinary requirements, as per the Trust Property Control Act[1] (hereinafter referred to as "the Act), would need to be adhered to. However, if you would like the trust to benefit from the tax concessions provided by the South African Revenue Services (SARS) to Public Benefit Organisations (PBOs) then further steps would need to be taken.

Creating the charitable trust

There are two ways of creating a trust, either by way of a will or by way of a contract. A trust that is created in the last will and testament of the founder is thus a testamentary trust. When a trust is set up during one's lifetime an inter vivos trust is created.

In terms of a testamentary trust the will also serves as the trust deed. "The requirements for the formation of a testamentary trust on the death of the testator may be summarised as follows:

- a testator (founder) who had the earnest intention to create a trust as manifested in the will;
- properly defined trust property;
- named or ascertainable beneficiaries."[2]

An inter vivos trust is created if the following requirements are met:

- Clearly defined property;
- Named or ascertainable beneficiaries or a clearly defined impersonal object;
- A trustee who has agreed to act as such and to whom a letter of authority has been issued in terms of section 6 of the Act[3] and who as trustee has a claim to the trust property or owns it."[4]

Once the trustees have been appointed for both testamentary and inter vivos trusts the essential elements become the same[5] and so does the administration, save for the subjective elements of the particular trust deed. Therefore, if the trust deed permits, either trust can be registered as a PBO. In most instances trusts are of a discretionary nature and therefore the trustees are permitted to act in the best interest of the trust and its beneficiaries. If the trust is of a charitable nature it could be in the best interest of the trust and beneficiaries to register the trust as a PBO.

1 Trust Property Control Act 57 of 1988
2 PA Oliver et al, 'Trust Law and Practice', LexisNexis Service Issue 5, October 2017 at page 2-13
3 Supra note 1
4 Supra note 2 at page 2-15
5 Id

Requirements of a PBO

The requirements of a PBO are set out in the Income Tax Act6 and the registration thereof is governed by SARS. Before I delve into the legislative requirements for setting up a PBO I would like to discuss the practical element. The first step that needs to be taken in order to register a trust as PBO would be to lodge an application with SARS on the prescribed form. The trust deed should also accompany the application together with the letters of authority and identity document copies of the trustees. If the trust has been in existence for longer than a year, the financial statements of the trust should also be submitted. Further, proof of the trust's bank account would also need to be provided.

The conditions and requirements, which SARS would use to assess the application, for registering as a PBO are contained in section 30 of the Income Tax Act7. The section provides the following:

"For the purposes of this Act—

'public benefit activity' *means--*

a) any activity listed in Part I of the Ninth Schedule; and
b) any other activity determined by the Minister from time to time by notice in the Gazette to be of a benevolent nature, having regard to the needs, interests and wellbeing of the general public;

'public benefit organisation' *means any organisation –*

a) which is a company formed and incorporated under section 21 of the Companies Act, 1973 (Act No. 61 of 1973), or a trust or an association of persons;
b) of which the sole object is carrying on one or more public benefit activities(including any undertakings or activities which are not prohibited under subsection (3)(b)(iv)), where

i) all such activities are carried on in a non- profit manner and with an altruistic or philanthropic intent;

ii) no such activity is intended to directly or indirectly promote the economic self-interest of any fiduciary or employee of the organisation, otherwise than by way of reasonable remuneration payable to that fiduciary or employee; and

iii) at least 85 per cent of such activities, measured as either the cost related to the activities or the time expended in respect thereof, are carried out for the benefit of persons in the Republic, unless the Minister, having regard to the circumstances of the case, directs otherwise: Provided that cost incurred for the benefit of persons outside the Republic shall be disregarded to the extent of donations received by that organisation from persons who are not resident and receipts and accruals derived directly or indirectly therefrom which donations, receipts and accruals have not previously been taken into account for purposes of this proviso; and

6 Income Tax Act 58 of 1962 section 30
7 Id

a) where

i) each such activity carried on by that organisation is for the benefit of, or is widely accessible to, the general public at large, including any sector thereof (other than small and exclusive groups);

ii) each such activity carried on by that organisation is for the benefit of, or is readily accessible to, the poor and needy; or

iii) that organisation is at least 85 per cent funded by donations, grants from any organ of state or any foreign grants;'"

A PBO is therefore any organisation that carries on one of the approved public benefit activities listed in Part I of the Ninth Schedule and/or complies with the requirements in section 30 and/or is approved by the Commission under section 30(3)[8]. The list of public benefit activities are quite extensive and will not be included in this article.

If a charitable trust were to be successful in its application as a PBO it is essential that the trust still be run in accordance with its stated charitable purpose throughout its existence.

An important factor to note when deciding whether or not to register a charitable trust as a PBO, and whether the trust deed would be able to meet the requirements of the section 30 of the Income Tax Act, is the following:

"iii) required on dissolution to transfer its assets to-

(aa) any similar public benefit organisation which has been approved in terms of this section;

(bb) any institution, board or body which is exempt from tax under the provisions of section 10(1)(cA)(i), which has as its sole or principal object the carrying on of any public benefit activity; or

(cc) any department of state or administration in the national or provincial or local sphere of government of the Republic, contemplated in section 10(1)(a) or (b);"[9]

If the trust deed specifies that at dissolution the trust property is to be transferred to any individual or entity other than the types specified above then the requirements to register as a PBO will not be met. The Act[10] also requires that the PBO must have at least three people, who may not be connected to each other, who accept the fiduciary responsibility for the PBO. Therefore, the trustees cannot be related to each other. The limitations of trading should also be noted if that is how the trusts intends funding its charitable endeavours.

[8] Id
[9] Id
[10] Id

The primary advantage for registering a charitable trust as a PBO would be to benefit from the tax concessions. By registering as a PBO it does add to the onus of administration for the trustees but ultimately the benefits would need to be weighed against the potential disadvantages. One potential disadvantage is that it could equate to an increase of costs with regards to the reporting requirements and further work required by the trustees.

A charitable trust not registered as a PBO is taxed at the flat rate of 45% on income earned and the inclusion rate for capital gains tax is 80%. This should be compared with the tax concession afforded to PBO's as discussed below.

Tax concession afforded to PBOs

Income Tax

Section 10(1)(cN) provides an exemption, for approved PBOs, on receipts and accruals from income tax provided they meet certain requirements:

"10. Exemptions.—*(1) There shall be exempt from normal tax—*

(cN) the receipts and accruals of any public benefit organisation approved by the Commissioner in terms of section 30(3), to the extent that the receipts and accruals are derived—

i) otherwise than from any business undertaking or trading activity; or

ii) from any business undertaking or trading activity—

(aa) if the undertaking or activity—

(A) is integral and directly related to the sole or principal object of that public benefit organisation as contemplated in paragraph (b) of the definition of "public benefit organisation" in section 30;

(B) is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost; and

(C) does not result in unfair competition in relation to taxable entities;

(bb) if the undertaking or activity is of an occasional nature and undertaken substantially with assistance on a voluntary basis without compensation;

(cc) if the undertaking or activity is approved by the Minister by notice in the Gazette, having regard to—

(A) the scope and benevolent nature of the undertaking or activity;

(B) the direct connection and interrelationship of the undertaking or activity with the sole or principal object of the public benefit organisation;

(C) the profitability of the undertaking or activity; and

(D) the level of economic distortion that may be caused by the tax exempt status of the public benefit organisation carrying out the undertaking or activity; or

(dd) other than an undertaking or activity in respect of which item (aa), (bb) or (cc) applies and do not exceed the greater of—

i) 5 per cent of the total receipts and accruals of that public benefit organisation during the relevant year of assessment; or

ii) R200 000."[11]

The exemption is afforded to PBOs for income tax on accruals and receipts which are derived in a manner that is specified in section 10(1)(Cn). The basic exemption refers to an amount equal to the greater of 5% of the total receipts and accruals of the PBO during the relevant year of assessment or R200 000[12]. The SARS Tax Exemption Guide for Public Benefit Organisations in South Africa provides examples of what could be considered as total receipts and accruals[13]. It is interesting to note that the sale of immovable assets would also be included when determining the total receipts and accruals[14].

PBOs may, if approved, issue tax-deductible receipts in terms of section 18A[15]. A PBO may qualify for approval if they carry on a public benefit activity listed in Part II of the Ninth Schedule[16]. A PBO may not accept donations that are subject to conditions that could benefit the donor or any connected person; be it directly or indirectly[17].

A taxpayer, including a trust, making a bona fide donation in cash or property is entitled to a deduction from their taxable income to a section 18A approved organisation. The allowable deduction may not exceed 10% of the taxable income (excluding any retirement fund lump sum benefit, retirement fund lump sum withdrawal benefit and severance benefit) of the tax payer 'as calculated before allowing any deduction for donations under section 18A[18], with the exception of a portfolio of collective investment schemes. For collective investment schemes amounts paid or transferred during years of assessment commencing on or after 1 January 2012,

[11] Id section 10
[12] SARS Tax Exemption Guide for Public Benefit Organisations in South Africa page 19 Issue 5, 27 January 2017 http://www.sars.gov.za/pages/Results.aspx?sq=1&k=Tax%20Exempt%20Guide%20For%20Public%20Benefit%20Organisations%20in%20South%20Africa
[13] Id page 15
[14] Id
[15] Supra note 6
[16] Id
[17] Supra note 12 page 28
[18] Id page 31

the section 18A deduction for a taxpayer that is a portfolio of a collective investment scheme is based on a specific formula[19].

The excess donation can be carried over to the next year of assessment.

Donations Tax

Natural persons enjoy an annual exemption in respect of donations up to a value of R100 000 (non-natural persons such as companies only enjoy a R10 000 exemption in this regard). Donations tax is thereafter levied at a rate of 20% on the first 30 000 000 donated per year, and thereafter at a rate of 25% in respect of the annual donations exceeding R30 000 000. There is however an exemption provided for donations made by or to PBOs in terms of section 56(1)(h)[20] of the Income Tax Act.

Estate Duty

If one were to leave a bequest to a PBO in your will you are entitled to a deduction in your estate duty calculations, thereby reducing the total value of your estate and potential estate duty payable. A natural person enjoys an abatement of R3 500 000 (where the spouse of such person had previously died, this abatement could be as high as R7 000 000) where-after estate duty is levied at 20% on the dutiable estate value up to R30 000 000, and at 25% on the dutiable estate exceeding 30 000 000[21].

Transfer Duty

Transfer duty[22] is payable when one acquires immovable property. The amount payable depends on the value of the property. A PBO is exempt from paying transfer duty provided the property is wholly or substantially used for carrying on a public benefit activity[23].

Dividends Tax

A PBO that is a beneficial holder[24] of dividends is exempt from paying dividends tax[25]. Dividends tax is levied at 20% and is usually withheld and paid to SARS by the company that is declaring

[19] Haupt et al, "Notes on South African Income Tax", H&H Publications 2018 page 158.
The formula being
A = B x 0.0005 (section 18A(1)(A))
A the s 18A deduction B the average value of the aggregate of all the participatory interests held by investors in the portfolio for the year of assessment; this is determined by using the aggregate value of all of the participatory interests in the portfolio at the end of each day during that year.

[20] Supra note 6

[21] Estate Duty Act 58 of 1962, section 4(h)

[22] Transfer Duty Act 40 of 1949 as quoted in SARS Tax Exemption Guide for Public Benefit Organisations in South Africa Issue 5 at page 38

[23] Transfer Duty Act 40 of 1949 section 9(1)(c)

[24] Supra note 12 at page 39

[25] Section 64F(1)(C) and section 64FA(1)(a) of the Income Tax Act

the dividend. The PBO needs to inform the company, or rather make a declaration[26], that it is exempt from tax due to its status as a registered PBO.

If the investment is held in a trust it is important to determine the type of trust, namely a vesting or discretionary trust. If the beneficiaries have a vested right to the dividends then they are the beneficial owners and therefore would not qualify for the exemption.[27]

Securities Transfer Tax

A PBO is exempt from securities transfer tax provided it declares to whomever holds the security that it is tax exempt by virtue of its status as a PBO[28]. This tax is levied at a rate of 0.25% on listed and unlisted security that is transferred.

Capital Gains Tax

A PBO does not enjoy a blanket exemption for CGT on any gain as a result of a disposal of a capital asset as there are certain activities that will not be disregarded: these are business undertakings or trading activities.[29] A donation, however, will be disregarded by the donor for CGT purposes[30].

Conclusion

It is thus clear that there are various concessions made by the legislature with regards to taxes and levies related to public benefit organisations. In addition to the tax concessions provided, PBOs also receive an exemption with regards to the skills development levy[31].

The Davis Tax Committee published a report in March 2018 relating to, "The Public Benefit Organisation and Tax Systems"[32]. In the report it is acknowledged that PBOs, and philanthropy in general, play an important part in South Africa and in essence help alleviate the burden on the state. Therefore the report looked at whether the incentives were sufficient to encourage and benefit organisations and individuals with charitable endeavours. At this stage the concessions were deemed sufficient and the view is held that tax alleviation should not be the only factor encouraging philanthropy.

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[26] Ibid
[27] Ibid
[28] Ibid page 40. Securities Transfer Tax Act 25 of 2007, section 8(2)
[29] Ibid page 41
[30] Ibid page 46
[31] Ibid page 41
[32] http://www.taxcom.org.za/docs/20180329%20Final%20DTC%20PBO%20Report%20to%20the%20Minister.pdf

In the case of a charitable trust that was set up for philanthropic endeavours it could thus be in the best interest for both the beneficiaries of the trust as well as persons contributing to the trust, if the trust is registered as a PBO.

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The Constitutional Court's Latest on Loans Payable on Demand and Prescription

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Introduction

Prescription of debt is a very well-known concept, but in fact very few people actually know what it entails. Prescription is regulated by The Prescription Act 68 of 1969 (hereafter referred to as The Act) and there are four questions to consider when determining if a debt has prescribed:

(1) What type of debt is it?

(2) How long is the application prescription period?

(3) When did prescription begin to run?

(4) Was prescription delayed or interrupted?[1]

Prescription is important when a creditor wants to collect on a debt and make sure that it is within the prescribed period. The Prescription Act[2] however also provides the consumer with protection against debt collectors harassing them to pay old inflated debts.

Types of debt and period of prescription

There are various prescription periods in in the act, but the most important ones are:[3]

- ☐ A 30-year prescription period that applies to all debt arising as a result of a judgement, or mortgage bonds, and any other debt that is owed to state related entities such as the Receiver of Revenue, traffic departments or municipalities.[4]
- ☐ A 3-year period applies to all "normal" debt, such as car loans, school fees, gym contracts, credit- and store card accounts to name a few.

When does prescription begin to run?

Section 12 of the Prescription Act provides as follows:

(1) Subject *to the provisions of subsections (2) and (3), prescription shall commence to run as soon as the debt is due.*

(2) If the debtor *wilfully prevents the creditor from coming to know of the existence of the debt, prescription shall not commence to run until the creditor becomes aware of the existence of the debt.*

(3) A debt shall not be deemed to be due until the creditor has knowledge of the identity of the debtor and of the facts from which the debt arises: Provided that a creditor shall be deemed

[1] A Jansen van Rensburg Short Notes on Prescription Schoeman Law Inc 2015
[2] Act 68 of 1969
[3] Section 11 of the Prescription Act 68 of 1969
[4] W Knowler Prescribed Debt: a confusing and contentious issue www.businesslive.co.za/bt/money/2018-02-24

to have such knowledge if he could have reasonably acquired it by exercising reasonable care.

It is therefore very clear that prescription shall only commence once the debt is due. The Act does not define the word debt, but it is established in law that a wide meaning has been given to the term which includes both a general meaning as well as a debt resulting from a delict.[5] It was also held in *Apalamah v Santam Insurance Co*[6] and later confirmed in the Appeal Court that a debt is only due when it is recoverable. There is a difference when the debt comes into existence and when it is recoverable, even though the dates may coincide. A debt becomes recoverable once the debtor is under an obligation to perform immediately. This is usually easy to establish when the debt resulted from a contract, as the contract should stipulate when the debt is due.

Was prescription delayed or interrupted?

Section 13 of The Act states that the running of prescription will be delayed should one of the following impediments exists:

- ☐ The creditor is a minor, insane or under curatorship;
- ☐ The debtor is outside the borders of the Republic of South Africa;
- ☐ The creditor and debtor are married to each other;
- ☐ The creditor and debtor are partners and the debt arose from a partnership agreement;
- ☐ The debtor is a member of the governing body of the juristic person (the creditor);
- ☐ The debt is the object of a dispute or arbitration;
- ☐ When an executor in a deceased estate has not yet been appointed.

The impediment must stop within one year before the date of prescription is completed in order for prescription to be delayed and extended for one year.

The running of prescription is interrupted by:

- ☐ An acknowledgement of debt by a debtor. Payment towards the debt could also be seen as a tacit acknowledgement.
- ☐ A summons served by the creditor on the debtor in order to claim payment of the debt due.

Once a debt has prescribed a creditor can no longer claim the debt.

[5] Extinctive Prescription MM Loubser 1996 32.
[6] 1975 (2) SA 229 (D) at 232-G

Recovering prescribed debts

The National Credit Act 34 of 2005 (hereafter referred to as the NCA) was introduced to provide fair, transparent, competitive, sustainable, responsible, effective and accessible credit market and industry as well as to protect customers.

In March 2015 the NCA was amended to add a new section 126B:

Section 126B(1)(b) states, *inter alia*, that no person may continue to collect or re-activate a debt under a credit agreement[7] to which the NCA applies:

(i) which has been extinguished by the Prescription Act, No 68 of 1969; and
(ii) where the defence of prescription is raised, or would have reasonably been raised, had the consumer been aware of such a defence, in response to a demand, whether as part of legal proceedings or otherwise.

In December 2016 a majority decision by the Supreme Court of Appeal in *Kaknis v ABSA Bank Limited and* another[8] handed down judgement that section 126B of the NCA cannot be applied retrospective to any credit agreements entered into before March 2015.[9]

Loans payable on demand

In September 2017 the Constitutional Court handed down a judgement that will definitely change the way loan agreements will be structured in future. The case was about contractual freedom and prescription, with the focus on the importance of parties considering the long term implications of the contractual terms they enter into.

Trininty Asset Management (Pty) Ltd v Grindstone Investments (Pty) Ltd[10]

The facts of the case were as follows:

- ☐ During 2007 the Appellant and Respondent concluded a written loan agreement.
- ☐ The Appellant loaned the Respondent an amount of R3 050 000.
- ☐ The loan agreement contained a clause that the capital shall be due and payable to the lender within 30 days from the date of the delivery of the Lender's written demand.
- ☐ The monies were advanced in February 2008 and the one and only demand was received from the debtor during 2013.
- ☐ The Respondent denied the existence of the debt and the appellant then lodged a liquidation application against the respondent.

[7] Car and home loans, credit card accounts, store card accounts etc.
[8] 08/16 (2016) ZASCA 206.
[9] W Knowler Prescribed Debt: a confusing and contentious issue www.businesslive.co.za/bt/money/2018-02-24
[10] (1040/15) [2016] ZASCA 135

- ☐ The respondent relied on prescription as one of the defences. Section 11(d) of the Prescription *Act* states that a debt will prescribe in three years after it has become due, unless the running of prescription is interrupted.
- ☐ Even though the respondent acknowledged receiving this demand for payment during 2013, the Constitutional Court stated that acknowledgement does not revive an already extinguished debt.
- ☐ The court further stated that merely because a term in a loan agreement created conditions for demand and repayment, it did not mean that prescription only started once the demand was made.
- ☐ The majority in the Constitutional Court held that prescription started to run on the day the loan was effected and the money paid, and that no clear and unequivocal intention to delay prescription existed.

The question now arises as to how prescription applies to a loan account between a trust and the founder, especially in light of the provisions of Section 7C of the Income Tax Act[11]?

It is quite common for family members to loan money to one another, or even for a founder of an *inter vivos* trust to structure a loan between the trust and himself. It is further practise that the loan agreement will have a clause that state "*the loan will be payable back on demand*".

According to Phillip Haupt[12] if a loan to a trust prescribes it will not constitute a donation by the lender, who might not have been aware of the running of prescription. In such an instance there will be no donations tax payable and then also no loan for section 7C[13] to apply to. He further states that even though the loan will be extinct, there will be either an application of paragraph 12A of the Eighth Schedule[14] if the loan funded a capital asset or section 19 of the Income Tax Act[15] if the loan funded deductible expenditure or a depreciable asset. This will be taxed in the hands of the trust.

From the above it is clear that even if the loan between the founder and the trust prescribes there will be other tax consequences to consider.

Conclusion

Loans between family members or connected parties such as trusts or companies, can be a contentious issue and the parties need to be very sure if this will be a "*never never*" loan[16] or is the intention at some point in the future for the loan to be settled. Should there be no date of

[11] Income Tax Act 58 of 1962
[12] P Haupt Notes on South African Tax 2017, p826, H & H Publishers.
[13] Provision whereby interest shall be levied is currently 7,5% on any outstanding loan between the trust and a lender. Should the lender however charge a lesser rate a donations tax event could be triggered
[14] A capital gains tax event
[15] Income Tax Act 58 of 1962
[16] As described by the Judges of the Constitutional Court in the Trinity Asset Management case where the intention is to never call up the loan.

repayment but the loan is payable back on demand, the agreement must stipulate very clearly what is meant by that.

The clearest possible indication that parties wish to delay prescription would be to express that clearly in any agreement that the loan will not become due and prescription will not run, unless a demand was made or that the demand is subject to certain conditions.[17]

Prescription is a defence that a debtor must raise and no court is allowed to take note thereof out of their own motion. The calculation of prescription can be very complex and help from a legal professional should be sought.

[17] J van Niekerk Prescription of on-demand loans – The Constitutional Court's decision in Trinity v Grindstone www.werksmans.com/legal-briefs-view/prescription

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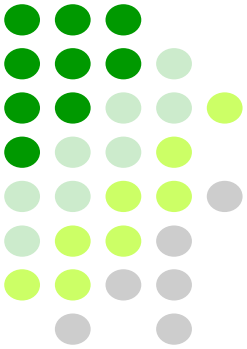

Income Tax

An Estate Plan Thwarted: Section 7(8) of the Income Tax Act Revisited

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Introduction

The widespread and increased tendency to make use of a trust[1] and the fact that many South Africans have emigrated from South Africa[2] (or still contemplate emigration) necessitated the writer to revisit section 7(8) of the Income Tax Act[3]. The reasons for setting up an *inter vivos* trust is as varied and diverse as the reasons South Africans opt to emigrate and a typical example includes the following situation:

Mr Jones established an inter vivos trust with himself, his wife and children as beneficiaries to the Jones Family Trust. Mr Jones' youngest son, Vinnie, on completion of his undergraduate degree in music, decided to move to Italy to follow his dream of becoming the next Andrea Bocelli.

The focus of this article is to understand the possible tax consequences to Mr Jones, as founder and donor of the trust, the Jones Family Trust itself and its beneficiaries, such as Vinnie.

Please note that foreign trusts, and related topics (e.g. South African residents who own shares in companies held in foreign trusts or who makes loans and/or donations to companies held in foreign trusts[4]) are outside the purview of this article and shall therefore not be discussed[5].

The beginning of the end for trusts?

The erstwhile South African Minister of Finance, Pravin Gordhan, announced in the 2013 Budget Speech[6] that:

"A tax review will be initiated this year to assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability."

In the *National Budget Review,* published on 27 February 2013[7], the following was stated on page 54 under the heading "Reforming the taxation of trusts":

"To curtail tax avoidance associated with trusts, government is proposing several legislative measures during 2013/14. Certain aspects of local and offshore trusts have long been a problem

[1] As at 31 October 2015 there were, according to the Davis Committee's Second Report, 333 465 active trusts in South Africa.
[2] Staff writer, ***Stats show that 'lower-income' South Africans are also emigrating***, BusinessTech, 12 April 2018. https://businesstech.co.za/news/lifestyle/237403/stats-show-that-lower-income-south-africans-are-also-emigrating? [Accessed on 18/08/2018.]
[3] Act 58 of 1962 (as amended)
[4] Section 1 of the Companies Act 71 of 2008[4] defines a trust as being a "juristic person" for the purposes of that Act and can therefore be a shareholder of a company in its own right.
[5] Proposals in the Draft Taxation Laws Amendment Bill, 2018 pertaining to shares in companies held in foreign trusts by South African residents include the amendment of section 7(8)(a) of the Income Tax Act, section 25B of the Income Tax Act and paragraph 72 of the Eighth Schedule to the Act.
[6] http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf [Accessed 18/08/2018].
[7] http://www.treasury.gov.za/documents/national%20budget/2013/review/FullReview.pdf [Accessed 18/08/2018].

for global tax enforcement due to their flexibility and flow-through nature. Also of concern is the use of trusts to avoid estate duty, which will be reviewed[8]*. "*

Reasons for the setting up of an *inter vivos* trust may have nothing to do with the avoidance or lessening of any tax. One of the possible reasons may simply be that the winding up of estates can take an inordinate length of time, resulting in long delays and much frustration for the beneficiaries and that the divestiture of assets to a trust by the deceased before death is but a means of avoiding this. Another reason may be that with an *inter vivos* trust the estate planner has the opportunity of scrutinising the ability and integrity of the trustees during his/her lifetime and that it has nothing to do with an attempt to conceal assets and thereby save on estate duty and/or income tax.

Aspects of taxation

Tax, the payment of tax and the parties responsible for its effective collection have been the subject of much ridicule[9]. And if the news media are to be believed, the one thing that rich and poor South Africans share is that we both complain about taxes. But trusts, unlike for example companies, are not subject to rigorous and extensive legislative regulation. Trusts are governed largely by the common law. Both estate planners and financial planners need to understand, especially from an estate planning perspective, where the possible future is being protected by the realities of the present, that while the consideration of case law is vitally important in order to properly understand our trust law, the law of trusts remains in the process of development[10].

Trusts and income tax:

The Income Tax Act[11] (hereinafter referred to as "the Act") was amended in 1991[12] to extend the definition of "person" to include a trust[13].

Section 1 of the Act defines a "trust" as meaning "*any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person*".

[8] On 17 July 2013 the then Minister of Finance, Mr Pravin Gordhan, announced the members of the Tax Review Committee (the Committee) as well as the Committee's Terms of Reference to give effect to the Minister's previous announcement in February 2013 when he tabled the 2013/14 Budget that government will initiate a tax review this year "*to assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability*".

[9] "65% of people say that cheating on your income tax is worse than cheating on your spouse. The other 35% were women." Jay Leno. http://www.larryponcpa.com/page6.html. [Accessed 18/08/2018].

[10] National Treasury's Explanatory Memorandum on the Draft Taxation Laws Amendment Bill became available for public comment on 16 July 2018.

[11] Act 58 of 1962

[12] The definition of a person was amended to specifically include a trust following the judgment in CIR v Friedman and Others NNO 1993 (1) All SA 306 (A)

[13] Government Gazette, Vol. 313, No. 13374

As a person a "trust" is therefore liable for income tax and capital gains tax (CGT) in its own right. Where the trust is taxed on income, it is taxed in the same way as a natural person except that it is not entitled to the primary rebate and it is taxable at a flat rate of 45%. A trust does not, like a natural person, enjoy the exemption from tax of the first R23 800/R34 500 per annum in respect of South African interest[14].

However, when income is received by or accrues to a trust it is not always taxed in the hands of the trust[15].

Section 25B of the Act is the principal taxing section relating to trusts.

In terms of section 25B of the Act:

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

(2) Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant deed of trust, agreement or will of a deceased person, that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary.

Generally speaking, section 25B embodies the "conduit principle", which entails that income received by, or which is accrued to or on behalf of a beneficiary, will be taxed in the hands of the beneficiary[16]. Section 25B is applicable to both testamentary trusts and *inter vivos* trusts where section 7 does not apply. In essence, if the trust income vests in the beneficiaries in the same tax year that it is received by the trust, the beneficiaries are taxed on it. However, if the income does not vest in the hands of the beneficiaries in the same tax year in which it is received, the trust is taxed on it.

A "beneficiary" is defined in section 1 of the Act as follows:

"*beneficiary in relation to a trust means a person who has a vested or contingent interest in the whole or portion of the receipts or accruals or the assets of that trust*."

[14] Botha et al, The South African Financial Planning Handbook 2018, Lexis Nexis Durban, at page 839
[15] Botha et al, The South African Financial Planning Handbook 2018, Lexis Nexis Durban, at pages 858 - 859
[16] Armstrong v CIR.1938 AD 343

As explained above, section 25B of the Act is subject to the provisions of section 7 of the Act. Section 7 is an anti-avoidance provision aimed at taxing, in the hands of a donor, any income, in general, which has resulted from a "donation, settlement or other disposition" including where a loan account to the trust in terms of which no interest or below-market value interest is charged" by said donor. According to Davis et al, a "donor" can be the founder of the trust or any other person making a "donation, settlement or other disposition" to the trust. In this regard it is important to note that if no donation, settlement or other disposition is present, the provisions of section 7 will not apply. The section will also only apply while said donor is alive and hence the reason why the "donor" can also be somebody other than the founder of the trust.

With regards to the anti-avoidance provisions as contained in section 7 of the Act, Vinnie, in our example above, need to be advised of section 7(8) of the Act. Section 7(8) of the Act covers the situation where a South African resident, such as Mr Jones, shifts income into the hands of non-South African residents (including offshore trusts) by disposing of income-generating assets to such non-resident.

Section 7(8) currently[17] provides that:

(a) Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition.

Section 7(8) is therefore only applicable if the donation, settlement or other disposition was made by a South African "resident" for income tax purposes[18].

Trusts and capital gains tax (CGT):

It has been explained above that a "trust", as a "person" for income tax purposes, may be liable for income tax and CGT in its own right.

CGT was introduced with effect from 1 October 2001 and is applicable to capital gains (or capital losses) made after that date. CGT applies to assets acquired both before and after 1 October 2001 that are disposed of after that date. A trust, which is a South African tax resident, would be subject to capital gains tax on any net capital gain realised on the "disposal" of an

[17] The Taxation Laws Amendment Bill, 2018 proposes to amend sections 7(8), 10B(2) and 25B(2A) of the Income Tax Act and paragraphs 64B, 72(b) and 80(3) of the Eighth Schedule to the Act in order to address the use of trusts to defer tax or recharacterise the nature of income,.

[18] Davis DM *et al*, Estate Planning, 2018 – SI 52 at 6.3.6A

"asset" subject to various provisions contained in the Eighth Schedule to the Act. A capital gain on the disposal of an asset arises when the proceeds received on the disposal exceeds the base cost of the asset, whereas a capital loss will typically arise when the base cost of the asset exceeds the proceeds received.

Botha M *et al*[19] explains that disposals by a trust for capital gains tax purposes include the following:

- The vesting of an interest in an asset to a beneficiary of a trust; or
- A sale transaction with a third party (i.e. a normal sale transaction).

The Eighth Schedule to the Act contains anti-avoidance provisions similar to the provisions of sections 7 and 25B(2A) of the Income Tax Act and provides that if the trust is funded by way of donations or similar dispositions, the capital gains may be attributed to the "donor". In the absence of such attribution rules, the vesting or non-vesting of the capital gain in a beneficiary shall determine whether the trust or the trust beneficiary is to be taxed. If the gain vests in a non-resident beneficiary, the gain shall be taxed in the hands of the trust, unless an attribution rule applies.

Paragraph 72 of the Eighth Schedule contains a provision similar to section 7(8) of the Act. Paragraph 72 provides that where a resident has made a donation to a non-resident and by reason of such donation a capital gain accrues to the non-resident, paragraph 72 shall deem the capital gain to be the donor's capital gain.

In addition to paragraph 72, sight must not be lost that sections 80A to 80L of the Act[20] may be applicable where CGT has been avoided, reduced or postponed through the use of trusts. Also if a trust is a sham, SARS can simply treat the "trust's" capital gains as those of the founder of the trust. Sections 80A - 80L of the Act may therefore result in the trust income being taxed in the hands of the founder or donor of the trust[21] .

Trustees therefore need to be cognisant of the fact that where a capital gain is derived from, or are attributed to a donation, settlement or other disposition made by a person, the amount of that capital gain may be subject to the attribution rules contained in paragraphs 68 to 72 of the Eighth Schedule. While paragraph 73 limits the total capital gain that can be taxed in the hands of that person to the amount of the benefit derived from that donation, settlement or other disposition by the person to whom it was made, the resident who is liable for payment of the tax

[19] Botha et al, The South African Financial Planning Handbook 2018, Lexis Nexis Durban, at page 864 - 865
[20] An "arrangement" as defined in section 80L is considered an impermissible avoidance arrangement if:
- its sole or main purpose was to obtain a tax benefit;
in the context of business or otherwise it was entered into or carried out in a means or manner which would not normally be employed for *bona fide* business purposes other than obtaining a tax benefit or in the context of business only, it lacks commercial substance.
[21] Davis DM *et al*, Estate Planning, 2018 – SI 52 at 6.1

is entitled to recover it from the non-resident who is actually entitled to the proceeds on the disposal of such asset. Paragraph 80(2) of the Eighth Schedule of the Income Tax Act is subject to paragraph 72 of the Act.

Paragraph 80(2) provides:

"(2) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect *of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than a person, organization, entity or club contemplated in paragraph 62(a) to (e)) who is a resident has a vested interest or acquires a vested interest (including an interest caused by the exercise of a discretion) in that capital gain but not in the asset, the disposal of which gave rise to the capital gain, the whole or the portion of the capital gain so vested*

(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the gain vests."

In summary, the capital gain determined in respect of a disposal will, in terms of paragraph 80, be taxed in the hands of the beneficiary in whom that asset vested unless that gain is attributed to another person in terms of paragraphs 68, 69, 71 or 72 of the Eighth Schedule.

The responsible taxpayer

Despite the critique against the effectiveness of section 7(8) and paragraph 72 it must be remembered that where any taxpayer does not account properly for assets outside the Republic, an amount of estimated foreign income will be subject to income tax. Therefore, failure to report foreign assets adequately will result in the inclusion in taxable income of a deemed amount of income based on the undisclosed foreign assets. This is given effect to by section 78 of the Act which provides that where the Commissioner has reason to believe that a resident has not declared or accounted for any funds or assets owned outside the Republic or where the income or capital gains from any funds or assets outside the Republic could be attributed to that resident in terms of section 7 or Part X of the Eighth Schedule, the Commissioner must estimate the amount of foreign currency of such funds or the market value of such assets. The Commissioner may estimate the value after taking into account any information at his or her disposal which includes information relating to:

- any funds or assets transferred by that resident from the Republic;
- any amount received by or accrued to that resident from any source outside the Republic; or
- the period that has elapsed since those funds or assets were transferred, or amount was received or accrued.

The estimated taxable income is calculated by applying a percentage equal to the "official rate of interest" as contemplated in the Seventh Schedule to the estimated value of those funds or assets.

In addition to the above , section 7(10) of the Act, which came into operation on 1 January 2001 and applies in respect of years of assessment commencing on or after that date, compels any resident who, at any time during any year of assessment, makes any donation, settlement or other disposition contemplated in section 7 to disclose such fact to the Commissioner, in writing, when submitting his/her income tax return for such year and, at the same time, furnish such information as may be required by the Commissioner for the purpose of section 7[22].

The role of the trustees of the Jones Family Trust

If the trustees of the Jones Family Trust had a meeting and independently, without undue influence from Mr Jones and any beneficiary, applied their mind on whether to distribute any trust income, then the trustees may, in their discretion provided by the trust deed, distribute so much of the income available in the trust to any of the trust beneficiaries. It is however required from the trustees, before any such distribution is made, to realise that if such income is distributed to Vinnie, as a non-resident beneficiary, such income may be taxed in Vinnie's hands. However, where the income to Vinnie is attributable to a donation or other similar disposition by Mr Jones, as in extant case, such income shall be deemed to accrue to the resident donor and shall therefore be taxed in the hands of Mr Jones, and not Vinnie. It is only in the absence of the applicability of section 7 of the Act, that the position shall be governed by section 25B of the Act.

Conclusion

Our intentions may be sincere but our actions may lead to unnecessary and unwanted results as evidenced by Vinnie who, in exercising his right to emigrate and continue to be a recipient of the Jones family Trust, is the effective reason why Mr Jones may be taxed on trust distributions. Trust beneficiaries wanting to emigrate, and still benefit from trust distributions received by a resident trust need to consider the possible tax effect that their relocation may have on the donor and in this regard should seek specialist advice prior to embarking on their new found adventure.

[22] Davis DM *et al*, Estate Planning, 2018 – SI 52 at 6.3.6B

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Section 11 (a) and Employee Share Trusts

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Introduction

Share incentive schemes involving employees have become popular to ensure that employees participate in the growth of the company and as a tool for employee retention. These schemes are usually underpinned by loans to the employee share trust or company to facilitate the purchase of shares in the company.

This deduction of such a loan for tax purposes in terms of section 11(a) of the Income Tax Act (hereinafter referred to as "the Act") was the focus of the court case S G Taxpayer vs. Commissioner for The South African Revenue Services.[1]

Section 11 (a) of the Act:

Section 11 (a) of the Act provides as follows:

"*For the purposes of determining taxable income derived by any person from carrying on a trade there shall be allowed as deductions from the income of such person so derived:*

(a) *Expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature."*

Section 23(g) of the Act:

Section 23(g) does not allow a deduction of moneys, to the extent that such moneys were not laid out or expended for purposes of a trade.

Facts - S G Taxpayer vs. The Commissioner for The South African Revenue Services[2]

The taxpayer was a company that was a subsidiary of the holding company. The subsidiary company (the taxpayer) established a share incentive scheme for identified key management staff. In terms of the agreement the purpose of the scheme was to incentivise and retain the key managerial staff and provide a long-term equity plan over and above short-term incentives.

The holding company established a discretionary trust on 30 November 2004 and the holding company was the beneficiary of the trust until 13 December 2010. The subsidiary company provided an amount of R48 million to the Trust for the implementation of the scheme. The trust purchased a shelf company and the eligible management staff were allowed to purchase

[1] IT14624 [2018] ZATC 1 (9 May 2018)
[2] Footnote 1 supra

shares in this company at par value on 15 December 2004. The said staff were not allowed to trade these shares for 7 years and if they left the company prior to the expiration of the 7 year period, they would forfeit their shares to the remaining shareholders.

On 20 December 2004, the shelf company's share capital was used to issue 1000 preference shares. The trust subscribed for them using the R48 million. The shelf company used these proceeds to purchase shares in the holding company.

At the end of the 5-year period the holding company's shares had increased in value. The 1000 preference shares were cashed and undeclared dividends from the shelf company were paid to the trust. The redemption of the preference shares and the payment of dividends were settled by transferring the equivalent value of holding company shares to the trust. The shelf company sold the balance of these shares for cash.

On 13 December 2010 the employees were included as beneficiaries of the Trust. The subsidiary's contribution of R48 million was not repaid to it by the Trust. The annual financial statements of the Trust reflected that the cash was not transferred to the holding company and a loan was reflected as payable to the holding company. After termination of the scheme the shelf company was deregistered on 10 December 2012.

The subsidiary claimed the contribution of R48 million as a deduction against its taxable income in terms of s 11(a) of the Act. The deductions were disallowed because the SARS stated that the expenditure was not incurred in the production of taxable income as there was not a direct or causal link between the contribution of R48 million and the production of income. The SARS further stated that as the holding company was the sole beneficiary of the trust it would be the only party to have benefited directly from the R48 m contributed to trust and the employees were not participants in the trust. Further, the SARS argued that if the taxpayer's sole purpose was to incentivise the participants, they should have been the beneficiaries of the R48 million directly.

Requirements for connection between expense and income:

According to the court, one needs to assess the closeness of the connection between the expense and the income. The court stated the following in paragraph 34 of the judgment: "**The causal connection is not necessarily established by reference only to the incurring of the expense**

and the initial use to which it is put. It is the purpose of the expenditure – from the taxpayer's perspective – that must be considered, together with what that expenditure actually effects i.e. causes to happen or brings about."[3]

The following court cases were referred to in the judgement: **Port Elizabeth Electric Tramway Company Limited v CIR:[4]**

The court looked at the type of expenses that can be deducted and the closeness of the expenditure to the business operation. The court concluded that expenses attached to the performance of the business and carried out for the purpose of earning income are deductible "whether such expenses are necessary for its performance or attached to it by chance or are genuinely incurred for efficient performance provided they are so closely connected with it that they may be regarded as part of the cost of performing it" (paragraph 35).

CIR v Genn & Co. (Pty) Ltd[5]:

The court stated that reason of a company was to make profits and in effecting policies against fire was to continue making profits by providing for any losses it incurs in the event of a fire. The payment of the premium for the policy was for the purpose of earning income and the fact that no income was earned was irrelevant (paragraph 36).

CIR v Pick 'n Pay Wholesalers (Pty) Ltd[6] and CIR v Pick 'n Pay Employee Share Purchase Trust.[7]

The court held that if the taxpayer proved that the expenses incurred was to produce income, any unintended benefit to a third party or the realisation of other possibilities did not prevent the deduction of the expense (paragraph 38).

[3] Paragraph 34 of the judgment cited in footnote 1 supra
[4] 1936 CPD 241 at 16 and 17-18
[5] 1955 (3) SA 293 AD at 299C
[6] 1987 (3) SA 453 AD at 469-70
[7] 1992 (4) SA 39 AD at 55F-G

Solaglass Finance Co (Pty) Ltd v CIR[8]

The court stated that a court must look carefully at the evidence. If there is credible evidence about a taxpayer's purpose it is not open to the Court to turn what is in reality a consequence into a purpose and ascribe that to the taxpayer (paragraph 41).

Decision - S G Taxpayer vs. The Commissioner for The South African Revenue Services[9]

The transactions underpinning the scheme were not simulated or a sham. The contribution of R48 million which the taxpayer made to the trust was not made with the sole purpose of vesting that money in the holding company or to pay to the holding company without paying tax.

The purpose in creating and executing the scheme was to protect and increase the business of the taxpayer through motivation of key staff to be efficient and productive and remain as employees. The incentive was offered to and received by the employees. There was a financial benefit that would accrue to the subsidiary company and the holding company. However, this financial benefit cannot prevent the subsidiary company from claiming the payment of R48 million as a deduction for the purpose of earning income. The purpose of the expenditure was to incentivise the key staff through a scheme which facilitated the acquisition of an indirect investment in the shares of the holding company for scheme participants.

The purpose of the incentive scheme was:[10]

- "to encourage these employees to grow or increase the value of their indirect investment in holding company by contributing to the success and profitability of the taxpayer's business;
- to encourage employees with the required skills, knowledge and experience to remain in the taxpayer's employ;
- to facilitate, for the taxpayer, the retention of staff members with the skills and experience to maximise the profitability of its business and prevent crucial knowledge and experience being lost to the taxpayer through staff turnover; and
- thereby to preserve and enhance the income earning capacity of the taxpayer's business. "

[8] 1991 (2) SA 257 AD
[9] Footnote 1 Supra
[10] Paragraph 47 Footnote 1 supra

In terms of the trust deed the R48 million could only be used to capitalise the shelf company which had to purchase shares in the holding company. This was in line with the intention of the subsidiary company to allow the key staff to have an indirect investment in the holding company.

The fact that the holding company benefited did not detract from subsidiary company's purpose for setting up the incentive scheme. The increase in the value of the holding company was directly linked to the increase in the turnover and profits of the subsidiary company, being the main operating subsidiary of the holding company, which in turn was linked directly to purposes of the incentive scheme (as mentioned above). The subsidiary company established the existence of a "sufficiently close causal link between its expenditure viz. the contribution of R48 million to the Trust and its income producing operation." [11]

Conclusion

The above case clearly demonstrates that the deduction of expenditure in the production of income does not preclude any incidental benefits that may flow from it. These incidental benefits should further not prevent the taxpayer from claiming the tax deduction for expenses incurred. It is important to determine a sufficiently close connection between the expenses incurred by the taxpayer and the production of income.

[11] Paragraph 51 of the judgment cited in footnote 1 Supra

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Taxation of Minors

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Introduction

Many are of the opinion a minor child can only be registered as a tax payer when he or she becomes a major at 18 years old, and until such time the parents of the child are liable for their tax liability or there will just be no tax payable. This view is not correct. In certain circumstances parents do become liable for the payment of tax imposed on the income or investment of their children, but outside these circumstances minor children do become liable to pay tax in their own name.

Once a person's income exceeds the tax threshold amount, that person is obliged to register as a tax payer. Every person who becomes liable for income tax or becomes liable to submit a tax return must apply to the Commissioner of South African Revenue Services to be registered as a taxpayer.[1] A minor child is not excluded from becoming a registered taxpayer.

Minor children are taxed in their own name on income which is received or accrues to them, unless section 7 of the Income Tax Act[2] deems the income to be received by the child's parent/s.

Circumstances under which parents become liable for the tax of their minor children:

In the applicable legislation the phrase 'donation, settlement or other similar disposition' is referred to, hence understanding what is meant by a 'donation, settlement or other similar disposition is relevant to discuss at this point:

Donation – it is a wholly gratuitous disposition which contains no element of commerciality.

Settlement – "the transference of property to a beneficiary or trustees for the benefit of a beneficiary usually upon specific terms and conditions set out on a deed of settlement"[3]. This type of settlement must have been made gratuitously out of liberality or generosity[4].

Disposition – In two Supreme Court cases it was decided that "other disposition should be interpreted as having the same meaning as *donation and settlement* and that the section should read as "*donation, settlement or other similar dispositions"*[5] and it excluded transactions made for full value in money or money's worth. There had to be an element of liberality[6]. An example of a disposition would be a loan that is interest-free, or is given at an interest rate lower than an

[1] Income Tax act No. 58 of 1962, Section 66
[2] *Id section 7*
[3] Edward Daniel Carroll, SARS ability to attribute Trust Income and capital gain to a donor parent- mini dissertation , page 13<http://www.dspace.nwu.ac.za/bitstream/handle/10394/4820/Carroll_ED.pdf?sequences=2>
[4] *Id* at *13*
[5] Ovenstone v SIR 1980 AD
[6] Joss v SIR (1980 TPD)

arm's-length rate of interest, and is thus regarded as a disposition[7]. The loan is not the disposition, but the non-charging or lower rate of interest charged is the disposition.

Edward Daniel Carroll best describes this phrase as follows:[8]

"Before an amount of income can be attributed to a donor-parent the following fundamentals need to be present.

- There must be a donation settlement or other disposition.
- The income, and the donation, settlement, or other disposition must be causally linked i.e. the donation needs to be the "real efficient cause" of the income accruing to the minor beneficiary.
- Once this link has been established it becomes necessary to examine the disposition in order to determine the extent of the gratuitousness involved.
- Where the disposition is wholly gratuitous or is appreciably gratuitous not only is the link established but an apportionment can be effected. "

A common thread runs through the phrase "donation, settlement or other similar disposition" which is a disposal of property to another, other than for due consideration i.e. "other than commercially or in the course of business"[9].

In terms of section 7(3) of the Income Tax Act[10] if a parent made a donation, settlement or other similar disposition to their minor child which has resulted in:

- The minor receiving income; or
- Income accruing to or in favour of the minor child; or
- Income being expended for the maintenance , education or benefit of that minor child; or income accumulated for the benefit of the minor child,

such income will be deemed to be the income of the parent who made the donation[11].

Example 1: Mr Smith donates shares worth R500 000 to his child Thomas who is 10 years old. Any income resulting from this donation will be taxed in the Mr Smith's hands i.e. any interest or dividends generated.

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[7] Kari Lagler, Personal Finance 10 February 2016, Tax: Beware of "deeming" <http://www.iol.co.za/personal-finance/tax/tax-beware-of-deeming-1982693>
[8] Supra Carroll note 3 at 28
[9] *Id at* 19
[10] Supra, note 1 in section 7(3)
[11] Phillip Haupt, Notes on South African Income Tax at page 232 (2017) , H and H Publications

Example 2: Mrs Smith sells a house to her family trust. She lends the trust R3 000 000 interest free for the purchase of the house. At the time, the prevailing interest rate is 8%. At the end of the tax year the trust earns rental income of R300 000. The trust distributes R150 000 to Thomas (10 years old) and to Timothy (20 years old).

The donation value of the interest free loan is R240 000 (R3 000 000 X 8%). Since Thomas receives 50% of the income distributed, Mrs Smith will be taxed on R120 000 being 50% of the donation value and Thomas will be taxed on the remaining R30 000 of the income. Thomas is a minor child and the income resulted from the "disposition" of an interest free loan made available to the trust of which the minor, Thomas is a beneficiary. Timothy on the other hand will be taxed on his portion of the distribution of R150 000 as section 7(3) will not apply to him since he is not a minor.

If Mrs Smith charged a fair rate of interest on the loan, section 7(3) would not apply and Thomas would be liable to pay income tax in his hands.

Section 7(4) of the Income Tax Act also closes the loophole of a "cross donation". The income of a minor child is deemed to be the parent's income if that parent has made a donation, settlement or disposition or given some consideration to some other person or that other person's family in return for a donation, settlement or other disposition by that person to the parent's minor child[12]

The above section 7(3) and 7(4) also apply to income received by minor stepchildren, adopted children and illegitimate children.

Paragraph 69[13] attributes any capital gain to a parent of a minor child if a minor child makes a capital gain as a result of a donation settlement or similar disposition made by the parent to their child. It is a mirror image of section 7(3) of the Income Tax Act except that it applies to the disposal of capital assets and capital gain made as a result thereof.

Example 3: The same set of facts as in example 1 above. If Thomas sells his shares when he is 16 years old and makes a capital gain of R180 000, Mr Smith will be taxed on the gain of R180 000

Example 4: Same set of facts as in example 2 above. The trustees of the trust decide to sell the house exactly 2 years later and the trust makes a capital gain of R1 000 000 in respect of the sale. If the trustees distribute this gain in the same tax year to Thomas and Timothy equally, paragraph 69 will apply to Thomas only as he is a minor.

[12] *Id* at 233
[13] Supra, note 1 in Eighth Schedule

Since there has been a donation, settlement or other disposition made in that no interest was charged on the loan, the following interest would have been payable had the prevailing interest rate of 8% been charged on the loan in the last 2 years:

Year 1 – 3 000 000 X 8%	R240 000
Year 2 – 3 000 000 X8%	R240 000
Total of donation value	R480 000

Under paragraph 69[14] R240 000 (50% of the donation value) of the capital gain of R500 000 being Thomas's share of the gain will be taxed in the hands of Mrs Smith while R260 000 of the gain will be taxed in Thomas's hands. Timothy, being a major will be liable for the tax on his portion of the gain distributed to him.

Unit trusts are a common investment for parents to invest in the names of their children. It is flexible and an easy-to-access investment. It is important for parents to know that if they donate money in to an investment for their minor children or transfer an investment to their minor children the income will be taxed in the parents hands in terms of section 7(3) if the Income tax Act. If the units are later sold at a capital gain, paragraph 69 of the attribution rules of the Eighth Schedule will apply and the capital gain will be included in the parent's hands and not that of the minor child.

Circumstances under which a minor child will be liable to pay tax in his or her own hands:

Minors are liable for tax on the income generated from the money they inherit or receive as a gift/donation from anyone other than their parents, such as grandparents.

The actual amount of the donation, lump sum or inheritance will not be taxed in the child's hands but rather the growth on the investment will be i.e. any interest and /or dividends generated from the investment.

Minor children who are invested in life wrappers and endowment type investments will be taxed within the product. There is no exclusion for minor children.

Minor children invested in a lisp wrapper and unit trust type of investment will be taxed in their own hands at their marginal tax rates. They will also be entitled to allowable exemptions, deductions and the annual primary rebate. In the event of disinvestments capital gains tax may be payable by the minor child.

[14] Supra, note 1 in the 8th Schedule

Minors who are awarded retirement benefits of a deceased fund member and transfer the benefits into an annuity as well as minors who are beneficiaries of a living annuity and opts for the annuity to be continued, will be taxed in their own hands. They must be registered as tax payers should their income be above the tax threshold.

The recently launched tax-free savings investment allows individuals to earn tax free returns on investments. This is a common type of investment in which parents and grandparents invest their children and/or grandchildren i.e. in the name of the minor. As the name indicates, there is be no tax payable on the investment return but there is a hefty penalty if the annual investment limit (currently R33 000 per annum) or the total investment limit (R500 000) is exceeded.

Inheritances received by minor children are often held in a testamentary trust. As long as the youngest beneficiary is a minor, the testamentary trust will be regarded as a special trust and taxation will not be at the usual flat rate of 45% applicable to trusts. The income received by this special trust will be taxed on the sliding scale applicable to individual persons. Personal rebates and medical tax credit however do not apply.

Conclusion

Many parents, grandparents and other family members wish to provide gifts to minors. In so doing the tax implications must be considered. As the focus of this article is on the taxation of minors, the donations tax implications for the donor and the effect of low- or no-interest loans to trusts[15] have not been covered but should by no means be disregarded. Section 7 (3) and (4) and paragraph 69[16] are anti-avoidance tax measures to prevent parents of minors splitting their income and/or divesting their estates of assets to reduce its value in order to avoid payment of taxes.

[15] Supra, note 1 in section 7C
[16] Supra, note 1 in the 8th Schedule

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Trusts and CGT: The Impact of Section 7C and the Anti-Avoidance Measures on the Conduit Principle

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Introduction

Section 7C of the Income Tax Act was introduced on 1 March 2017 and is applicable to all low-interest or interest free loans to trusts by connected persons.

This section was further expanded on 19 July 2017 to further include loans made by connected persons to companies, which are owned by trusts, and to which that person is a connected person.

The purpose of this article will be to explore the possible impact that Section 7C, together with the existing anti-avoidance measures, might have on trusts from a Capital Gains Tax (CGT) perspective, focusing specifically on the trustees' authority to vest the capital gains in the hands of beneficiaries through the conduit principle.

The conduit principle

In South Africa, trusts pay income tax at a rate of 45%. Section 25B of the income Tax Act[1] (the Act) however stipulates that income or capital gains that have been distributed to beneficiaries will be taxed in the hands of the beneficiary, subject to the anti-avoidance measures contained in section 7 of the Act. These measures will be discussed in more detail below.

One significant aspect of this provision lies therein that the inclusion rate of a trust for CGT is 80% whilst the inclusion rate for individuals is 40%. These taxable capital gains are taxed at 45% in the hands of a trust and in the case of an individual at such person's marginal rate of tax, (i.e. a maximum rate of 45%). The effective rates at which CGT is levied are thus 36% for trusts and up to 18% for individuals. Therefore planners and trustees often opt to vest gains in the trust beneficiaries to make use of the lower effective rates for individuals.

Anti-avoidance measures and interest free loans

Section7 and 80A of the Act contains certain anti-avoidance measures which were implemented to prevent tax avoidance. .

Section 7(3) of the Act provides that the parent of a minor can be taxed where a donation, settlement or other disposition took place. With an interest free/low interest loan, the donation takes place if there is no interest levied or the interest rate levied is lower than the prescribed rate. It is furthermore only applicable where it is the parent of the minor who made the loan.

In essence, should SARS be of the view that a tax avoidance scheme was entered into, they may tax the person who is trying to avoid the tax.

[1] Income Tax Act 58 of 1962

Section 7C and donations tax

Section 7C of the act stipulates that loans owed by trusts to individuals, who are connected persons, should attract interest at a rate equal to the official rate of interest (currently 7.5%). Should the rate charged be less than the prescribed rate or no interest is charged, an amount equal to the difference of the interest rate charged and the prescribed rate will be a deemed donation by the individual who made the loan.

This deemed donation will attract donations tax and the individual concerned will be liable to pay the tax. The normal donations tax provision are applicable and therefore the R 100 000 annual donations tax exemption is factored into the calculation of the donations tax that is payable, where the donation is made by a natural person.

The difficulty that accounting professionals, planners and trustees are faced with is that, in the days prior to Section 7C, the annual donations tax exemption amount of R 100 000 was usually utilised by the person who made the interest-free loan in order to reduce the loan account over time. Since the implementation of Section 7C, non-compliance with the requirement of charging interest at the official rate the resultant deemed donation provision leads to the situation that an individual's R 100 000 exemption might be taken into account when calculating the donations tax payable as a result of the non-charging of interest. The exemption may therefore not be available to decrease the loan account still owing to the individual.

It is recommended that the trustees need to seek the guidance of their auditors in order to ascertain what the best approach is relevant to that trust's own circumstances.

CGT Consequences

The effect of the above will be best illustrated by way of an example.

Pre Section 7C:

Mr. A transferred a property to a trust and an interest-free loan account was created as a result of the transfer. He subsequently donated R 100 000 per annum of this loan account back to the trust which could have led to the loan account being diminished after a few years. If we assume that the trust sells the property after 10 years and no amount is owed on the loan to Mr. A, there is a capital gain made by the trust.

If the trust deed makes provision that the capital gain could be vested in the beneficiaries of the trust such gains will be taxed in their hands (irrespective of the fact that the beneficiaries may for example be minor children of Mr. A): because there is no amount owing by the trust to Mr. A, there is no donation, settlement or other disposition made by Mr. A, and the relevant provisions of section 7 will not be applicable. The beneficiaries would each pay CGT on their personal

inclusion rates and marginal tax rates as opposed to the higher rates applicable to trusts as discussed above.

Post Section 7C:

The same scenario applies, but as a result of the measures put in place by Section 7C, Mr. A is not able to lower the loan amount by way of donations and has an annual donations tax liability.

When the trustees decide to sell the property there is thus still an amount owing on the loan as it has not been repaid in full due to Mr. A's R100 000 donations tax exemption being used for purposes of the deemed donation related to the non-charging of interest.

This may bring the anti-avoidance measures contained in section 7 of the Act into play which might lead to a part of the capital gain being taxed in the hands of Mr. A (the person to whom the loan is repayable) as opposed to being taxed in the hands of the minor beneficiaries in whom the gains were to be vested.

The importance of these provisions lie in the fact that trustees usually vest income and capital gains in beneficiaries who have lower marginal rates, in order to make use of such lower rates as a means of saving tax.

It is also often the case that individuals who create trusts are taxed at a high marginal tax rate and have substantial estates.

If trustees decided to vest gains in beneficiaries to make use of their lower marginal rates of tax and SARS are of the view that the anti-avoidance measures are applicable and the gains must be taxed in the hands of the donor, the donor's marginal rate will be used, and as such more tax will be payable.

Conclusion

It is advisable that trusts repay loan accounts as far as reasonably possible. This needs to be done in order to prevent the impact of the anti-avoidance measures when the trustees decide to distribute capital gains to minor beneficiaries in the instance where a low-interest or interest free loan is granted to the trust by a person connected to the trust and especially where that person is the parent of minor beneficiaries of the trust.

From the above it is evident that financial planners need to be sure of the implications that interest free loans and Section 7C have on their clients' affairs and also ensure that the correct advice is given to their clients when dealing with such matters.

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The Capital Gains Tax Implications of Land Expropriation and Possible Roll-Over Relief

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Introduction

Expropriation of property, whether it is land or any other property, may have tax implications even if the disposal was not voluntary. This article aims to provide more clarity on the Capital Gains Tax (CGT) consequences of the involuntary disposal of property. The scope of this article is not to discuss expropriation without compensation but where some form of compensation has been received.

CGT is, generally speaking, applicable where there is a disposal of an asset that is capital in nature. When land or an asset is repossessed, with or without compensation, CGT may apply as a disposal of that asset has occurred. Paragraph 11(1) of the Eight Schedule to the Income Tax Act specifically defines expropriation as a form of disposal for CGT purposes.[1] However, the Income Tax Act does offer some relief for taxpayers who had their property expropriated.

CGT roll-ever relief in Paragraph 65 of the Eight Schedule to the Income Tax Act

Paragraph 65 of the Eight Schedule to the Income Tax Act[2] enables a person to elect to defer a capital gain when an asset has been disposed by way of operation of law, theft or destruction. Financial instruments, like shares, are however excluded from this provision[3]. Paragraph 65 determines that if an asset is expropriated, lost, stolen or destroyed and a person receives compensation (such as an insurance pay-out) at least equal to the base cost of the asset and the proceeds are used to acquire a replacement asset, the capital gains made can be deferred until the replacement asset is disposed of.

However before a person can defer the payment of capital gains tax as mentioned, the following requirements must be met[4]:

- The asset must be disposed of by way of operation of law, theft or destruction. Expropriation is seen as an operation of law;
- The proceeds must accrue to the person by way of compensation. For example an insurance pay-out or compensation for the expropriation of land;
- Another important consideration before paragraph 65 can apply is that proceeds of the disposal must be equal to, or exceed, the base cost of the asset that has been disposed of. So it must be a capital gain or break-even situation. When a capital loss arises, this provision does not apply.[5]
- The person must satisfy the Commissioner that the full proceeds will be reinvested in a replacement asset or assets. If less than all of the proceeds is used to acquire the replacement asset, paragraph 65 will not apply. The replacement asset however may cost more than the asset which is replaced.

[1] Paragraph 11(1) of the 8th Schedule to the Income Tax Act
[2] Act 58 of 1962
[3] Paragraph 65(1) of the 8th Schedule to the Income Tax Act
[4] Paragraph 65(1)(d) of the 8th Schedule to the Income Tax Act
[5] SARS Comprehensive Guide to Capital Gains Tax (Issue 6); page 508

A very important consideration in this paragraph is that the replacement asset must fulfil the same function as the old asset. For example, if a person receives compensation for the expropriation of a farm and invests the proceeds in shares in a company, the roll-over relief in paragraph 65 will not apply. A new farm must be acquired with the compensation received. The taxpayer may however purchase the shares of a company in which the replacement farm is registered;

- The replacement asset may be moveable or immoveable, tangible or intangible, but the replacement asset cannot be a personal-use asset as defined.[6] The replacement asset must be from a South African source. It thus seems then that although it will be possible to replace a farm that was situated in South Africa with another farm that is situated in South Africa, it would not be possible to replace such a farm with one outside of South Africa if the taxpayer wishes to rely on the above provision.[7]

  If the replacement asset is a moveable asset, it must not be attributable to a permanent establishment outside of South Africa and no other government other than the South African government may tax the asset;[8]

- The replacement assets must be acquired within 12 months of the date of loss, destruction or disposal (the contract to replace must be signed within 12 months);
- The replacement assets must be brought into use within 3 years after the date of loss, destruction or disposal;
- These periods can be extended by up to 6 months each if reasonable steps had been taken by the taxpayer.
- Where the taxpayer has acquired more than one replacement asset, the deferred capital gain tax must be apportioned between the replacement assets.[9]

A person making the election in terms of paragraph 65 must then disregard the capital gain in the year of disposal subject to:[10]

- Paragraph 65(4), which spreads the capital gain in proportion to capital allowances on any depreciable replacement assets;
- Paragraph 65(5), which triggers the capital gain (or in the case of depreciable assets, any untaxed remaining portion of it) when the replacement asset is disposed of; and
- Paragraph 65(6), which triggers the capital gain if a contract for the replacement asset is not concluded or the replacement asset is not brought into use within the prescribed periods.

[6] Paragraph 65(7) of the 8th Schedule to the Income Tax Act
[7] Section 9(2)(j) of the Income Tax Act
[8] Section 9(2)(k) of the Income Tax Act
[9] Paragraph 65(3) of the 8th Schedule to the Income Tax Act
[10] SARS Comprehensive Guide to Capital Gains Tax (Issue 6), page 510

Examples of the working of Paragraph 65

Example 1 – Hold-over of gain resulting from the involuntary disposal

Fred bought his farm in 2008 for R2 million. He did not make any improvements and the base cost for CGT purposes can be assumed to be R2 million. In March 2017 Fred's farm was expropriated and Fred received the amount of R5 million as compensation in July 2017. Fred signed a contract to buy another farm for R6 million in February 2018.

Because Fred has received compensation for a disposal by way of law (expropriation) and he has signed a contract to replace the expropriated assets for more than the compensation he received, he may elect to use the roll-over relief contemplated in Paragraph 65 and will therefore not be liable for CGT on the disposal of his property. The capital gain on the disposal of the original property is R3 million and this gain will be held over until the replacement asset is sold.

Example 2 – Personal-use replacement of asset

John owned an aircraft which he used in his charter business. The aircraft cost him R1.5 million in 2013. The aircraft was destroyed in an accident in 2017 and the insurance company paid him R2 million, which was the replacement value of the aircraft. John decided that he was not going to conduct aircraft chartering anymore and he purchased a new aircraft that he exclusively uses for personal purposes, for R2.4 million.

John may not elect to use the roll-over relief offered in paragraph 65 because he replaced the lost asset with a personal-use asset and therefor falls foul of limitations in Paragraph 65(7). The R500 000 capital gain on the original asset will be subject to CGT.

Final considerations and conclusion

It is important to note that if the taxpayer does not replace the asset as per the requirements of Paragraph 65, CGT will be payable as normal in the year of disposal. Furthermore, if the replacement asset costs less than the proceeds of the sale or compensation received, the roll-over relief offered in Paragraph 65 will also not apply. If the disposal of the asset happened in the normal order of business as a sale on a voluntary basis, and not because of the involuntary expropriation of the asset, Paragraph 65 will also not apply and CGT will payable on the disposal. If the proceeds of the disposal is less than the base cost, the taxpayer will suffer a capital loss and the normal rules with regards to capital losses will apply. The assessed capital loss will be carried forward to the following years of assessment.[11]

It can be argued that if a person's property is expropriated without compensation on an involuntary basis there will be capital loss, because the base cost will most probably exceed the proceeds (as there were no proceeds). This loss will be rolled-over to following years of

[11] Paragraph 4 of the 8th Schedule to the Income Tax Act

assessment.[12] The relief offered in paragraph 65 will most probably not apply because the taxpayer did not receive any proceeds from the disposal to trigger a capital gain and the purchasing of a replacement asset will therefore also not be applicable.

In conclusion it must be noted that the consequences of expropriation without compensation is not specifically addressed in current legislation. There is the possibility that more legislative insight will be provided when the final details on how and when implementation of expropriation without compensation will happen is made available.

[12] Paragraph 4 of the 8th Schedule to the Income Tax Act

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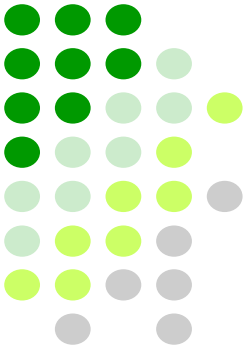

Investments

Stokvels- An Icon is Reborn

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Introduction

It is reported that during the early 19th century English settlers in the Eastern Cape held rotating cattle auctions known as "stock fairs" where members would pool resources to trade livestock. It is here where the name "stokvels" originated, also known as "istoki", "societies", "umgalelo", "gooi-gooi", "investment clubs", "saving-association", "stockfel", "stockfair", "mahodisana", "kuholisana", "chita" etc.[1]

With well over 810,000 registered stokvels and the National Association of Stokvels South Africa (NASASA), holding over 11 million local participants at the end of 2017, the South African stokvel economy is worth more than R49 billion[2] , and these figures are all steadily growing. In order for the investment and financial services community to fully understand the power stokvels wield, this article offers an introduction to stokvel basics. The aim of this article is thus to acquaint financial planners with stokvels and to assist in yielding a better service of this robust industry and bring it into mainstream financial world.

Body

The term "stokvel is defined in section 1 of the National Credit Act[3] as follows:

"stokvel" means a formal or informal rotating financial scheme with entertainment, social or economic functions, which-

a) consists of two or more persons in a voluntary association, each of whom has pledged mutual support to the others towards the attainment of specific objectives;

b) establishes a continuous pool of capital by raising funds by means of the subscriptions of the members;

c) grants credit to and on behalf of members;

d) provides for members to share in profits from, and to nominate management of, the scheme; and

e) relies on self-imposed regulation to protect the interest of its members;

A stokvel is thus a group of individuals who each make regular a contribution of funds which once pooled together are used in line with the group's common objective. It is often for financial purposes but can also be for social purposes, as the group self-determines how the funds are shared. It is ideal that the participants of a particular stokvel share a common value set and are like-minded in order to make their dynamic work. Stokvel objectives can differ widely, ranging

[1] http://muhaz.org/law-of-business-enterprises-300-onr300.html accessed 25 September 2018
[2] Old Mutual Savings and Investment Monitor Survey 2017 https://www.oldmutual.co.za/docs/default-source/personal-solutions/financial-planning/savings-and-monitor/latest-research-results/omsim_2017.pdf
[3] 35 of 2005

anything from providing for education to participant families; being a means savings for participants; utilising the power of collective savings to purchase wholesale groceries at discounted prices to being a means of investing funds on stock exchanges which require high minimum investments. The common thread in each however are saving towards a specific goal.

The legal nature of stokvels

Stokvels are typically not juristic persons, and do not enjoy separate existence to that of its participants like a company or close corporation. The legal arrangement which stokvels most resemble and often are, are partnerships.

A partnership is

1) A legal contract

2) Between two to twenty persons

3) Where each person contributes money, skill, labour or assets

4) To a common stock/ pool i.e. the partnership property

5) To carry on business with the objective of making a profit

6) For their mutual and joint benefit[4] .

From this we see that stokvels *may* often comply with this definition of a partnership, although stokvels participants usually contribute **funds** on a regular basis and not labour, skill or other assets. It is also common for stokvels to have participants in excess of the twenty person limitation.

In terms of similarities the stokvel is not a separate legal entity and the participants jointly share in the ownership of the stokvel property. It would seem a stokvel is therefore an anomaly in terms of its legal identity.

[4] Juta and Co-Gibson: South African Mercantile and Company Law Seventh edition 1999. Visser, Pretorius, Sharrock, Mishcke pg 247

Benefits and risks associated with stokvels

BENEFITS	RISKS
Invitation only allow for like-minded people to join.	Not having a properly constitution.
The social pressure of making regular contribution provide disciplined saving	The compulsory contributions could be burdensome on some participants
Each participant stands to gain	There is a perception that the informal nature also means that it is unstructured.
Flexibility of objective. Stokvel rules can be varied to suit a stokvel's particular needs.	If used only as a savings means for revolving withdrawals, it will yield low growth where banks invest the funds at lower interest rates[5].
Easy access of low income earners into savings market.	Poor governance.
Access to loans for participants.	Loans are not as generous as financial institutions.
Completely self-regulated.	Poor governance could make stokvel vulnerable to corruption.
Trust and familiarity between participants is vital.	Risk of funds being stolen where there is no accountability or funds not stored securely[6].

An icon reborn – The investment stokvel

There is no doubt that investment and savings stokvels directly influence a culture of saving and growing wealth. By identifying the pitfalls of stokvels but at the same time revering its strengths, financial institutions are able to service the stokvel industry better. Many financial institutions have come, and some are still coming on board by developing products which provide long term

[5] SA stokvels generate R44 bn each year-but members reap little reward by Rudzani Muluadzi www.gsb.uct.ac.za/stokvels accessed 25/09/2018
[6] https://en.wikipedia.org/wiki/Stokvel accessed 1 October 2018

investment options to stokvels in a way which supports principles of good governance and sound financial advice.

Partnering with a financial advisor allows an investment stokvel to align their stokvel objective and end goal with a sound financial plan. The stokvel itself would be the investor and the risk profile should thus be determined by the stokvel's objectives.

Principles of investment planning should be applied which include:

- Investing at regular intervals over the long term;
- Keep on investing through market lows when share prices are undervalued, so that you gain more wealth during the highs.
- Investing in a diversified portfolio so that when one part of the market does not perform, it is balanced out by another part of the market that does. This diversification gives the stokvel portfolio a sensible balance between different types of investments.
- The benefit of "time in the market": there will always be times when one asset class outperforms another.
- Sufficient time in investment to earn compound interest.

Each stokvel investor is unique. A good investment for one individual is not automatically a good investment choice for another. A partnership with a financial planner will provide tailor made financial solutions to the stokvel investor.

Founding documents

Stokvels are entirely self-regulated. Participants can decide exactly who may join, when contributions are paid and what is to happen to the funds etc. While many existing stokvels fail to have any formalities, NASASA recommends that all stokvels have a constitution. Some clauses in a constitution could include the following:

- Aims and objectives of the stokvel
- Particular stokvel rules
- Who may qualify to join
- Outline of executive functions like treasurer, secretary, chairperson and how they are to be appointed
- How any transactions are to be effected
- How and when meeting are to occur
- Contribution amounts, frequency and method of payment

- When participants become entitled to any benefit and how it is to be calculated
- What happens at the termination of membership due to death or voluntary exit – this will determine how much an existing member/deceased estate is entitled to
- If the constitutions is altered how this is to be effected

The *essentialia* and typical clauses of a partnership agreement[7] could serve as guidance to what the constitution should set out. This assists the effective running of the group and ensures that there is a clear understanding amongst members.

In addition to its constitution it is also helpful to appoint authorised signatories and to provide for a resolution to be passed each time a transaction is entered into by the stokvel. As a new investor, a financial institution will be obliged to ensure that all FICA requirements are met by the stokvel.

Conclusion

Given the amount of stokvel participants in South Africa, it is becoming increasingly financially relevant to determine if clients participate in existing stokvels, in order to include it in a client's needs analysis. If a client already participates it is necessary to review the contents of the constitution to determine how the participation would affect a client's estate plan, succession plan or investment goals.

If the corporate sector makes an effort to better understand stokvels and its participants, it will allow financial planner to not only fully embrace it but also to service and assist stokvel members to reap the maximum benefits available.

[7] Juta and Co-Gibson: South African Mercantile and Company Law Seventh edition 1999.Visser,Pretorius, Sharrock, Mishcke pg 247- 257

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Taxes Payable on Crypto-Currency

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Introduction

Each coin has two sides, on the one side "the head" and the other side "the tail". Crypto-currencies, or most commonly referred to as "Bitcoins", have two sides, even though we can't see a Bitcoin or touch it. On the one side, let's call this the head side of the Bitcoin, a lot of people want to buy Bitcoins or wished they did so ten years ago and on the other side, the tail side, they want to believe that this is not an asset or form of investment for tax purposes.

There is a well-known saying that only two things in life are certain, namely death and taxes. We will pay tax during our lifetime on most income received, capital gains tax on growth of relevant assets and value added tax ("VAT") on products and services purchased. When a person dies his/her estate may have the following tax implications: estate duty, capital gains tax, income tax and VAT if registered as a VAT vendor.

A pertinent questions often asked in this regard is whether a person will pay taxes on crypto-currencies in South Africa. In order to answer this question, we need to understand this new form of "currency" and how it works before we can determine if tax is payable on this "asset" and if so, the type of tax or taxes that are applicable to crypto-currency.

History on development in technology

Over the past 50 years, technology has developed significantly. In the 60's we all used audio tapes or cassettes, in the 70's the colour television came out and the first portable computer (laptop) was introduced. In the 80's the first 3D video game "robot" and the digital cellular phones, as big as bricks, became available. In the 90's the first version of internet explorer was released and ABSA bank was the first bank in South Africa to introduce online banking. Most people believed that they would get scammed and lose the money in their bank account if they use online banking. Currently there are very few people who still use cheques as a payment method.

In the 00's the first smartphone was introduced, GPS devises became available and social networking sites such as Facebook started.

Today only a few people still write letters or even use faxes – we either send an email or send them an instant message using our cell phones. A lot of the younger generation cannot even fathom the concept of going to a library when information on a specific topic is needed. Today almost everybody uses Google to search for information.

There is a possibility that crypto-currency will become more and more part of our daily use in the future in the same fashion that we currently use internet banking.

What is crypto-currency?

The term "currency' is not defined in the Income Tax Act[1] (hereinafter referred to as "the Act"). There is a view that crypto-currencies nonetheless constitute currency[2]. The South African Reserve Bank ("the Reserve Bank") however chooses to call crypto-currencies, such as Bitcoins "cyber tokens", because they don't believe it meets the requirements to be classified as currency.

According to the Deputy Governor of the Reserve Bank, Francois Groepe, crypto-currencies" don't meet the current requirements of money in the economic sense of the stable exchange, a unit of measure and a stable unit of value.[3]

"The Reserve Bank does not currently manage, control or regulate virtual currencies or crypto-currencies, but is continuing its effort to monitor this area as it progresses. They want to ensure or establish whether there is still compliance with exchange control regulations with transferring, buying or selling of crypto-currencies within South Africa."[4]

An exchange control guideline regarding the position on the purchase and selling of crypto-currencies within the exchange control regulation, was introduced by the Reserve Bank. If you move your current crypto-currency to another country, or are buying or selling foreign exchange outside the permissible way of a single discretionary allowance of R1 million, or individual foreign investment allowance of R10 million per annum, you could be infringing exchange control regulations.[5]

SARS is of the opinion that although "currency" is not defined in the Act, crypto-currencies are not a South African tender or wide medium of payment or exchange. In this regard crypto-currencies are not regarded by SARS as a currency for income tax or capital gains tax (CGT) purposes. SARS regards crypto-currencies as an asset of an intangible nature[6].

The definition of "financial instrument" in section 1 of the Act was amended via section 1(1)(c) of the 2018 Taxation Laws Amendment Act[7] to include any crypto-currency.[8] Financial

[1] Act 58 of 1962
[2] Notes on South African Income Tax, P Haupt, 2018, H&H Publications, Chapter 21, 21.8, p 670.
[3] South African Reserve Bank defines crypto-currencies as tokens, not money. Money web Online. www.mybroadband.co.za/cryptocurrencies-as-tokens-not-money. (Published on 25 May 2018).
[4] *Ibid*
[5] South African Reserve Bank. Currency and Exchange guidelines for individuals. (2018) Pg. 11 – 14.
[6] SARS's Stance on the Tax Treatment of Cryptocurrencies, 6 April 2018, http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx
[7] Act 23 of 2018
[8] REPUBLIC OF SOUTH AFRICA Government Gazette Vol. 643 17 January 2019 No. 42172 Cape Town Kaapstad No. 19 17 January 2019

instrument means any interest-bearing arrangement or financial arrangement based on or determined with reference to a specified rate of interest or time value of money.[9]

Digital currencies, such as Bitcoin, are being scrutinised more and more by regulators. The management of these funds are becoming more difficult in some countries, because of the rate at which they are growing. "The Reserve Bank has established Fintech unit, a financial technology unit to review positions on private crypto-currencies. A suitable policy framework and governing rule on private crypto-currencies held within South Africa is being designed by this unit."[10]

Bitcoin is only one of many crypto-currencies available, but it is the most common crypto-currency used by South Africans.

A Bitcoin is an online payment method according to Satoshi Nakamoto, who published his invention and released this open-source software to the world in 2008. According to Satoshi the Bitcoin system is a one-to-one system, i.e. a payment from one wallet to another wallet. Users can transact directly with each other all over the world almost instantly, without needing intermediaries such as banks, Paypal or any other company. "You can use your Bitcoins to pay for products or services with lower fees than your typical credit card fees."[11]

How do you obtain Bitcoins?

You first need to get a digital wallet ("wallet") and there are many forms available. You can open a wallet on your computer, mobile with the wallet app, a web based wallet that you can access through the web, a physical hardware wallet, or a secure paper wallet."[12]

You will receive a "public key" created by random characters. The "public key" is an address to your wallet visible to anyone for sending or receiving crypto-currencies.

When you create your wallet you will be requested to provide a "private key" which allows only the owner or person in posession of this "private key" access to the wallet's content. If you should lose this "private key" that gives access to your wallet, you will have no way of gaining this information. Unlike a password the "private key" can never be recovered because there is no controlling body for this system. Therefore if you die and nobody knows your "private key" access to your wallet's content will not be possible.

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[9] Notes *on South African* Income *Tax*, P Haupt, Thirty-Seventh Edition, 2018, H&H Publications,, Chapter 17, 18.8.1, page 501.
[10] Footnote 3 *supra*.
[11] So what exactly is a Bitcoin. www.bitcoinzar.co.za/home .
[12] Get a Bitcoin wallet. www.bitcoinzar.co.za/Bitcoin-wallet-types. (Accessed 6 November 2018)

"From your South African Bank account you transfer funds to the exchange, and once the funds have cleared, you can trade the ZAR for Bitcoins. These Bitcoins can also be purchased in South Africa by doing face to face trades with sellers who prefer to meet in person. These Bitcoins will be transferred or paid into your wallet. Bitcoins can be transferred from foreign countries to your home country within hours without even using a bank account. This is called Bitcoins remittances and a foreign worker can transfer Bitcoins to an individual in his or her home country. If you transfer money using Bitcoin to a South African resident using Payfast, you can accept Bitcoins and have them instantly converted to South African Rand. The cost on this transfer is more or less 1,9% on the deposit value and take about an hour for confirmation of the transfer." [13]

Taxation of bitcoins in South Africa:

Bitcoin is a decentralised digital currency, meaning no company or entity (such as the Reserve Bank of South Africa or even the South African Revenue Services) can control Bitcoins or even monitor your wallet content. [14]

Your wallet's content can only be monitored and controlled by the person who has access to your "private key".

The first question to be answered is whether a person should declare crypto-currency received from another wallet or the crypto-currencies that were sold for a profit or loss to the South African Revenue Service.

The second question is whether taxes are payable, even if nobody has access to or is aware of your account.

According to a media release from SARS on 6 April 2018, *"SARS will continue to apply normal income tax rules to crypto-currencies received. Any gains or losses made when you sold your crypto-currency will form part of your taxable income as Capital Gains Tax ("CGT"). The onus is on the taxpayer to declare all crypto-currency related taxable income in the tax year of assessment in which it is received or accrued."* [15]

[13] How to invest in Bitcoins in South Africa. www.bitcoinzar.co.za/home/what-is-a-bitcoin-exchange. (Accessed 6 November 2018)
[14] See footnote 3 *supra*.
[15] http://www.mybroadband.co.za/News/Cryptocurrency.-SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx (6April 2018)

What types of taxes are payable on Bitcoins in South Africa?

Haupt holds the view that a Bitcoin is an asset and that normal rules pertaining to capital and revenue apply to Bitcoins[16].

SARS characterises a crypto-currency as an asset of an intangible nature, but agrees that the *"determination of whether an accrual or receipt is revenue or capital in nature is tested* under *existing jurisprudence"* and that "*taxpayers are also entitled to claim expenses associated with cryptocurrency accruals or receipts, provided such expenditure is incurred in the production of the taxpayer's income and for purposes of trade. Base cost adjustments can also be made if falling within the CGT paradigm".* In the SARS media release on this issue the following guidance is provided[17]:

"Gains or losses *in relation to cryptocurrencies can broadly be categorised with reference to three types of scenarios, each of which potentially gives rise to distinct tax consequences:*

(i) A cryptocurrency can be acquired through so called "mining". Mining is conducted by the verification *of transactions in a computer-generated public ledger, achieved through the solving of complex computer algorithms. By verifying these transactions the "miner" is rewarded with ownership of new coins which become part of the networked ledger.*

This gives rise to an immediate accrual or receipt on successful mining of the cryptocurrency. This means that until the newly acquired cryptocurrency is sold or exchanged for cash, it is held as trading stock which can subsequently be realized through either a normal cash transaction (as described in (ii) or a barter transaction as described in (iii) below.

(ii) Investors can exchange local currency for a cryptocurrency (or vice versa) by using cryptocurrency exchanges, which are essentially markets for cryptocurrencies, or through private transactions.

(iii) Goods or services can be exchanged for cryptocurrencies. This transaction is regarded as a barter transaction. Therefore the normal barter transaction rules apply."

The SARS media release also provides that where taxpayers are uncertain of the tax implications of transactions involving crypto-currencies, they may "*seek guidance from SARS through channels such as Binding Private Rulings (depending on the nature of the transaction)*".

[16] *Notes on South African Income Tax*. P Haupt, Thirty-Seventh Edition, 2018, H & H Publications, 2.7.11, page 50.

[17] SARS's Stance on the Tax Treatment of Cryptocurrencies, 6 April 2018, http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx

Income Tax on Bitcoins

In terms of the definition of "gross income" in section 1 of the Income Tax Act, No. 58 of 1962 ("the Act") it is clear that if Bitcoins were received by a person during a year of assessment, it may form part of his/her gross income if the receipt is not of a capital nature:

"Gross income" in relation to any year or period of assessment, means –

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature."

When a taxpayer receives Bitcoins during a year of assessment as payment for products sold and/or services rendered, or the taxpayer buys and sells or exchanges bitcoins on a regular basis, the revenue value of Bitcoins will in terms of Section 1 of the Act form part of gross income and thus taxed as normal income.

Example:

Mr. A is an accountant and received a salary of R500,000 and also a performance bonus of R150,000 in the 2018/2019 tax year. Mr. A also renders services to clients by repairing their computers after hours. Mr. A heard about Bitcoins and decided to open a digital wallet and requested his clients to pay for his serves with Bitcoins. Mr. A received Bitcoins in the 2018/2019 year of assessment to the value of R200,000. He uses these Bitcoins to buy products from overseas because the transaction fees are not as expensive as with his credit card.

Income tax payable by Mr. A during the 2018/2019 year of assessment:

Salary……R500,000

Bonus……R100,000

Bitcoins received for services……R200,000

Gross Income……R800,000

In terms of Section 11(a) of the Act, a general deduction is allowed in determination of taxable income: *When determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived – (a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of capital nature.*

Example

Mr Y receives Bitcoins as payment for goods and services rendered. He uses these Bitcoins to pay for goods and services for him to be able to receive further income. The Bitcoins he received will be included as "gross income" in terms of Section 1 of the Act and in terms of Section 11(a) of the Act, all expenditure actually incurred in the production of income will qualify as be a deduction against his "gross income".

In terms of Section 20A of the Act losses made from a trade will be ring fenced in relation to the income received/accrued from that trade in certain circumstances. Where section 20A is applicable any losses made from the specified trade may only be set off against income from such trade, and not against other income that accrued to or was received by a taxpayer.

Section 20A(2)(b) of the Act was amended via section 37 of the 2018 Taxation Laws Amendment Act[18] to include the acquisitions and disposal of crypto-currencies. When a natural person's taxable income for the year of assessment is equal to or above the amount of taxable income against which the maximum marginal rate of tax (currently the maximum marginal rate of tax is levied at 45% on taxable income exceeding R1,500,000) is levied, Section 20A of the Act will be applicable if such a person incurs an assessed loss in respect of a trade constituting the acquisition or disposition of any crypto-currency. This will have the effect that assessed losses made during the year of assessment in respect of trade in crypto-currency would only be deductible against revenue received from the trade in crypto-currency.

If a person's taxable income is below this maximum marginal tax rate income, these ring-fencing principles will not be applicable.

Capital Gain/Loss Tax on Bitcoins

When a taxpayer receives or buys Bitcoins during a year of assessment, and store these Bitcoins in a "digital wallet" and is not regarded to be trading in same, the gain or loss made when disposing of these Bitcoins will be regarded to be of a capital nature and will be taxed as taxable capital gains or deductible as capital losses. The intention of the Bitcoin owner when he/she bought or received the Bitcoins, is thus important when the owner disposes of these Bitcoins to determine if the gain will be taxed as normal income or treated as a taxable capital gain or loss during the year of assessment. Thus, if a person regularly trades and speculates with Bitcoins, any Bitcoins received constitute gross income and be taxed at the marginal tax rate of the individual.

[18] Act 23 of 2018

In the following court cases the intention of taxpayer is important to determine if payments received will be revenue or capital in nature:

In ITC 1283 a former Angolan resident converted assets into coffee beans, which he imported into South West Africa and subsequently sold. The court held that the proceeds were of capital nature as the taxpayer's intention was merely to salvage his capital and he was not engaged in carrying in a trading business with coffee beans.[19]

In ITC 1543 the taxpayer's acquired assets for a long term investment purpose as a hedge against inflation. The court approach (Fagan J) to the problem in this case was to consider not only the prospect of a sale at a profit but also the degree of permanence and the question of floating and fixed capital. The court held that an asset acquired for resale at a profit (as a hedge against inflation) is of a capital nature if it is acquired with the intention of holding for a length of time as a fixed asset.[20]

In CIR v Nel the taxpayer had invested his surplus cash into Krugerrands which he intended to hold as a long-term investment. He was forced to sell some of his Krugerrands to have liquidity to buy another asset. The court held that his intention when he bought the Krugerrands was "for keeps". The purpose of the sale was not to make a profit but was to have liquidity to acquire another asset. The proceeds were held to be of a capital nature.[21]

If the intention of the taxpayer was, when he acquired Bitcoin to "save" them in his wallet for growth, at disposal of the Bitcoin the profit or loss made will be regarded as capital nature. This will not be taxed as gross income in terms of Section 1 of the Act. This will be taxed as Capital Gains Tax ("CGT").[22]

CGT will not only be levied on profits made on the sale of assets, but also on any other disposal or deemed disposal of assets, where the proceeds on disposal of the assets are not included in "gross income" for income tax purposes. In terms of the Act the "taxable capital gain" must be included in the taxable income of a person for the year of assessment. The "taxable capital gain" is calculated in terms of the Eighth Schedule (the "Schedule") of the Act.[23]

Capital gains are included in taxable income at 40% of the "net capital gain" for natural persons and at 80% for companies, trusts, close corporations and legal entities for the year of assessment.

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[19] *Notes on South African Income Tax*, P Haupt, Thirty-Seventh Edition, 2018, H&H Publications, Chapter 2, 2.7.11, Page 50.

[20] See footnote 19 *supra*, p 52

[21] See footnote 19 *supra*, p 52

[22] See footnote 19 *supra*. This was also stated in the article published by SARS on 6 April 2018 at http://www.mybroadband.co.za/News/Cryptocurrency.-SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx

[23] Act 58 of 1962; s 26

The net capital gain multiplied by this inclusion rate will be taxed as taxable income on the marginal tax rate applicable.[24]

"Net capital gains" are all the capital gains for the year of assessment added together less exclusions (where applicable) and assessed capital loss brought forward from the previous year of assessment.[25]

For CGT purposes is an asset defined as:[26]

- Property of whatever nature (movable or immovable).
- Including tangible and intangible assets (corporeal and incorporeal).
- Including rights or interest of whatever nature to or in such property.
- Excluding any currency (other than coins made mainly from gold or platinum).

As previously stated, Bitcoin is an asset. Bitcoin is a medium of exchange and has value. This value can be stored in your wallet or can be used as payment for products or services.

For CGT purposes, any currency is excluded from CGT. However, as stated earlier, Bitcoin is not regarded as currency.

Therefore CGT may be applicable to Bitcoins as stated in the Eighth Schedule of the Act.

Example:

Mrs. X is a well known fashion designer in South Africa. She also exports designs to other countries on request. After she met Mrs. Y from the USA Mrs. X was requested to design a wedding gown and six bride's maid dresses. She quoted Mrs Y for all these dresses a cost of R150,000. Mrs. Y asked Mrs. X if she could do the payment with Bitcoins. Mrs. X already has a Bitcoin wallet and gave Mrs Y the public key information for her to transfer this money into her wallet on 15 September 2018.

After two months, during November 2018 Mrs. X invested the Bitcoins to purchase shares in an overseas company (FDC Ltd.). Exchange control permission was granted to Mrs. X for the purchase of shares. The cost of the shares were R290,000 and the value of the Bitcoins she received at R150,000 had increased to the value of R290,000.

[24] Act 58 of 1962; Paragraph 10 of the Eight Schedule
[25] Act 58 of 1962; Paragraph 8 of the Eight Schedule
[26] Act 58 of 1962; Paragraph 1 of the Eight Schedule

On the 27th of January 2019 Mrs X exchanged her shares in the FDC Ltd for shares in FBD Ltd. At time of the exchange the shares in FBD was valued at R430,000. When goods or services are exchanged without using currency this is a barter transaction. All the shares were held as capital assets if Mrs. X ever decided emigrate out of South Africa.

Taxable income for 2018/2019 year of assessment in respect of Mrs. X:

Bitcoins received for services and products.....R150,000

Revenue on Bitcoins on disposal Note 1..... Nil

Gross Income.....R150,000

Minus Exemptions..... (R0)

Minus Deductions..... (R0)

Taxable Income before Taxable Capital Gain.....R150 000

Ad Taxable Capital Gain:

Market Value of Bitcoins.....R290,000

Base Cost of Bitcoins.....(R150,000)

Gain on disposal Section 26A of the Income Tax Act.....R140,000

Add:

Market Value of Shares in FDC Ltd.....R430,000

Base Cost of Shares in FDC Ltd.....(R290,000)

Gain on disposal Section 26A of the Income Tax Act.....R140,000

Equals Total capital gain.....R280,000

Less: Annual Exclusion (Note 2).....(R40,000)

Net capital gain (Note 3).....R240,000

Included as taxable capital gain of 40%.....R 96,000

Taxable Income (R150 000 + R96 000).....R246,000

Note 1:

For purposes of this example it is assumed that the difference between R290,000 and R150,000 as calculated above is accepted by SARS as being of a capital nature. In practice this will depend on on various factors, as discussed above.

When she bought shares in FDC Ltd for R290,000 it was a disposal of Bitcoins and the shares will have a base cost of R290,000. The growth of value of Bitcoins from R150,000 to R290,000 over the few months will be subject to capital gain tax (see footnote 23).

Note 2:

When Mrs. X exchanged her shares in FDC Ltd for shares in FBD Ltd. Capital gain of R140,000 (R430,000 – R290,000) was made on the FDC Ltd shares. Therefore, the R140,000 will be "taxed capital gains" in terms of Section 26A of the Income tax Act.

Note 3:

Paragraph 6 of the Eighth Schedule to the Income Tax Act provides the "aggregated capital gain" must be reduced with the annual exclusion of R40,000 when dealing with a natural person. Therefore, R280,000 less R40,000 = R240,000 will be included as a taxable capital gain.

Note 4:

Paragraph 10 of the Eighth Schedule to the Income Tax Act that stipulates the inclusion rate of natural persons to be 40%. Therefore the "net capital gain" x 40% = taxable capital gain. Mrs X traded in her own name (i.e. not via an entity), therefore: R240,000 x 40% = R96,000 'taxable capital gain for year of assessment'.

Value Added Tax on Bitcoins

When Bitcoins are used or any other crypto-currency, for services and goods, or sells Bitcoins will VAT arise from these transactions?

When receiving Bitcoins by a VAT vendor it has no specific VAT effect for a vendor. It is the same as being paid in cash because the vendor is receiving bitcoins and not supplying them. VAT will arise from supplying goods or services rendered by the vendor, regardless of how it is paid for.

Will the use of Bitcoins to pay for services or goods by a vendor have any VAT effect?

When Bitcoins are used to pay for services or goods this is called a barter transaction. The vendor is supplying Bitcoins in return for the value of goods and services thus there will be a VAT effect for a vendor.

When goods or services are imported, VAT must be paid on the importing of goods into the Republic, whether or not the importer is a vendor.[27]

VAT is collected by the Department of Customs and Excise and is calculated as follows:[28]

VAT = 15% x [Purchase price or customs value + customs duty + 10% of customs value]

'Input tax'[29] is defined as –

If VAT is paid by die vendor on the import of goods that will be consumed, used or supplied in the enterprise in the course of making taxable supplies.

Where a VAT vendor has imported goods for the purpose of his enterprise, he can claim this VAT as a deduction from output tax.[30]

When services are imported to South Africa and the South African resident is a VAT vendor or will be using the service in his (taxable) enterprise, VAT will not be payable on the imported service.[31]

Imported services are defined as[32] –

If the services are to be used or consumed in the Republic (otherwise than for the purpose of making taxable supplies). This provision does not apply to zero-rated or exempt services.

Example:

Company XFA (Pty) Ltd is a registered VAT vendor. Mrs. A renders services to the company and received R100,000 for the year of assessment. Equipment was bought by the company and received a tax invoice to the value of R20,000. This company has a digital wallet with Bitcoins to the value of R200,000 to have funds available to make international payments. Company XFA (Pty) Ltd paid an international company for services to the value of R130,000.

VAT for the company

Transfer of Bitcoins to Mrs A for services……R100,000

Payment for equipment……..…R 20,000

Total standard-rated supplies……..……R120,000

Payment in Bitcoins: International company……..……..……R130,000

[27] Act 89 of 1991; s 7(1)(b)
[28] Act 89 of 1991; s 13
[29] Act 89 of 1991; s 1(a)(ii)
[30] Act 89 of 1991; s 16(3)(a) and (b)
[31] Act 89 of 1991; s 14
[32] Act 89 of 1991; s 1

VAT will not be payable on this transaction – Section 14 of the VAT Act.

Output tax: 15/115 of R120,000……..……R 15,652

Input tax:

Tax invoice from supplier of equipment R20,000 x15/115……(R2,609)

Estate Duty on Bitcoins

In terms of the Estate Duty Act 45 of 1955 ("the Act") an estate consists of all property and deemed property of a person at the date of death.[33]

Property is defined as: [34]

- any right in or to property,
- movable or immovable,
- corporeal or incorporeal.
- Whether the assets is tangible or intangible.
- It includes ownership and any other interest in or right in property, such as the right to use or occupation.

SARS regards a Bitcoin or any other crypto-currency as an asset of an intangible nature[35] and for this reason Bitcoin will be defined as property for estate duty purposes.[36]

As already mentioned, when creating a wallet you will be required to create a "private key" to gain access to your wallet's content. If you should lose this private key no access can be gained to the wallet. If a person dies without giving his private key to someone else, all his/her Bitcoins will be lost.

Example:

Mrs. X created a Bitcoin wallet in 2011 and bought Bitcoins equal to the value of R50,000. In 2015 she opened her own business and received income either by way of cash or Bitcoins. She used the Bitcoins she received to pay for goods and services.

In 2017 Mrs. X decided to bequeath her estate to her inter vivos trust for the benefit of her husband and children. When she opened her wallet she gave her husband the "private key" to her wallet if he needed to make payments using Bitcoins.

[33] Act 45 of 1955; s 3(1)
[34] Act 45 of 1955; s 3(2)
[35] http://www.mybroadband.co.za/News/Cryptocurrency/255109-SARS-details-its-bitcoin-tax-plans-for south-africa.html 6 April 2018)
[36] Act 45 of 1955; s 3(2)

In 2018/2019 she received Bitcoins as payment for services and goods she rendered. The value of the Bitcoins she received for goods and services was R650,000. The value of expenses paid using Bitcoins was R200,000 for goods and services needed to gain income. She never registered as a VAT vendor. The intention of Mrs X to hold the Bitcoins received as a capital asset and not as trading stock.

On the 15 of January 2019 she passed away (at age 55). The value of her Bitcoins at date of death was R8,500,000. Income received in her wallet from 1 March 2018 to date of death was R650,000 (as mentioned above). The executor of her estate knew about her Bitcoin wallet, but did not have access to her "private key". How will Bitcoins be taxed in the 2018/2019 year of assessment? For purposes of this example we assume that SARS accepted her Bitcoins were held as capital and not as "trading stock" for income tax purposes (in practice this may be treated differently, depending on the surrounding circumstances as discussed above).

Income tax payable by Mrs. X for 2018/2019 year of assessment:

Gross Income received	R 650,000
Less: Deductions in terms of Section 11(a) deduction	(R 200,000)
Nett Income before capital gains	R 450,000
Capital gains on date of death (Note 1)	R 3,080,000
Taxable income	R 3,530,000
Tax payable in terms of the income tax table 2018/2019*	R1,445,541
Less Rebates:	
Primary Rebate	(R 14,067)
Tax payable (Note 2)	R1,431,474*

Note 1

Market Value of Bitcoins	R 8,500,000
Less Base cost of Bitcoins	(R 500,000)**
Gains	R 8,000,000
Less Annual Exemption (death)	(R 300,000)
Taxable gain	R 7,700,000
At inclusion rate of 40%	R 3,080,000

- **For this example we assume that the value in Mrs X wallet was held as for capital growth purposes and therefore the base cost of R50,000 plus R450,000 will be used for capital gains tax calculation purposes.

*** 2019 tax year (1 March 2019 - 28 February 2019)**

Taxable income (R)	Rates of tax (R)
0 – 195 850	18% of taxable income
195 851 – 305 850	35 253 + 26% of taxable income above 195 850
305 851 – 423 300	63 853 + 31% of taxable income above 305 850
423 301 – 555 600	100 264 + 36% of taxable income above 423 300
555 601 – 708 310	147 891 + 39% of taxable income above 555 600
708 311 – 1 500 000	207 448 + 41% of taxable income above 708 310
1 500 001 and above	532 041 + 45% of taxable income above 1 500 000

In her personal return her executor should declare all income received from 28 March 2018 to date of death. In terms of the example above Mrs. X's income tax payable will be R1,431,474.

After the personal tax return is filed and income tax is paid to SARS, the individual must be deregistered for income tax purposes and the deceased estate must be registered as a new tax payer. In the estate's tax return income from 16 January 2019 to 28 February 2019 should be declared and tax will be payable on all income received from date of death to the end of the financial year. An income tax return must be filed each financial year of assessment until the estate is finalised.

Estate Duty: (Assume no other property, deemed property or income in her estate)

Property in terms of Section 3(2) of the Estate Duty Act 45 of 1955.....		R8,500,000
Add: Deemed Property.....		Nil
Gross Estate.....		R8,500,000
Less: Deductions in terms of Section 4 of the Estate Duty Act		
Section 4(b):	Income Tax Payable: Mrs. X	(R1,431,474)
Section 4(c):	Executors fees @4.025% (3.5 + 15% VAT) of R8,500,00	(R 342,125)
Taxable estate.....		R6,726,401
Less: Section 4A Abatement.....		(R 3,500,000)
Dutiable Estate		R 3,226,401
Estate Duty Payable @ 20%.....		R 645,280

The value of the wallet as at date of death should be included in her estate in terms of Section 3(2) of the Act for estate duty calculation as this is property in her estate.

If the executor does not have access to the private key of the deceased and nobody can give him/her the private key he/she will have no access to the content of the wallet. Because Bitcoin is property in the estate of the deceased it must be included as property. The value in terms of Section 5 of the Act[37] the fair market value[38] must be included in the estate for estate duty purposes. The fair "market value" of property is defined in section 1 of the Estate Duty Act as the price which would be obtained upon the sale of the property between a willing buyer and a willing seller dealing at arm's length in an open market. If the executor has no access to this private key he/she will not be able to determine the value as at date of death, and nobody will be willing to buy this asset. The Master of the Free State High Court discussed this issue during a session at the University of the Free State in 2018 with fiduciary specialists, and according to the Master the value that must be included is R0 for Bitcoin without a private key.

If the executor knows who has the "private key" he will be obligated to request this information from this person. In terms of the Estate Duty Act[39] estate duty must be calculated and is payable by the executor of the estate. Such a person will in terms of our law be obligated to provide the executor with the private key[40].

According to SARS the onus is on the taxpayer to declare these bitcoins.[41] As an executor of the estate the onus will be on the executor to declare Bitcoins.

Conclusion

When a person is paid via crypto-currency such as Bitcoins for services rendered or products sold, the value thereof must, in terms of the Income Tax Act, be included in the gross income of such person upon receipt or accrual thereof.

If a taxpayer bought or received a crypto-currency, the intention of the owner is an important factor to determine if the value must be included in the taxable income as a taxable capital gain or whether it will be taxed as revenue on disposal thereof. If the intention of the owner of this asset is or was to "save" this asset for capital growth, the value on date of disposal will be included as a taxable capital gain in the taxable income of the taxpayer. Capital gains tax will be payable on date of disposal of this asset.

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[37] Act 45 of 1995; s 5(1)(g)

[38] In terms of paragraph (a) of the definition of "fair market value" in Section 1 of the Estate Duty Act 45 of 1955, the fair market value means – the price which could be obtained upon sale of the property between a willing buyer and a seller dealing at arm's length in an open market.

[39] Act45 of 1955; s 12, 13(1); *Notes on South African Income Tax*, P Haupt, Thirty-Seventh Edition, 2018, H&H Publications, Chapter 28, 28.10, Page 883.

[40] In this regard see Section 26(2), (3) and (4) of the Administration of Estates Act 66 of 1965.

[41] www.mybroadband.co.za/News/Cryptocurrency/255109-SARS-details-its-bitcoin-tax-plans-for south-africa.html (6April 2018)

When Bitcoins are used to pay for services or goods this is called a barter transaction. The vendor is supplying Bitcoins in return for the value of goods and services there will be a VAT effect for a vendor.

At death of a person the value of the Bitcoins at date of death will be included in the deceased estate as property for estate duty purposes. When a person dies all his/her assets will be transferred to the deceased estate and this will be regarded as a disposal for capital gains tax purposes. Any crypto-currencies received from date of death to the end of the financial year, will be deemed to be income it was used as payment for goods or services. If the intention was to "save" these crypto-currencies for growth then all growth will be deemed to be a capital gain for income tax purposes.[42]. If the intention was however to speculate in crypto-currencies, i.e. to hold it as "trading stock", receipts on disposal will be of a revenue nature.

According to SARS the onus is on the taxpayer to declare all his crypto-currencies received or disposed of during the year of assessment. If the taxpayer does not declare these crypto-currencies received or disposed of, SARS will treat this as tax evasion.

[42] *Notes on South African Income Tax*, P Haupt, Thirty-Seventh Edition, 2018, H&H Publications, Chapter 21, 21.8, Page 669-670.

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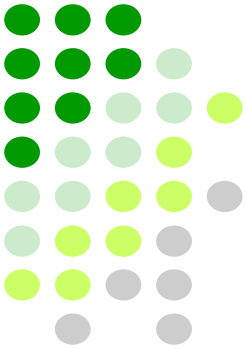

Retirement Planning

Emigration & RA's: An Update

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Introduction

Many South Africans are seeking opportunities outside of South Africa. One of the questions that financial planners are often confronted with is what options are available to clients who are members of retirement funds and more specifically retirement annuity funds upon emigration?

Position prior to 2008

Prior to 1 March 2008, retirement annuity (RA) fund members who emigrated from South Africa (and were therefore no longer tax residents in SA), could not access their retirement annuities prior to reaching the age of 55.[1]The definition of a "retirement annuity fund" in Section 1 of the Income Tax Act (hereinafter referred to as "the Act") was amended in July 2008 to allow a member who discontinued contributions before retirement, to commute his/her retirement annuity in full upon formally emigrating from South Africa.[2]

Position 1 March 2015

The **Taxation Laws Amendment Act of 2015** amended the definition of "retirement annuity fund" once again to allow for the full commutation of an interest in a retirement annuity fund where:

- a person ceases to be a South African resident[3] ; or
- the person leaves South Africa on expiry of a work or visiting visa before his/her retirement date.

Based on the language used in this section, it appeared that it was not a requirement anymore for a South African resident to formally emigrate in order to commute his/her interest in a retirement annuity. Such member would merely have to show that he/she was no longer a South African resident.

The **SARS "External Guide-Emigration and Cessation of Work Visas" (Revision 3)** however still indicated that formal emigration was a requirement for commutation of an interest in a retirement annuity fund where South African residents leave South Africa. The SARS Guide thus appeared to differ from the definition of retirement annuity fund as per section 1 of the Act.

The **SARS "External Guide-Tax Directive: Emigration and Cessation of Work Visas" (Revision 4)** was then released and clearly indicated that a member of a retirement annuity fund can commute his/her full interest in a retirement annuity fund where the member ceases to be a resident or emigrates from South Africa prior to their retirement date. Members were thus able to commute their full interest in a retirement annuity fund for a lump sum, prior to retirement if they **ceased to be resident** in South Africa.

[1] As provided for in the definition of "normal retirement age" in section 1 of the Income Tax Act, 58 of 1962
[2] Taxation Laws Amendment Act 3 of 2008
[3] As defined in the Income Tax Act 58 of 1962

Position 1 March 2016

The **Taxation Laws Amendment Act 2016** was however promulgated on 19 January 2017, and again the definition of a retirement annuity fund in section 1 of the Act[4] was amended making it clear that **formal emigration** is still a requirement where a resident leaving South Africa wishes to commute his/her interest in a retirement annuity fund in full prior to his/her retirement date. In terms of this amendment a member who discontinues his/her contributions prior to his/her retirement date will be entitled to the payment of a lump sum benefit at the expiry of the visa that was issued in terms of paragraph (b) or (i) of the definition of 'visa' in section 1 of the Immigration Act, No 13 of 2002.

The effective date for this amendment was **1 March 2016.**

The **SARS "External Guide-Tax Directive: Emigration and Cessation of Work Visas" Revision 7[5])** was then released and clearly indicated that a member of a retirement annuity fund can commute his/her full interest in a retirement annuity fund where the member **emigrates** from South Africa prior to their retirement date **and** that emigration is recognised by the South African Reserve Bank for purposes of exchange control.

Non-residents who are employed in South Africa on a contractual basis, for a certain period of time and are contributing towards a retirement annuity fund whilst they are working /staying in South Africa, will be allowed to withdraw their lump sum[6] benefit from a retirement annuity fund prior to his/her retirement date at the expiry of certain listed visas.

Taxation of Lump sum benefit

The withdrawal benefit of discontinued contributions when a member of a retirement annuity fund formally emigrates or a non-resident's working or visiting visa expires, is regarded as a lump sum benefit as contemplated in paragraph 2(1)(b)(ii) of the Second Schedule to the Act[7] and will be taxed as a withdrawal benefit according to the withdrawal tax tables.

All taxable retirement fund lump sum withdrawal benefits (from Provident Fund, Pension Fund and Retirement Annuity Fund) which accrued as from 1 March 2009, retirement lump sum benefits which accrued as from 1 October 2007 and severance benefits that accrued as from 1 March 2011 are aggregated.

[4] Paragraph (b)(x)(dd) of the definition of 'retirement annuity fund' in section 1(1) of the Income Tax Act.
[5] SARS External Guide – Tax Directive: Emigration And Cessation Of Visas(Version 7)
[6] The definition of lump sum benefit paragraph 1 of the Second Schedule of the Income Tax Act.
[7] Paragraph 2(1)(b)(ii) of the Second Schedule to the Income Tax Act.

This aggregated amount is taxed according to the table below:

Taxable income from lump sum benefits	**Rate of Tax**
R0 – R25 000	0% of the taxable
R25 001 – R660 000	18% of the taxable income exceeding R25 000
R660 001 – R990 000	R114 300 plus 27% of the taxable income exceeding R660 000
R660 001 – R990 000	R203 400 plus 36% of the taxable income exceeding R990 000

The tax is reduced by the tax calculated in accordance with the above table on such lump sum benefit(s) which accrued prior to the accrual of the current lump sum.

The Employees' tax reflected on the tax directive is determined on the taxable portion of the lump sum payable after the allowable deductions have been taken into account in terms of the Second Schedule to the Act.

In terms of paragraph 2(1) and 9(3) of the Fourth Schedule to the Act, before a lump sum can be paid out, the retirement annuity fund administrators, trustees or insurers must apply for a tax directive from SARS.

Requirements Tax Directive- Residents emigrating[8]

When applying for a tax directive from SARS, the retirement annuity fund administrators, trustees or insurer must complete a manual Form C and attach the following supporting documents for submission to SARS:

- A letter from the Authorised dealer to confirm that the emigration was recognised by the South African Reserve Bank for purposes of exchange control;
- A copy of the TCC **(tax clearance certificate)** in respect of emigration issued by SARS; or
  - An affidavit indicating the reason a TCC **((tax clearance certificate)** cannot be provided; and
- The member's certificate of residency obtained from the relevant **Tax Authority** of the country in which the member **resides.**

[8] SARS External Guide – Tax Directive: Emigration And Cessation Of Visas (Version 7) Paragraph 5.1 page 4

Requirements Tax Directive- Non-residents visa expiring[9]

When applying for a tax directive from SARS the retirement annuity fund administrators, trustees or insurer must complete a manual Form C and attach the following supporting documents for submission to SARS:

- A copy of the Certificate of residency obtained from the relevant **Tax Authority** of the country in which the member resides or is employed.
- A copy of the passport indicating an exit from South Africa.
- A copy of the visa indicating the expiry date and the applicable paragraph in the definition of "visa" in section 1 of The Immigration Act in terms of which the visa was issued.[10]

Retirement age

A member of a retirement annuity fund can only commute his/her interest in a retirement annuity fund on emigration if he or she has not yet reached retirement age. Where a member has reached his/her retirement age in terms of the policy contract and the rules of the fund, the member will not be able to commute the full interest in the retirement annuity fund as a lump sum in terms of paragraph (b)(x)(dd) of the definition of a retirement annuity fund in section 1(1) of the Act.

It appears that SARS allows member's older than 55 years to commute their full interest in a retirement annuity fund upon emigration as a lump sum where the contract's maturity date is open-ended and the client has not elected to retire or the maturity date was a later date than the client's current age. Policy documents will have to be submitted to SARS as proof of the open-ended maturity date or later retirement date.

Conclusion

It is clear from the above that financial planners should take great care when advising clients on the options available to them with regard to their retirement annuities when they emigrate from South Africa. The following are important points to consider:

- The client's age: is the client younger or older than 55?
- If the client is older than 55: Establish the maturity date in terms of the retirement annuity fund or contract of the client. In this regard the possibility of the retirement date/age being open-ended should also be investigated.
- Taxation – the emigration surrender releases all the capital in the form of a lump sum but tax is levied at the withdrawal table (which is more tax onerous than the retirement table). It should also be borne in mind that the principle of aggregation (any previous lump sums accrued or received on or after the relevant dates by the client will be taken into account) will apply when the tax is calculated, whether the lump sum accrues on surrender, withdrawal, retirement or death.

[9] SARS External Guide – Tax Directive: Emigration And Cessation Of Visas (Version 7)
[10] SARS External Guide – Tax Directive: Emigration And Cessation Of Visas (Version 7)

- If retirement is considered the retirement tax table is applicable to the lump sum taken (a maximum of one third if the retirement interest is allowed as a lump sum in these circumstances, unless the value of the retirement interest in the fund is smaller than R247 500). The principles of aggregation will also apply here, if relevant.

It is thus clear that the client's circumstances, needs, objectives, tax liability, need for liquidity, etc. need to be taken into account when making a decision in this regard.

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