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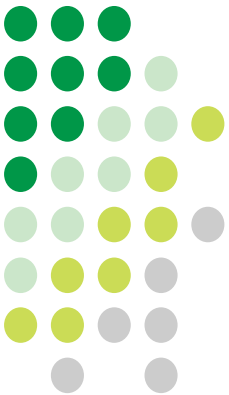

Premiums & Problems

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Premium & Problems Literary Award

The recipients of the

Premiums & Problems Article Edition Literary Award

for **2015** are

Madeleine Marais

For her contribution entitled

Estate duty and capital gain tax on offshore assets

Chris de Jager

For his contribution entitled

Capital gains tax on agricultural properties

and

Carl Muller

For his contribution entitled

Capital gains tax and limited rights created in a will

In reaching their decision, the judges have taken into account the technical correctness, how informative the article is, learning potential for the reader, method and effectiveness of transfer of relevant information, originality, practical applicability and potential for marketing opportunities.

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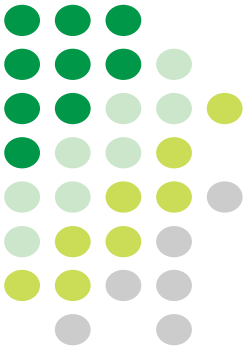
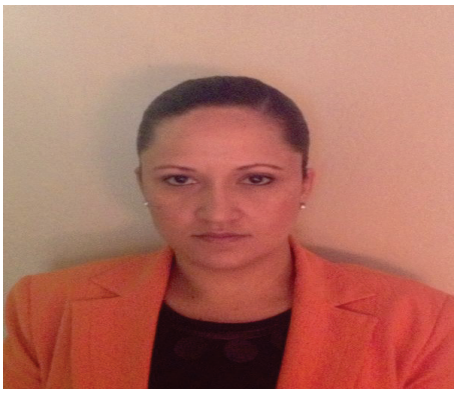


Business Assurance

Mergers and acquisitions - its impact on buy & sell agreements.



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Introduction

Business assurance aims at solving the problems that arise on the death, disability or a retirement of a partner, shareholder in a company, member of a close corporation, sole proprietor or key person. However, what makes business insurance particularly significant is that it does much more than providing for all that personal insurance does. It provides for business continuity and even for strengthening the business structure[1].

We cannot predict what will happen in the future but only ensure that we are covered for future events.

Mergers, acquisitions and takeovers have been part of the business world for centuries. In today's dynamic economic environment, companies are often faced with decisions concerning these actions – after all, the job of management is to maximise shareholder value. Through mergers and acquisitions, a company can (at least in theory) develop a competitive advantage and ultimately shareholder value[2].

This article will explore the impact that a company merger has on an existing buy and sell agreement.

What is a Merger?

A merger occurs when a company finds a benefit in combining business operations with another company, in a way that will contribute to increased shareholder value. It is similar in many ways to an acquisition, which is why the two actions are so often grouped together as mergers and acquisitions.

How does it work?

In theory, a merger of equals is where two companies convert their respective stocks to those of the new, combined company. However, in practice, two companies will generally make an agreement for one company to buy the other company's common stock. In some rarer cases, cash or some other form of payment is used to facilitate the transaction of equity. Usually the most common arrangements are stock-for-stock. Mergers do not occur on a one-to-one basis, that is, exchanging one share of Company A's stock will typically not get you a share of the merged company's stock. Much like a split, the amount of the new company's shares received in exchange for your stake in Company A is represented by a ratio. The real number might be 1 for 2.25, where 1 share of the new company will cost you 2.25 shares of Company A. In the case of fractional shares, they are dealt with in one of two ways: the fraction is cashed out

[1] Botha M & Others (1009:2013).
[2] Investopedia Staff, para.2.

automatically and you get a cheque for the market value of your fraction; or the number of shares is rounded down[3].

Transaction Procedure

In terms of the Companies Act 71 of 2008 (hereinafter "the Act"), two or more companies which wish to merge are required to enter into a written agreement setting out the terms and means of effecting the merger. The Act prescribes certain matters which are required to be included in the merger agreement, but otherwise places few limitations on the substance of the agreement, and companies ultimately have considerable latitude to structure the merger transaction in a manner that best meets their requirements. In particular, the Act allows considerable flexibility as to the consideration that may be paid[4]. It contemplates not only a "traditional" merger transaction, where shares in the merging companies are converted into shares in the merged entity, but also allows for other forms of consideration to be paid to the shareholders of the merging companies. This would include the possibility of shareholders of one or more of the merging entities being paid in cash (which creates the possibility of a merger being used as a squeeze-out mechanism) or receiving shares in an entity other than the merged entity (such as, the holding company of the merged entity) as consideration[5].

Once the merger agreement is concluded, the merger must then be submitted to the shareholders of each of the merging entities for approval[6]. Approval of 75% of the voting rights exercised in respect of the resolution by disinterested shareholders is required. Furthermore, if shareholders holding 15% or more of the voting rights voted against the proposed merger, any dissenting shareholder may require the company to first seek court approval for the transaction before implementation. Even if the 15% threshold is not reached, any shareholder who has voted against the resolution may apply directly to the court for review of the transaction. Outside of these specific shareholder protections, a merger can also trigger appraisal rights for disgruntled shareholders, in terms of which they can, subject to certain requirements, require the company to buy their shares at fair value.

Once the requisite shareholder approval is obtained, the final step to follow before implementation is to notify every known creditor of each of the merging companies of the merger. Any creditor which believes that it will be materially prejudiced by the merger is entitled to apply to court within 15 business days of being notified for a review of the transaction. If no creditors object to the transaction, the parties may proceed with the implementation of the merger.

[3] Elmerraji, para.3.
[4] Yuill, 2013: para.4.
[5] Section 113 of the Companies Act 71 of 2008.
[6] Provided that the board must first be satisfied that each of the surviving merged entities will be able to satisfy the prescribed solvency and liquidity test.

Implementation Procedure

A notice of merger must be filed with the Companies Commission, and upon receipt of such notice the Commission will issue a registration certificate for each new company, and deregister each of the merging companies which are not intended to survive the transaction. The merger then takes place in accordance with the terms and conditions of the merger agreement. In terms of the Act all the assets and liabilities of the merging companies are transferred to the merged company or companies. This means that companies can avoid the costs and legal formalities normally required for the transfer of a business from one entity to another, as well as the length of time it takes to transfer things such as immovable and intellectual property.

The merger procedure has a significant advantage over a more conventional sale of business, in that it provides for automatic transfer of the property and obligations of the merging entities, as well as the dissolution of the non-surviving entities without having to go through the formal liquidation proceedings.

The sale of a business will however be useful where an acquirer may want to cherry pick certain assets and/or obligations of the target company, as opposed to acquiring them all. A sale of business also only requires the approval of the shareholders of the disposing company, as opposed to a merger where the approval of all merging entities' shareholders are required.

Scheme of Arrangement Procedure

This procedure is flexible, which involves an arrangement between a company and the holders of any class of its securities which may be used for a variety of different procedures, including, *inter alia*, a reorganisation of the share capital or a takeover. This has been the preferred method of implementing a friendly takeover in the South African context. Typically the scheme of arrangement will be entered into between the acquirer, the target and the target shareholders, whereby the acquirer will acquire all or a substantial portion of the targets shares[7].

The Tender Offer

For this procedure to be carried out, the acquirer is required to make a mandatory offer for all the shares of the target once they have acquired a specified percentage of the target's shares, an acquirer can squeeze out the minority if 90% or more of the shareholders not related to the acquirer accept its offer and the directors are not entitled to take any action that may frustrate the bid. This procedure has certain benefits – it does not require the approval of the acquirer's shareholders nor does it give rise to any appraisal rights[8] on the part of the acquirer

[7] Yuill, op cit, para.8.

[8] In terms of Investopdedia, an appraisal right is the statutory right of a corporation's minority shareholders to have a fair stock price be determined by a judicial proceeding or independent valuator, and the obligation for the acquiring corporation to repurchase shares at that price. An appraisal right is a

or the target's shareholders. It is typically the acquiring company's method of choice in the context of hostile takeovers, given that the co-operation of the target's board is not required in the way that it is for a merger or a scheme. However, shareholders can bring enormous pressure to bear on a target company board of directors to negotiate a sale by scheme or merger by the acquirer making a public "bear-hug" approach stating their willingness to pay a premium price. The down-side of a tender offer is that a much higher (90%) is required for a squeeze-out than under a scheme or a merger (75%)[9].

Buy & Sell Agreements

A buy-and-sell agreement, also known as a buyout agreement, is a legally binding agreement between co-owners of a business that governs the situation if a co-owner dies, is disabled, is forced to leave or chooses to leave the business[10].

The agreement contains several legally binding clauses that stipulate amongst others who and the price to be paid for the share.

Just as with a Merger, a valuation of the company needs to be made for the value of each shareholder's shares, in order to determine a price for the sale of the shares in the buy and sell agreement in question. Thus a price is attached to the value of the shares. The sale of shares is usually funded through life cover where one party to the agreement would take out life cover on the life of the other party or *vice versa*.

The buy and sell agreement will under normal circumstances provide for terms and conditions for the cancellation of the agreement; the following events would trigger a termination/cancellation:

(1) Shareholders consent to termination/cancellation in writing;

(2) Liquidation of the Company or the sequestration of the shareholders estate before the date of sale;

(3) Any of the shareholders ceasing to be shareholders of the Company for reasons other than those that allows the sale of share in the agreement.

When one of the above events is triggered the normal recourse would be to cede the life cover back to the life covered or the owner of the policy retains the right, title and interest in the policy of assurance.

Of particular interest is what will happen when there is a Merger and there is a Buy and Sell agreement in place?

protection policy for shareholders, preventing corporations involved in a merger from paying less than the company is worth to the shareholders.

[9] Yuill, op cit, para.10.

[10] Wikipedia.

When a Merger is about to take place, one can conclude that the following will happen:

(1) Depending on whether the parties to the buy and sell agreement will continue to be shareholders of the merged entity, the parties to the buy and sell agreement together with the parties of the other company need to decide whether they will enter into a new buy and sell agreement;

(2) The old buy and sell agreement would then be void as the merging company would be deregistered;

(3) A new buy and sell agreement will need to be entered into;

(4) The merged company will need to be valued in order to make provision for funding of the disposal of the shares held under the merged company.

Conclusion

One can only come to the conclusion that a new buy and sell agreement needs to be effected for a merged company, as there will definitely be new shareholder's, the shareholding of all the shareholders of the merging entities would undeniably change, thus making the value of their shares greater or lesser, and resulting in the initial life cover taken out by the parties to the initial buy and sell agreement, as either excessive or insufficient.

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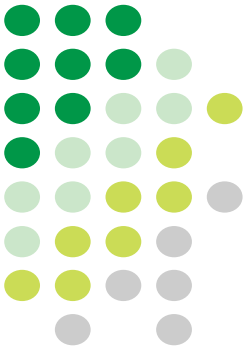

Estate Planning

Estate duty and capital gain tax on offshore assets.

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Introduction

Many South Africans have invested in offshore property in recent years but neglected to consider the tax effect from an estate planning point of view, as it is often assumed that offshore assets will not form part of a resident's estate for estate duty purposes. In South Africa residents are taxed on worldwide income and capital gains and estate duty is levied on the worldwide assets of ordinarily residents including offshore assets. Therefore, it is essential to consider the amount of estate duty and capital gain tax (hereinafter referred to as "CGT") payable on death with regards to offshore assets, as this will have an effect on the liquidity of the estate.

The South African tax system and estate duty

South Africa has a "residence" basis of tax. A resident is a person who is "ordinarily resident" in South Africa as defined in section 1 of the Income Tax Act[1]. In terms of section 3 of the Estate Duty Act[2], "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 is deemed property of that person at that date". It is therefore clear that estate duty has an impact on offshore assets as well as assets situated within South Africa. In terms of section4 (e) of the Estate Duty Act[3], property situated outside South Africa will attract estate duty unless certain exclusions exist. These exclusions are the following. Should deceased have acquired the property:

- ❑ before he became ordinarily resident in the republic for the first time, or
- ❑ after he became ordinarily resident in the Republic for the first time –
  - o by donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the republic ; or
  - o by inheritance from a person who at the date of his death was not ordinarily resident in the republic; or
- ❑ out of the profits and proceeds of any such property proved to the satisfaction of the Commissioner to have been acquired out of such profits or proceeds[4].

Capital Gains Tax

Its terms of paragraph 40 of the Eighth Schedule of the Income Tax Act[5] a deceased is deemed to have disposed of his assets for an amount equal to market value on the date of his death[6]. This will give rise to a capital gain in the deceased's hands immediately before his death. When dealing with assets acquired or disposed of in a foreign currency, it is necessary to determine

[1] 58 of 1962; Phillip Haupt,Notes on South African Income Tax 25 (2013)
[2] 45 of 1955
[3] *Id.*
[4] *Id.*
[5] 58 of 1962
[6] Phillip Haupt,Notes on South African Income Tax 856 (2013)

the capital gain or loss in rands as stated in paragraph 43 of the Eighth Schedule. Paragraph 43 prescribes the conversion rules and prescribes when such conversion should take place and the appropriate exchange rate. Paragraph 43(1) is applicable where the expenditure derived from and proceeds incurred are in the same foreign currency[7]. Paragraph 43(1A) applies where the expenditure derived from and proceeds incurred are in different currencies[8].

Capital gains and losses are determined as follows in terms of paragraph 43(1):

- Determine the capital loss in foreign currency
- Covert the foreign currency capital gain or loss into rands at the date of disposal by applying the average exchange rate for the year of assessment in which the asset was disposed of (or deemed to be disposed of), or by applying the spot rate at the date of the disposal or deemed disposal[9].

Proceeds in foreign currency (say)	£100 000
Base cost in that currency (say)	£40 000
Capital gain	£60 000
Translate into local currency either at average rate	
for the year or at spot rate on the date of disposal:	
£60 000 x R18,10(say)	R1 086 000

Paragraph 43(1) of the Eight Schedule does not make provision for the currency fluctuation between the date the expenditure is incurred and the date of disposal of the asset[10]. If the rand declines it will benefit a person holding a foreign asset as the base cost is converted into rands at a lower exchange rate ruling at the date of disposal which results in giving more rands as opposed to a higher rate at the date the expenditure was incurred[11].

If a resident owns immovable property outside South Africa, for example a holiday home and this asset is sold out of the residents foreign estate, if the currency in which the expenditure was incurred and the currency in which the proceeds were received or accrued differ, then paragraph 43(1A) of the Eight Schedule will apply.

Mr A purchased a holiday home in France for R750 000 in 2006. Mr A died in November 2013 and in November 2013 the asset was sold out of his foreign estate for €200 000. He did not use it as a permanent establishment.

[7] *Income Tax Act 58 of 1962; Phillip Haupt,Notes on South African Income Tax 922 (2013)*
[8] *Id.*
[9] *C. Bornman, Estate Planning: The impact of estate duty and capital gains tax on offshore assets, 32 (2010)*
[10] *Id.*
[11] *Id.*

Proceeds translated to Rands at average rate for the 2013 tax year (say)	R1 800 000
Base cost in local currency	(R750 000)
Capital gain per paragraph43(2)(a)	R1 050 000

Note that with this translation only the proceeds need to be converted as the base cost is already in local currency. The proceeds must be converted at the average rate for the year of assessment during which the asset was sold. With the result being that tax is based on the currency gain or loss as well as on the real gain or loss[12].

Where an asset is bought in one foreign currency, and sold in another, the capital gain or loss is determined in the foreign currency of disposal by using the average exchange rate for the year and then converted to local currency, again at the average exchange rate.

Mr A purchased a building in the UK for £25 000 in 2010. Mr A died in November 2013 and in November 2013 the asset was sold out of his foreign estate for$40 000. He did not use it as a permanent establishment.

Proceeds in the foreign currency of sale	$40 000
Translate the base cost at the average exchange rate for the year of assessment during which the asset was bought £25 000 x $1.43(say)	($35 750)
Capital gain in $	$4 250

Translate the capital gain to local currency at the average rate for the year of assessment during which the asset is sold. $4 250 x R10, 50(say) R44 625

The effect of Double Tax Agreements (DTA's) and estate tax treaties

When a resident has an offshore asset, cross-border taxation is involved and the impact of Double Tax Agreements (hereinafter referred to as DTA's) and estate tax treaties should be considered. It is possible that estate duty may arise in both the foreign country where the assets are situated as well as South Africa, leading to double taxation. Estate treaties should be taken into account when determining whether the deceased will be liable for estate duty in South Africa or in the country where the asset is situated. DTA's and estate tax treaties make provision for the allocation of the primary right to tax in the country where the income is sourced and grant relief in the resident country by either exempting the income or crediting foreign tax paid against the South African tax charge[13].

[12] C. Bornman, Estate Planning: The impact of estate duty and capital gains tax on offshore assets, 32 (2010)
[13] *Id*. at 63

Example

Mr B, a South African resident died 23 June 2014 and owned an apartment in the UK. The value of the property is R8 000 000.

In terms of the estate tax treaty between SA and the UK[14] estate duty will be levied in terms of article 6(1) of the treaty and immovable property may be taxed in the contracting state in which such property is situated. 40% inheritance tax may be levied on the property situated in the UK. However in terms of the Estate Duty Act[15], 20% estate duty will be levied on the same property in South Africa as the deceased estate is liable estate duty for all property or deemed property.

In terms of article 12 of the estate tax treaty between SA and the UK[16] where a contracting state imposes tax on the property, the former contracting state shall allow so much of its tax as is attributable to such property a credit equal to such amount of the tax imposed in the other contracting state in connection with the same event as is attributable to such property.

If the UK levies 40% inheritance tax and South Africa levies 20% estate duty, the relief will be limited to 20% as this is the tax imposed in the South African deceased estate. The effect would be that 20% inheritance tax will be levied in the UK and 20% estate duty in South Africa[17].

The deceased estate of Mr B may be subject to R1 600 000 inheritance tax in the UK (applicable if the UK *situs* assets are in excess of £325,000, other exclusions and deductions not taken into account) and R1 600 000 estate duty in South Africa (excluding exemptions and deductions) with the effect the estate will be liable for 40% "estate tax liability" on the offshore property.

South Africa and the UK have also entered into a DTA and CGT will be levied in terms of article 13(5) of the DTA[18]. It terms of this "gains from the alienation of any property other than referred to in paragraph 1, 2, 3 and 4 of this Article shall be taxable only in the contracting state of which the alienator is a resident". The deceased estate of Mr B, as a non-resident of the UK, will currently only be liable for CGT in South Africa with regards to the offshore property. This is however all about the change in April 2015 with the extension of UK CGT to residential property owned by non-resident individuals. South Africans now only pay 13.3% on the gains of property

[14] Convention between the Government of the Republic of South Africa and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on estate of deceased persons and on gifts.
[15] 45 of 1955
[16] *Id.*
[17] C. Bornman, Estate Planning: The impact of estate duty and capital gains tax on offshore assets, 70 (2010)
[18] New convention between the government of the Republic of South Africa and the government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of Double Taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains.

sold in the UK. From April 2015 they will pay 28% in the UK and 13.3% in SA, but due to the DTA relief they will only pay CGT in the UK because of its higher rate[19].

No DTA or estate tax treaty

When there is neither a DTA nor an estate tax treaty with the country where the assets are situated, section 16(c) of the Estate Duty Act[20] and section 6*quat* of the Income Tax Act[21] will apply. In terms of section 16(c) of the Estate Duty Act where a deceased estate is subject to estate/inheritance tax in a foreign country, such tax will be deductable from any estate duty chargeable under the Estate Duty Act[22]. This deduction is however limited to the amount of South African estate duty payable in respect on the offshore property. However if the deceased resident owned property in a country which has a DTA with South Africa, the relief will be available in terms of the DTA and the section 16(c) rebate will not be available[23].

Section 6*quat* is aimed at providing relief against double tax by allowing, as a rebate against South African tax, any foreign tax paid (converted to rands) in respect of foreign income included in South African taxable income (section 6*quat*(1))[24]. The purpose of the section 6*quat* rebate is to prevent double taxation on foreign source income and the rebate is limited to the South African tax attributable to the foreign source income[25]. In terms of section 6*quat*(1)(e) any capital gain as contemplated in section 26A from a source outside the Republic will give rise to a rebate. Section 6*quat*(1) is however subject to section 6*quat*(2) which provides that the rebate shall not be granted in addition to any relief provided under a DTA[26]. It may however be granted in substitution for DTA relief should the wording of the DTA allow for it.

Conclusion

It is clear from the above that careful consideration should be given to the effect estate duty and CGT will have on estates where offshore assets are involved as this can affect the liquidity of the estate. The worst case scenario would be that a South African resident can be liable for estate duty and CGT in both South Africa as well as the country where the assets are situated. However the existence of several DTA's and estate tax treaties as well as the domestic provisions against double taxation of section 6*quat* of the Income Tax Act[27] and section 16(c) of the Estate Duty Act[28] will limit the impact thereof to a certain extent.

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[19] Amanda Visser: UK capital gains tax ' is bad news for SA'
[20] 45 of 1955
[21] 58 of 1962
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The accrual claim - Problems and solutions

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Introduction

Estate planning for couples married out of community of property with the accrual can be a tricky exercise. A claim by a surviving spouse against a deceased estate in terms of the accrual system can cripple an estate plan and leave a trail of frustrated and disappointed heirs in its wake.

Many married people who are married out of community of property are not aware that the accrual system applies to their marriages. For many such couples, the accrual system and its many challenges remain undetected until it is too late.

This article will look at the potential problems which the accrual system could create for both deceased estates and surviving spouses. The article will also explore possible life assurance and other practical solutions to these potential problems.

Background

The accrual system has been described as a 'deferred community of property" or a deferred sharing of the profits of spouses married out of community of property. On dissolution of a marriage whether by death or divorce, the net increases in the spouses' respective estates are notionally added up and then divided equally. The accrual is thus the difference between the net of the estate at commencement, properly escalated and the net value at dissolution[1]. In terms of section 3(1) of the Matrimonial Property Act[2] (the Act) at dissolution of a marriage the spouse whose estate shows no accrual or a smaller accrual acquires a claim against the other spouse or his or her estate, for an amount equal to half the difference between the accrual of the respective estates of the spouses. In short:

1) the accrual of each separate estate is first established,

2) the accruals added together, and then

3) divided by two

The Act provides that in respect of marriages out of community of property entered into after 1 November 1984, the accrual system will automatically apply unless it is expressly excluded in terms of an antenuptial contract[3].

The accrual claim can either be an asset (deemed property) or a liability in a deceased estate.

[1] Satchwell J in the case of Radebe and Another V Sosibo NO and Others 2011 (5) SA 51 (GSJ) at Para 14
[2] Act 88 of 1984
[3] Section 2 of the Matrimonial Property Act 88 of 1984

Problems for Estate Planning

The impact of the accrual system is felt hardest on the death of a spouse. An accrual claim in favour of a surviving spouse is a liability in the deceased spouse's estate. The claim is a preferred claim, which is determined before effect is given to any testamentary disposition, donation *mortis causa (*a donation in anticipation of death) or succession to any portion of that estate in terms of the law of intestate succession[4]

It follows therefore that the accrual claim should be taken into account in the liquidity calculation of a planner and should be specifically provided for in the estate plan. In the absence of adequate provision certain bequests may fail, or worse, the estate may be rendered insolvent.

Example

Jack and Jill are married out of community of property (with accrual by default). During the estate planning process the parties must anticipate and make provision for two double edged contingencies:

Contingency 1

The possibility that Jack will die first and Jill will have a claim against his estate (i.e. Jack will have the greater accrual)

Or

The possibility that Jill will die first and Jack will have a claim against her estate (i.e. Jill will have the greater accrual)

While in the normal course, life cover is normally recommended to take care of any potential liquidity problems in an estate, this solution must be applied circumspectly when it comes to 'accrual marriages'

Possible solution 1

A policy on Jack's life payable to his estate to settle the accrual claim

The problem with this option is that any additional life cover will have the unintended dual consequence of increasing the value of Jack's estate (resulting in higher estate duty and executor's fees) and increasing Jill's accrual claim.

[4] Section 4(2) of the Matrimonial Property Act

It is generally accepted that policies payable to third parties do not form part of assets for purposes of the accrual calculation.[5] On the other hand policies payable directly to the deceased estate are included in the calculation.

The example below illustrates

Example

Jack		**Jill**	
Commencement value	R0.00	Commencement value	R0.00
Current Assets	R10 000 000	Current Assets	R500 000
Accrual	**R10 000 000**	**Accrual**	**R500 000**
Potential claim	R0	Potential claim	(10 000 000 – 500 000)/2= R4 750 000

If Jack merely takes an additional policy on his life (payable to his estate) to provide the funds to settle the accrual claim, the impact on his estate will be as follows:

Commencement Value	R0.00
Current Assets (including the policy)	R14 750 000
Accrual	R14 250 000
Accrual claim	R 7 125 000

The additional policy will have the effect of not only increasing his estate (resulting in high estate duty) but also increasing Jill's accrual claim by a whopping R2 375 000.

This solution is therefore appropriate in this situation.

Possible Solution 2

Life cover on Jack's life payable to Jill

While this option will provide Jill with a lump sum payment on Jack's death, it is submitted that unless the policy is specifically designated for this purpose in a duly registered antenuptial contract between the parties, there will be nothing precluding her from further claiming her accrual share from the estate. This could happen in situations where the relationship of the spouses had deteriorated immediately prior to Jack's death and little provision had been made for Jill's maintenance.

[5] Elzette Muller, The treatment of life insurance policies in deceased estate with a perspective on the calculation of estate duty, 2006 (69) THRHR. See also, Old Mutual Premiums and Problems Edition 2007, page E48

In the same vein it can also be argued that if Jill decides to waive her right to claim the payment, the policy proceeds in place of the accrual payment then she could be liable for donations tax (see discussion later).

Possible Solution 3

Life cover on Jack's life payable to a family trust

Instead of making the policy payable to his estate or to his spouse, Jack could consider making a third party the beneficiary on the policy. Structuring the policy in this manner will ensure that the policy is not taken into account in the accrual calculation. One of the methods could be to have the life cover pay out to a family trust and obligate the trustees (by virtue of the trust deed) to ensure that the trustees are bound to settling the estate liabilities.

It must be kept in mind that this will only be a viable solution if a life company, with whom the cover is taken is able to structure their policies whereby a beneficiary will only be able to receive a benefit upon the compliance with any condition, as prescribing conditions in one's will, will not affect the life assurance company's obligations to pay the nominated beneficiary appointed in the life assurance contract. In the event that a life assurance contract does make provision for this, a substitute beneficiary would then also have to be nominated in that contract in case the first beneficiary repudiates.

It is submitted that the third party can also be a natural person. The nomination or the third party will be subject to the condition that the proceeds be used to settle Jack's estate liabilities.

Although the policy will be deemed property in Jack's estate for estate duty purposes, it is submitted that this is probably the most plausible solution.

Contingency 2

The possibility that Jack will die first and Jill will have a claim against his estate (i.e. Jack will have the greater accrual)

Or

The possibility that Jill will die first and Jack will have a claim against her estate (i.e. Jill will have the greater accrual)

How do you plan for a situation where the surviving spouse owes the deceased spouse's estate?

Possible Solution 1

Life cover on Jack's life, payable to Jill

This option will ensure that Jill has sufficient funds to settle the accrual claim. Since the policy will not be payable to the estate, it will not included in the accrual calculation. The policy will however be deemed property for the estate duty calculation.

Can the Accrual claim be waived?

In terms of the Matrimonial Property Act,[6] the accrual claim is only acquired on the dissolution of a marriage by either death or divorce. The spouses therefore do not acquire any real right in the property of each other as before the dissolution, the spouse with the smaller accrual only has a contingent right to claim in terms of the accrual system. The right only becomes vested when the contingency (death) materialises.[7] It follows therefore that the right to claim under the accrual system only vests after the death of the spouse with the larger accrual. The claim is therefore not a claim against the deceased spouse but against that spouse's estate (a separate legal persona). Hence, if an accrual claim against the deceased estate is waived, it will not be seen as a gratuitous disposition in favour of one's spouse. It is accordingly submitted that the donations tax exemption, which applies to donations between spouses,[8] would not apply in the case where the right to claim is waived.

Settlement in Assets

Some writers[9] state that the accrual claim does not necessarily have to be settled in cash. According to this school of thought, the claim can also be settled with assets or a combination of assets and cash. In this case the surviving spouse would be entitled to choose assets from the deceased estate instead of monetary compensation. While in the normal course this solution would be ideal, it has its limitations.

Firstly, if the relationship between the spouses had deteriorated prior to the respective spouse's death and insufficient provision has been made for the maintenance of that spouse, then it is unlikely that the surviving spouse would be willing to accept assets in place of cash.

Secondly, if, at the time of death the estate has insufficient assets to meet the accrual claim, then this option would not be possible.

[6] Section 3(1) of the Act
[7] Bester AJ in DS, R V DS, M and Others
[8] Section 56(1)(b) of the Income Tax Act 58 of 1962
[9] Jacqui van Marcke, Momentum, Leverage, August 2010

Antenuptial Agreements

An Antenuptial Contract, also known as a Prenuptial Contract or "Prenup", is a contract entered into by two people prior to their marriage, to stipulate the terms and conditions for the exclusion of community of property between them. The terms and conditions may not be illegal, immoral or contrary to public policy.

Section 4(1) (b) (ii) of the Act states that an asset which has been excluded from the accrual system in terms of the antenuptial contract of the spouses, as well as any other asset which he acquired by virtue of his possession or former possession of the first-mentioned asset, is not taken into account as part of that estate at the commencement or the dissolution of his marriage.

Parties marrying into this system are therefore free to exclude certain assets from falling within the ambit of the accrual calculation. It is therefore advisable for parties in this situation to take out life policies at the inception of their marriages to cater for the two contingencies described above and include them in their antenuptial agreement. These policies should be reviewed regularly to ensure that they will provide sufficient funds to settle any potential accrual claims between the parties.

An antenuptial agreement should be registered before the marriage or within six months of it.

Donations between spouses

In the determination of the accrual of the estate of a spouse, a donation between spouses, other than a donation *mortis causa*[10], is not taken into account either as part of the estate of the donor or as part of the estate of the donee[11] .

Apart from using life policies, a party whose estate faces a potentially large accrual claim can trim the value of his or her estate by donating some of his assets to his spouse to limit the growth of his estate. Such donations are also exempt from donations tax and capital gains tax.[12]

[10] A donation in anticipation of death
[11] Section 5(2)
[12] Paragraph 67 of the Eighth Schedule to the Income Tax Act.

Conclusion

As has been highlighted above, estate planning for persons married out of community of property (with the accrual) can be tricky. There are however many ways in which spouses married under this regime can plan their estates to ensure minimal disruption during the winding up stage. It is imperative for financial planners to request copies of their client's antenuptial contracts, so as to ascertain whether the accrual system has been specifically excluded or not. It is also important that commencement values be identified and assets are valued accurately. As highlighted above, as much as there are complications when planning for these types of marriages, there are also great opportunities for business for financial planners who could offer solutions for these complications.

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Valuation of shares in a company owning farming property for purposes of estate duty and capital gain tax

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Introduction

The purpose of this article is to give some insight with regard to the valuation of a share or interest in a Company or Close Corporation for purposes of estate duty and capital gains tax, where the assets of the company or close corporation includes fixed property and specifically farming / agricultural land. The specific sections of the Estate Duty Act ("the Act") [1]relevant to the afore-mentioned valuation will be discussed in more detail below. To assist estate planners in this market, this article would also discuss SARS's view on the issue as well as what is allowed in practice.

Section 5(1) (f) *bis*[2]

Section 5 of the "the Act "specifies in detail the basis of valuation for all property and deemed property included in the estate. Shares in unlisted companies are valued in terms of the provisions laid down in Section 5(1)(f)*bis* of "the Act", irrespective of whether or not it is sold in the course of liquidation of the estate, and disregards the price realised if so sold)[3].

"The Act" provides that for the purpose of section 5(1) (f)*bis* "the term "shares" includes any members' interest or any class of shares, stock, debenture stock, debentures or right to purchase members' interests or to subscribe for or purchase shares, stocks or debentures and the term "company" includes any company or close corporation incorporated in the Republic or elsewhere"[4].

Farming Land

The provisions governing the valuation of unlisted company shares set out above are subject to a further valuation provision where the company concerned owns immovable property on which bona fide farming operations are being carried on in the Republic. In these circumstances the value of that immovable property, so far as relevant in determining the value of the shares of the company, is to be determined on the basis set out in the definition of "fair market value" in section 1 of the Act.[5]

The concept "fair market value" is, however, specifically defined in the Act in relation to immovable property on which a *bona fide* farming undertaking is being carried on in the Republic. This essentially means the amount determined by reducing the price which could be obtained upon a sale of the property, between a willing buyer and a willing seller dealing at arm's length in an open market by 30%.[6]

[1] Estate Duty Act No.45 of 1995
[2] Section 5 of the Estate Duty Act No.45 of 1995
[3]Section 5(1)(a) of the Estate Duty Act No.45 of 1995
[4] Section 5(5) of the Estate Duty Act No.45 of 1995
[5] Section 5(1A) of the Estate Duty Act No.45 of 1995
[6] Section 1 of the Estate Duty Act No.45 of 1995

Fair Market Value

"Fair market value, means—

(a) the price which could be obtained upon a sale of the property between a willing buyer and a willing seller dealing at arm's length in an open market; or

(b) in relation to immovable property on which a *bona fide* farming undertaking is being carried on in the Republic, the amount determined by reducing the price which could be obtained upon a sale of the property between a willing buyer and a willing seller dealing at arm's length in an open market by 30 per cent."[7]

Valuation of Immovable Property form –REV 246[8]

In determining the value of a share held in a company where the assets includes a fixed property or farming land, SARS requires that REV 246 be completed. One can use this form as a general guideline when determining the value of farming land as part of the assets of a company when determining the value of the share for Estate Duty purposes. The following information needs to be taken into account:

- The value of unreaped crops, or unpicked fruits, plantations, orchards, vineyards ,also planted lucern, sugar cane, pineapples, cotton and the like must be included.
- Type of farming activities
- General type of farming in the area
- Approximate area of buildings (including dwellings, outbuildings and sheds) and state of repair.
- Value of various types of farming land R/Ha including Grazing, Dry land, Land under irrigation, Crops under irrigation (eg. Citrus, sugar, etc.)
- Comparable transactions in the area used to substantiate the fair market value of the farming land being valued. SARS recently made the requirement of comparable transactions in the area used to substantiate the fair market value of the farming land being valued, compulsory by adding an additional Section F to REV 246.[9]
- Confirmation that bona fide farming operations are conducted on the property.

Allowable deductions when calculating equity

Note that the value of the deceased's shareholding in a company, comprising of farming land, will not be the same as the value of farming land in the name of the deceased as sole

[7] Section 1 of the Estate Duty Act No.45 of 1995
[8] Available on the SARS website: http://www.sars.gov.za/Pages/Forms.aspx?pageid=C24
[9] In terms of feedback from persons who practice in this market, comments have been made that SARS will not accept a valuation if Section F is not completed.

proprietor, as the equity of the shareholding in the company will be the value after taking into account liabilities such as loan accounts, debtors etc and taxation.[10]

Example: Valuation of shares for Estate Duty Purposes

The financial statements as at date of death reflect the following assets and liabilities:

Farming property	R 1000 000
Current Assets	R 10 000
Creditors	R 5000

The farm was valued for R 2 500 000 as at date of death

Calculation

Fair Market Value of farming land		R2 500 000
Less:	30%	R1 750 000
Plus:	Current Assets	R 10 000
Less:	Trade and other creditors	R5000
		R1 755 000
Less:	Capital Gains Tax[11]	R 139 860
	Dividend Tax[12]	R242 271
Value of 1(100%) ordinary share		R1 372 869

Example: Valuation of shares for Capital Gains Tax Purposes

The financial statements as at date of death reflect the following assets and liabilities:

Farming property	R 1000 000
Current Assets	R 10 000
Creditors	R 5000

The farm was valued for R 2 500 000 as at date of death

[10] This being normal taxation resulting from the capital gain and the dividend tax implications thereof.
[11] Note 1
[12] Note 2

Calculation

Fair Market Value of farming land	R2 500 000
Plus: Current Assets	R 10 000
Less: Trade and other creditors	R5000
	R2 505 000
Less: Capital Gains Tax[13]	R 279 720
Dividend Tax [14]	R 333 792
Value of 1(100%) ordinary share	R1 891488

Note 1 Capital Gains Tax

Valuation	R 1 750 000
Less Base Cost	R 1 000 000
	R 750 000
CGT Inclusion rate 66,6%	R 499 500
Tax @ 28%	R 139 860

Note 2 Dividend Tax

Net asset Value	R 1755 000
Less CGT	R 139 860
	R1 615140
15% Dividend Tax	R242 271

Note 3 Capital Gains Tax

Valuation	R 2 500 000
Less Base Cost	R 1 000 000
	R 1 500 000
CGT Inclusion rate 66,6%	R 999 000
Tax @ 28%	R 279 720

[13] Note 3
[14] Note 4

Note 4 Dividend Tax

Net asset Value	R 2 505 000
Less CGT	R 279 720
	R2 225 280
15% Dividend Tax	R 333 792

Note that, subject to certain exceptions,[15] the valuation for Estate Duty purposes differs from the valuation of the same shares for capital gains tax purposes, only in the case where the company or CC owns farming property on which a *bona fide* farming undertaking is being carried on.

Conclusion

It is important to take all relevant information into account when calculating the value of the shares of a company where farming property is part of the assets of such a company. It is important to take note of the specific deductions allowed by SARS when calculating the equity as illustrated in the example above. The latest financial statements is of utmost importance but take into account the fact that the value of fixed property or farming land reflected in the financial statements is normally the cost price of the property and not the market value of such property. The value arrived at will have a huge impact on the recommendations made by the estate planner or financial adviser and therefore the necessary care must be taken when calculating the value of shares for estate duty purposes.

[15] See 31(4) of the 8th Schedule of the Income Tax Act

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Identifying clients financial needs through estate plan reports

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Introduction

The purpose of this article is to highlight the usefulness and value of identifying financial needs of clients through the exercise of compiling an estate plan report. Many clients have the intention but do not have the time, knowledge or skill to analyse their entire financial affairs. As their financial advisor this is your opportunity to compile an estate plan report and present to them a holistic view of their financial situation. The various analyses conducted in terms of the case study below are generally covered in most estate plan reports but not limited to these. Sometimes clients are very specific about what they would like to have covered in the estate plan report and a report can be compiled accordingly.

There are many misconceptions about estate planning, such as, it is all about trying to save on estate duty; it is for large estates only and is solely concerned with the handling of an estate after the death of the client. This is an incorrect understanding of the true purpose of such a plan.

Estate planning is about developing a plan that will enhance and maintain the financial security of clients and their families during their lifetime and the orderly disposition of property at death; it is about increasing the client's estate and conserving existing assets[1]; examining financial needs and assets to ensure that heirs are provided for in the best possible way and providing guidance to the client under a variety of circumstances. Clients appreciate this effort from the financial advisor as it illustrates the interest that the financial advisor has over their financial affairs.

The case study below and the analyses, comments and recommendations that follow are typical of the manner in which estate planning is conducted.

Case Study:

Lionel is an Engineer (45) and is married to Tanya (45) by ante nuptial contract (ANC). She is a beautician and has her own salon. They have twin boys (6). Lionel has a 45% share holding in a consulting company. His pension fund value is R3m to which his children are the nominated beneficiaries.

Lionel and his co share holder have a buy and sell agreement in place. They also have a verbal agreement between themselves that each business partner fund their own premium. Lionel wants to make the testamentary trust beneficiary on the buy and sell policy as he is concerned that his business partner may change his mind about purchasing his business interest

[1] www.americancollege.edu/assets/pdfs/fa271-2011-chapter1

Both the business partners have signed a resolution approving and authorising the Company to take out the key person policy on Lionel's life.

In terms of Lionel's Will:

- Tanya is to receive the house.
- The proceeds of the buy and sell agreement is to be held in trust. The trustees are to utilise the proceeds to fund the children's education and the balance of the capital, if any is to be used to get them started off in life.
- The residue has been left to the testamentary trust.
- His 2 sons are the beneficiaries to the trust.
- He has appointed his 2 brothers as executors to his estate and trustees to the testamentary trust

1. Estate Duty Analysis:

	Value	
Primary residence	2 000 000	
2 Apartments	2 300 000	
Business Interest	5 000 000	
Cash in the bank	500 000	
Deemed Assets:		
Life policy 1 (to spouse)	3 000 000	
Life policy 2(to parents)	1 000 000	
Life policy (buy and sell)	5 000 000	
Life policy(key person policy)	2 000 000	
Total value of the Estate	**20 800 000**	
Less Deductions:		
Masters fees	600	
Funeral expenses	15 000	
Executors fees (9 800 000 X3.99%)	391 020	
Liabilities – bond	1 200 000	
CGT[2]	498 168	
Income Tax [3]	100 000	
Section4q – house and policy	5 000 000	
Total deductions	**7 204 788**	
Net Estate	**13 595 212**	
Less Section 4A Abatement	3 500 000	
Dutiable Estate @20%	10 095 212	
Estate duty	**2 019 042**	

[2] Calculation of base cost determined in terms of the 20% Rule.
[3] An assumption made as per the client's instruction

Estimated Capital gains Tax (CGT)

Asset	Base Cost	Proceeds	Exclusions	Gain/loss
Primary residence	400 000	2 000 000	Roll-over. Inherited by spouse	Nil
Apartments	460 000	2 300 000		1 840 000
Business	1 000 000	5 000 000	1 800 000	2 200 000
Total gain				4 040 000

Less annual exclusion	300 000
Gain	3 740 000
Inclusion rate	33.3%
Taxable capital gain	1 245 429
Marginal rate	40%
CGT payable	**498 168**

2. Liquidity Analysis:

Liquid Assets:	
Cash in bank	500 000
Total Cash	**500 000**
Cash required for:	
Masters fees	600
Funeral expenses	15 000
Executors fees (9 800 000 X3.99%)	391 020
Liabilities	1 200 000
CGT	498 168
Income tax	100 000
Estate duty	2 019 042
Total	**4 223 830**
Cash shortfall	**(3 723 830)**

3. Death Needs Analysis:

Tanya requires R30 000 pm X12 = R360 000 until 80 years.

Children require = R10 000 pm per child until 25 years

Tanya		**Children**	
Bgn		Bgn	
1 P/Y		1 P/Y	
360 000	PMT	240 000	PMT
35	N	19	N
0.93458[4]	I	0.93458	I
PV	10 804 529	PV	4 160 338
Available: Policy1	3 000 000	Available: Business:	5 000 000
Required:	10 804 529	Required:	4 160 338
Shortfall	**(7 804 529)**	**Surplus**	**839 662**

Comments and recommendations based on the analyses:

1) Additional life cover is necessary to make provision for the following shortfalls:
   i. Liquidity Analysis [3 723 830/0.7681][5] 4 848 106
   ii. Death Needs Analysis [for spouse] 7 804 529
   12 652 634

2) The buy and sell policy is dutiable as it does not comply with one of the exemption requirements in terms of section 3(3) (a) (iA) of the Estate Duty Act i.e. no premium must have been paid or borne by the deceased/life assured. In this instance each party paid the premiums on their own lives

   The key person policy does not comply with one of the exemption requirements for estate duty purposes in terms of section3 (3) (a) of the Estate Duty Act i.e. the requirement that 'policy must not have been effected by or at the instance of the deceased'. In this instance Lionel signed the resolution authorising the company to take out a policy on his life. This act can be construed as if the policy was effected at his instance; hence the exemption for estate duty purposes cannot apply.

Since both the policies are dutiable there are two options available to the client to remedy the situation:-

i. The financial advisor could increase the life covers to incorporate estate duty. Hence cover increases required would be as follows:

[4] The resultant rate is based on the assumption of a growth rate at 8% and escalation rate at 7%
[5] To make provision the additional estate duty and executors fees in the life cover

Buy and sell policy- 5 000 000/.8 = 6 250 000	increase by	1 250 000
Key person policy- 2 000 000 /.8= 2 500 000	increased by	500 000
		1 750 000

ii. The financial advisor could take out new policies and structure the policies in a way so as to comply with the estate duty exemption requirements available

3) Unless Lionel's brothers have the knowledge of winding up estates, one could suggest that a professional executor be appointed to wind up the estate. This will avoid delays in the process. The brothers or perhaps one of them may be a co-executor if Lionel so wishes. With regard to the appointment of trustees of the testamentary trust, at least one of the trustees should be unrelated to the client so as to maintain objectivity particularly in emotional or sensitive situations.

4) Lionel and Tanya should decide upon the appointment of a guardian to their children in the event of their simultaneous death or failing a natural guardian. The appointment of a guardian should be made in terms of their Wills. The latter will avoid the delay and costs involved in applying to the High Court for an appointment of a guardian to their minor children.

5) The use of the donations tax exemptions should be brought to Lionel's attention as this can, over the years, assist in reducing his estate to some extent. He could for example make donations up to R100 000 per annum into an investment in his children's names, which would result in the reduction of the provision that would need to be made for them.

6) In terms of a buy and sell arrangement, the testamentary trust cannot be the beneficiary to the policy on Lionel's life. The beneficiary to the buy and sell policy should be the owner of the policy i.e. Lionel's business partner because he is contractually bound in terms of the agreement to purchase Lionel's business interest from Lionel's executor. He therefore requires funds to fulfil the obligations in terms of the agreement and these funds will flow through from the policy proceeds. If the trust is nominated as the beneficiary to the buy and sell policy, it would not only defeat the purpose of the buy and sell agreement but would also place the business partner in a vulnerable financial position as he will need to seek funds elsewhere to purchase the business interest. It is quite difficult for the average business person to generate a relatively large amount of capital at a moment's notice, hence the purpose and structure of the buy and sell arrangement. If the executor simply transfers the business interest to the partner without receiving funds this would appear as a donation and SARS will certainly expect donations tax to be paid by the donor i.e. the estate. On the other hand if the business interest is not transferred to Lionel's business partner as a result of that business partner not being in a position to fund the purchase, the agreement could be terminated which would allow the executor to sell the interest to any interested party. However, this may not necessarily be in the business's best interest and could hinder any succession planning by the business partners.

7) In terms of the death needs analysis, the children will probably benefit from the pension fund. However there is no guarantee that the Board of Trustee will make a 100% award to the children. In terms of section 37C they will also consider Tanya for a portion of the award as she is a dependant as well. Hence the shortfall in terms of the death needs analysis is based on an assumption that the pension award will be made 100% in favour of the children. If the spouse receives a portion then her shortfall will be reduced to that extent.

8) There is a possibility that Lionel may be interested in creating an inter vivos trust in order to "freeze" his estate and to create wealth in a trust. A discussion about the pros and cons of creating the trust during his life time should be discussed as well as the costs of creating a trust and taxes involved in the transferring of assets into a trust. The business interest and /or the 2 apartments are the growth assets which could possibly be transferred into a trust

9) Lionel should consider creating an investment portfolio considering that he is 45 years old and still has time in the market. The benefits of investments should be pointed out to Lionel and suggestions be made for a diversified and well balanced investment portfolio. The opinion of an investment specialist can be obtained if necessary.

10) Retirement annuity funds (RA's) is a retirement savings vehicle but can also be utilised for estate planning purposes as well. Investing in RA's will also be a savings in taxes as RA's do not attract any income tax, dividends tax, capital gains tax, estate duty nor any executors fees. The member of an RA can claim a tax deduction against taxable income in respect of the contributions he/she makes towards the RA. Hence an RA can serve the purpose of both a retirement and estate planning tool.

Structuring of policies

The impact of not structuring policies correctly is huge! Let us compare the impact the buy and sell policy and keyperson policy in this case study has had on estate duty alone. Had they been structured by a 'prudent' financial advisor you will note that the estate duty would be far less as compared to the policies structured by the 'not so prudent' financial advisor.

Estate duty comparison:

Assets	**NOT PRUDENT**	**PRUDENT**
Primary residence	2 000 000	2 000 000
2 Apartments	2 300 000	2 300 000
Business Interest	5 000 000	5 000 000
Cash in the bank	500 000	500 000
Deemed Assets:		
Life policy 1 (to spouse)	3 000 000	3 000 000
Life policy 2(parents)	1 000 000	1 000 000
Life policy (buy and sell)	***5 000 000***	-
Life policy(key person policy)	***2 000 000***	-
Total value of the Estate	**20 800 000**	**13 800 000**
Less Deductions:		
Masters fees	600	600
Funeral expenses	15 000	15 000
Executors fees (9 800 000 X3.99%)	391 020	391 020
Liabilities – bond	1 200 000	1 200 000
Income Tax + CGT	598 168	598 168
Section4q – house and policy	5 000 000	5 000 000
Total deductions	**7 204 788**	**7 204 788**
Net Estate	**13 595 212**	**6 595 212**
Less Section 4A Abatement	3 500 000	3 500 000
Dutiable Estate @20%	10 095 212	3 095 212
Estate duty	**2 019 042**	**619 042**

The difference of R1 400 000 is regrettably the "cost" the client has to pay for inappropriate advice!

Nowadays clients are increasingly becoming financially savvy and financial advisors who do not act in the best interest of their clients are often taken to task for this. In order to avoid complaints being lodged with the Ombudsman and the risk of being debarred, financial advisors must make every endeavour to understand the impact of the recommendations made to their clients and very importantly the tax implications on the recommendations made. If necessary the opinion and guidance from specialists in the various areas of estate planning should be sought.

Conclusion

From the above case study, we have identified the following:-

- ❑ The estate will be cash strapped if liquidity provision is not made
- ❑ A possible shortfall in terms of Tanya's income on death of Lionel,
- ❑ The buy and sell policies and keyperson policy need to be reviewed. Either the cover amount be increased to incorporate estate duty alternatively have new policies issued to save on estate duty,
- ❑ The possibility of creating an inter vivos trust and conducting business with the trust (both risk and investment),
- ❑ Utilisation of the donation tax exemption every year through possible investments in the children's names,
- ❑ Investments for Lionel himself as he does not appear to have an investment portfolio for wealth creation,
- ❑ Investing in retirement annuity funds can be a useful estate planning tool
- ❑ Amending the Will to include the appointment of a guardian of choice, appointing a professional executor and at least one independent trustee.

Financial advisors need to be wary when presenting an estate plan report to the client, as in some instances clients may become overwhelmed when the various financial need areas and shortfalls are pointed out to them and recommendations put forward. If the latter is the case rather advise the client to prioritise their most urgent concerns and address those first. Some of the recommendations can be considered once again at a review session. At no point should a client feel pressured into implementing any recommendation.

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Amendments to trust deeds, should beneficiaries be added?

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Broker Distribution : Gauteng

Introduction

The amendment of trust deeds has come under the spotlight recently in our courts. This article will discuss the scenario where the founder and the trustees of an *inter vivos* trust (living trust) are considering making amendments to a trust that will now, following recent case law, be null and void (invalid) unless the consent of the trust beneficiaries has not been obtained prior to the proposed amendment being made.

Classification of Trusts

Trusts in South Africa can be classified in a number of different ways, based on *inter alia,*:

- whether the founder is alive or dead; or,
- the rights of beneficiaries and ownership of trust property.[1]

Each of these classifications is briefly discussed below.

- *Trusts* mortis causa – these trusts are also referred to as testamentary or "will" trusts. These are trusts which are formed on the death of the founder of the trust.
- *Trusts* inter vivos – these are trusts which are formed during the lifetime of the founder.[2]

Trusts in the strict sense – in the case of a trust in the strict sense, the assets and liabilities of the trust are owned and administered by the trustees in their official capacity on behalf of the beneficiaries in accordance with the provisions of the trust deed. In other words, legal ownership, or so-called "bare ownership", of the trust property vests in the trustees but the trustees do not hold beneficial ownership of those assets. The trustee is the owner and administrator of trust property, only for the purposes of administration of the trust, and they do not personally acquire any rights (as trustee) in respect of trust assets. Section 12 of the Trust Property Control Act 57 of 1988 specifically provides that trust property does not form part of the personal estate of the trustee (as trustee). In estate planning, trusts "in the strict sense" are usually the trusts that are used.[3]

Bewind trusts (*or trusts in the "wide" sense*) – in such a trust, the beneficiaries acquire a vested right upon the creation of the trust, and their rights are only limited in that the control and administration of the assets are transferred to the trustees. An example of such a trust arises when assets are bequeathed to a minor, but are placed under the control of a trustee who will administer those assets on behalf of that minor. In this case, full ownership of the assets vests in the minor, but control of the assets lies with the trustee.[4]

[1] The South African Financial Planning Handbook 2013 page 812-814 [The Law and Taxation of Trusts].
[2] Supra
[3] Supra
[4] Supra

Discretionary trusts – in such a trust the beneficiaries do not have any vested rights, and any income or capital which they may receive is determined purely in the discretion of the trustees.

Vesting trusts – in such a trust the beneficiaries do have vested rights either to income or capital or to both. The rights that the beneficiaries have are real rights, not just personal rights.

The parties to a trust are:

(i) The founder (also known as the settlor) is the person who establishes the trust. As far as estate planning is concerned, the founder is usually the client who wishes to enter into the plan. Because an inter vivos trust is a contract, the client should be the founder and, as such, will remain a party to the contract. This is particularly important if any variations or amendments to the trust deed are to be made in the future.[5]

(ii) The trustees are those persons that will be responsible for the administration of trust assets for the benefit of the beneficiaries. Trustees can also consist of family members, auditors, attorneys, professional trust companies or a combination of the above.

(iii) The beneficiaries are the persons for whose benefit the trust has been created and usually will consist of the founder's children and their descendants. [6]

Amendment of a testamentary trust deed

Generally a court cannot vary the terms of a testamentary trust because of the principle of freedom of testation. However if a testamentary trust contains discriminatory or unconstitutional provisions, a court can delete the offending parts of the trust deed. For example, a court deleted certain clauses in a trust which provided that certain students were prevented from applying for university bursaries on the grounds of religion and race.[7] This is in terms of section 13 of the Trust Property Control Act,[8] which gives the court certain powers regarding the amendment of a trust deed. The section provides as follows:

"If a trust instrument contains a provision which brings about consequences which in the opinion of the court the founder did not contemplate or foresee and which hampers the achievements of the objects of the founder; or prejudices the interests of the beneficiaries; or is in conflict with public interest; then the court may (on application of the trustee or any interested person), delete or vary such provision or make any other order which the court deems just in the circumstances, including and order terminating the trust."[9]

Amendment of an *inter vivos* trust deed

It has been accepted that a trust *inter vivos* is a contract for the benefit of a third person, a so-called *stipulatio alteri.* The contracting parties are the founder and the trustees. It is important to

[5] Supra page 1 footnote 1, page 817.
[6] Trust in a nutshell by P. A. Olivier and G P J van den Berg, November 2006.
[7] Supra page 1, footnote 1, page 824.
[8] The Trust Property Control Act 57 of 1988.
[9] Supra footnote 7.

understand the legal basis of an *inter vivos* trust because its legal basis has a direct impact on a number of issues, such as the amendment of trust deeds.

The general rule is that the court does not have the power to vary contracts and thus no power to vary *inter vivos* trusts. Nevertheless, section 13 of the Trust Property Control Act[10] also applies to *inter vivos* trusts.

In *Hofer and Other v Kevitt*[11] the court referred to the *Crookes v Watson*[12] in which it was accepted that a trust *inter vivos* is a contract for the benefit of a third person and unless the beneficiaries have accepted the benefit stipulated for them, the trust deed can be varied by agreement between the founder and the trustee. The *Hofer* decision means that the founder of an *inter vivos* trust is free to make changes when they choose to do so by agreement with the trustees, which could include the replacement of beneficiaries. If the beneficiaries (either vested or discretionary) have accepted the benefits which have or may accrue to them in terms of the trust deed, the beneficiaries become part of the contract (that is part of the trust), and any variations or amendments thereto can only be made with their approval.[13]

In *Potgieter v Potgieter NO and Others*[14], clause 2 of the trust deed specifically provided that the trustees could amend the capital beneficiaries of the trust but not after the death of the founder and only with the founders consent during his lifetime. The founder made amendments without consulting the existing beneficiaries. The court found that the benefits of the trust had been accepted by the legal guardian of the beneficiaries on their behalf, and that therefore no amendment to the trust was possible without their prior consent (notwithstanding the express provisions of the trust deed). The amendments were therefore found to be null and void. [15]

These cases are a clear indication that trust beneficiaries must be part of the amendment of the trust deed process when benefits have been accepted by them. Brand JA explains it in the Potgieter judgement as follows:

"in consequence, the founder and trustee can vary or even cancel the agreement between them before the third party has accepted the benefits conferred on him or her by the trust deed. But once the beneficiary as accepted those benefits, the trust deed can only be varied with his or her consent. The reason is that, as in the case of a stipulatio alteri, it is only upon acceptance that the beneficiaries acquire rights under the trust".[16]

[10] Supra footnote 9.
[11] [1997] 4 ALL SA 620 (SCA).
[12] [1956] (1) SA 277 (A).
[13] Supra page 2, footnote 7.
[14] 2012 (2) SA 637 (SCA).
[15] Supra footnote 13.
[16] Wills & Administration of Estates, Wills and Trusts, Section B18 (18.2.2) [R.P. Pace & W.M. Van Der Westhuizen].

When is a benefit accepted by a beneficiary?

"Acceptance of benefits" must be defined very clearly. Does it mean, for example, that if income is distributed to trust beneficiaries that a benefit has been accepted by them? In a recent and yet unreported court case in the Western Cape High Court[17], it was decided that, notwithstanding the fact that the amendment was made in terms of an amendment clause in the trust deed empowering the founder and the trustees to amend the trust deed, the amendment was null and void due to the fact that the beneficiary who received certain monies from the trust was not a party to the deed of amendment.

The effect of this decision means that **any beneficiary** that has received **any benefit** from the trust shall from that moment on have to be a party when the trust deed needs to be amended. Therefore both capital and income beneficiaries would have to consent to an amendment if they had accepted any benefit from the trust, which in effect, amounts to that beneficiary having a veto right. [18]

This is exactly where the difficulty arises with regard to when a beneficiary of a discretionary trust has accepted a benefit from a trust. In this regard, the following is pertinent:

"Whether or not the beneficiary has accepted the benefits of a trust, or become a part of the contract that formed the trust, will depend on the facts of each case. Just because a beneficiary has accepted an immediate or current benefit does not necessarily imply an acceptance of the contract in terms of which the right to benefit was conferred by trustees. It is submitted that something more should be done in order to make that beneficiary a part of the contract in terms of which the trust was formed, such as making that beneficiary aware of the existence of the contents of the trust deed together with the proof of this awareness and proof of acceptance of the benefits that may or may not be conferred in terms of the trust instrument.

Another problem which might arise is that there could be difficulty in obtaining the requisite consent from the beneficiaries to vary a trust deed if the beneficiaries are numerous and widely dispersed. It must also be borne in mind that if the guardian of a minor beneficiary agrees to the variation on behalf of the minor and that the variation is to the minor's prejudice, the minor may be able to have the variation set aside. If a minor's guardian is deceased or incapacitated, the consent to variation would be required from the Master of the High Court.[19]

[17] Adv. Leon Zazeraj NO vs Johannes Jordaan, Andre Du Plessis, WA Boonzaaier & Professor Kobus van Schalkwyk [Western Cape Division case number: 22526/11].
[18] PWC Estate & Trust Advisory Services Quarterly Publication (60 Seconds with Gert Van Den Berg).
[19] Davis, Beneke & Jooste, Estate Planning Section B, paragraph 5.9.2 [2014].

Conclusion

Therefore, when considering a variation of the trust deed of an *inter vivos* personal trust, it is of paramount importance to establish first whether the beneficiaries have acquired any form of a right and whether they have accepted any benefits conferred upon them. If not, the trust deed can be amended by an agreement between the founder and the trustees. If beneficiaries have accepted benefits from the trust, only those beneficiaries who have actually accepted must be made party to the amendment. In terms of the above cases, such acceptance and the involvement of the beneficiaries to the variation overrules any stipulation regarding amendments in the trust deed.

The beneficiaries can argue that because they were not a party to the contractual agreement, that may exclude them from being involved in the variation of the trust deed, they are not bound by such a stipulation excluding them, but that they prefer to rely on the legal working of the *stipulatio alteri* in terms whereof they acquire the right to be a party to the amendment once they have accepted a benefit from the trust. It is equally possible to argue that once the beneficiaries have accepted the benefit they acquire not only the rights but also the duties in terms of the agreement and therefore have to abide by the exclusion as a party to a variation. Despite very creative arguments this was not raised in *Potgieter v Potgieter*[20] and has not yet elsewhere been authoritatively decided and therefore despite some clarification on some important points in the *Potgiete*r case it remains part of the grey area surrounding our trust law. The *Potgieter* case does bring clarity as to the kind of right acquired by the beneficiary when accepting the benefit conferred on him or her in terms of the trust deed.[21]

When considering any variation the starting point usually is the trust deed itself and its variation clause. However in all instances this is not in itself a free ticket to vary the deed, but has to be accompanied with a checking of the rights of beneficiaries especially vested rights, also whether the founder is still alive and whether the beneficiaries have accepted any benefits (causing the rules of the *stipulatio alteri* to possibly find application). Where the founder is deceased or not available (i.e. where he/she is alive but cannot be traced or has since creation of the trust become mentally incapable of handling its own affairs) and where the trust deed lacks a variation clause or any other similar power to vary the trust deed the statutory powers of the court, or an application to court in terms of the common law may have to be resorted to.[22]

[20] 2012 1 SA 637 (SCA).
[21] Supra page 3 footnote 16.
[22] Supra footnote 20.

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Capital gains tax implications on agricultural properties in estate planning

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Introduction

Agricultural property is still considered a farmer's most valuable asset and many farmers still own their agricultural property, their fundamental means of generating income, in their personal capacity. The value of agricultural property has increased substantially over the past few years and proper estate planning is therefore of paramount importance.

The method of valuating agricultural property for estate purposes has undergone a significant change on 1 February 2006, when the Estate Duty Act[1] was amended by section 1(1)(a) of the Revenue Laws Second Amendment Act[2]. The so called 'Land Bank valuation' was replaced with the valuation applicable to all other property, namely, the price that could be obtained between a willing buyer and willing seller dealing at arm's length in an open market, but must be reduced by 30 percent in recognition of the fact that 'Land Bank valuations' were lower than the 'fair market value'. The reason for this reduction is that the 'Land Bank value' represented the fair agricultural or pastoral value of the property and not the open market value.

This article attempts to identify some of the challenges and potential pitfalls that financial planners should look out for when planning a farmers estates, due to fact that certain practical issues are often not taken into consideration when dealing with the complexities of the estate of a farmer.

Capital Gains Tax

Capital gains tax is included in a taxpayer's taxable income in terms of section 26A of the Income Tax Act,[3] the liability for which is calculated in terms of the Eighth Schedule to the Income Tax Act[4]. All capital gains made on the disposal of assets are subject to capital gains tax unless excluded by specific provisions[5].

A capital gain is the proceeds or deemed proceeds from the disposal or deemed disposal of an asset at market value less the base cost.

Market value of agricultural property

Immovable property on which *bona fide* farming operations is carried on may be valued at either the value contemplated in paragraph (b) of the definition of the term 'fair market value' in section 1 of the Estate Duty Act[6], or in terms of the price which could have been obtained

[1] Act 45 of 1955.
[2] Act 32 of 2005.
[3] Act 58 of 1962.
[4] Act 58 of 1962.
[5] Goodall ea 2014: 687.
[6] Act 45 of 1955.

upon a sale of the asset between a willing buyer and a willing seller dealing at arm's length in an open market[7].

As mentioned above, paragraph (b) of the definition of the term 'fair market value' in the Estate Duty Act[8] was amended by section 1(1)(*a*) of the Revenue Laws Second Amendment Act,[9] applicable to the estate of any person who dies on or after 1 February 2006.

'Fair market value' before 1 February 2006

Prior to the afore-mentioned amendments, 'Fair market value', also known as a 'Land Bank value', meant an amount representing the aggregate fair agricultural or pastoral value of the property and the value which any improvements situated thereon may be expected to add to such value of the property, together with the fair market value of any mineral rights attaching to the property, as at the date of the death of the deceased person.

The option as to which of the two market values should be used lied with the executor of the deceased estate. The so called 'Land Bank value' was introduced to meet the objections of the farming community to value agricultural property in relation to market prices, although there was no certainty that the 'Land Bank value' would have been lower than a sworn appraisement.

'Fair market value' on or after 1 February 2006

Post the amendment, 'Fair market value', means the amount determined by reducing the price which could be obtained upon a sale of the property between a willing buyer and a willing seller dealing at arm's length in an open market by 30 percent.

Paragraph 31(4)[10] restricts the use of the alternative value under paragraph (b) when the agricultural property is disposed of by way of death, donation, or non-arm's length transaction, provided that unless the alternative value under paragraph (b) is used to determine the valuation date value, also known as the value on 1 October 2001[11] in the case of pre-valuation date agricultural property or in the case of agricultural property acquired on or after the valuation date by way of inheritance, donation or non-arm's length transaction, and the property was acquired at a paragraph (b) value[12].

[7] Paragraph 31(1)(f) and paragraph 31(1)(g) of the Eighth Schedule of the Income Tax Act 58 of 1962.
[8] Act 45 of 1955.
[9] Act 32 of 2005.
[10] Eighth Schedule of the Income Tax Act 58 of 1962.
[11] Paragraph 31(4)(a) of the Eighth Schedule of the Income Tax Act 58 of 1962.
[12] Paragraph 31(4)(b) of the Eighth Schedule of the Income Tax Act 58 of 1962.

The purpose of paragraph 31(4)[13] is to match like with like by ensuring that the method used for determining the consideration received or accrued on disposal under paragraph 38 or 40[14] is the same as the method used in determining the base cost under paragraph 26, 27, 38 or 40[15].

Pre-valuation date agricultural property

Under paragraph 31(1)(f)[16] a person has a choice of either the market value or the paragraph (b) value. It is accepted that a person who has determined both values by 30 September 2004 (the completion date of all valuation date values) would be entitled to choose the value that gives the more favourable result in the circumstances. Thus, in order to make use of the paragraph (b) value, the 'Land Bank' value must have been used as the valuation date value. The 'Land Bank value' (disposal before 1 February 2006) or market value less 30 percent (disposal on or after 1 February 2006) can only be used for determining the consideration received or accrued on disposal by way of death, donation or non-arm's length transaction if the 'Land Bank value' is used in determining the valuation date value[17].

Therefore, if agricultural property is acquired before the valuation date and disposed of by way of death, donation or non-arm's length transaction on or after 1 February 2006, the 'Land Bank value' on 1 October 2001 must be used as the valuation date value if the market value less 30 percent is used to determine the proceeds.

Example 1 – Proceeds and base cost of pre-valuation date agricultural property disposed of by way of inheritance

Facts:

Peter acquired agricultural property on 1 October 1990 at a base cost of R 200 000 by inheritance from his late father. The 'Land Bank value' of the agricultural property on 1 October 2001 was R 1 500 000 and the market value was R 2 000 000. Peter valued the agricultural property on or before 30 September 2004.

On 30 September 2013 Peter passed away. The market value of the property at that stage was R 4 000 000. The executor determined the proceeds on death using market value less 30 percent[18].

[13] Eighth Schedule of the Income Tax Act 58 of 1962.
[14] Eighth Schedule of the Income Tax Act 58 of 1962.
[15] Eighth Schedule of the Income Tax Act 58 of 1962.
[16] Eighth Schedule of the Income Tax Act 58 of 1962.
[17] Comprehensive Guide to Capital Gains Tax Issue 4: 228.
[18] Paragraph 31(1)(f)(i) of the Eighth Schedule of the Income Tax Act 58 of 1962.

Result:

Peter's deceased estate will have a capital gain determined as follows:

Proceeds: [R 4 000 000 – 30% (R 1 200 000)]	R 2 800 000
Less: Base cost:	(R 1 500 000)
Capital gain:	R 1 300 000

Peter's executor has the choice in determining the base cost value of the agricultural property owned prior to 1 October 2001 in any of the following ways:

'Land Bank value': [R 1 500 000]

Time apportionment method: [(R 2 800 000 – R 200 000) X (11/23) = R 1 243 478]

20 percent Rule: [R 2 800 000 X 20% = R 560 000]

The executor is not permitted to use market value on 1 October 2001 as the base cost because market value less 30 percent has been used to determine the proceeds on death[19].

Example 2 – Proceeds and Base cost of pre-valuation date agricultural property disposed of by way of sale to a third party

Facts:

Peter acquired agricultural property on 1 October 1990 at a base cost of R 200 000 by inheritance from his late father. The 'Land Bank value' of the agricultural property on 1 October 2001 was R 1 500 000 and the market value R 2 000 000. Peter valued the agricultural property on or before 30 September 2004.

On 30 September 2013 Peter sold the property to a third party for R 4 000 000.

Result:

Peter is entitled to use either the 'Land Bank value' or market value to determine the valuation date value of the property. Since market value gives the higher base cost he will choose that value (R 2 000 000).

[19] Paragraph 31(4)(a) of the Eighth Schedule of the Income Tax Act 58 of 1962.

Result:

Peter will have a capital gain determined as follows:

Proceeds:	R 4 000 000
Less: Base cost: (Market value):	(R 2 000 000)
Capital gain:	R 2 000 000

In this circumstance the actual proceeds of R 4 000 000 must be accounted for.

Post-valuation date agricultural property

If agricultural property is acquired on or after the valuation date and disposed of by way of death, donation or non-arm's length transaction the market value less 30 percent may only be used if the agricultural property was acquired by way of inheritance, donation or non-arm's length transaction at a paragraph (b) value[20].

Example 3 – Proceeds and Base cost of post-valuation date agricultural property disposed of by way of donation

Facts:

Sarah acquired a farm by inheritance from her late father, Frank on 1 October 2002. Frank's executor had adopted 'Land Bank value' of R 1 500 000 for determining the proceeds on disposal of the agricultural property. The market value was R 2 000 000.

On 30 September 2013 Sarah donated the property to her son, James when the market value of the farm was R 4 000 000. Sarah decided to determine her proceeds by using market value less 30 percent.

Result:

Sarah will have a capital gain determined as follows:

Proceeds: [R 4 000 000 – 30% (R 1 200 000)]	R 2 800 000
Less: Base cost: ('Land Bank value'):	(R 1 500 000)
Capital gain:	R 1 300 000

Sarah's base cost will be equal to the proceeds of Frank's deceased estate which was equal to the 'Land Bank value'.

[20] Paragraph 31(4)(b) of the Eighth Schedule of the Income Tax Act 58 of 1962.

Example 4 – Proceeds and Base cost of post-valuation date agricultural property disposed of by way of donation

Facts:

Sarah acquired a farm by inheritance from her late father, Frank on 1 October 2002. Frank's executor had adopted market value of R 2 000 000 for determining the proceeds on disposal of the agricultural property.

On 30 September 2013 Sarah donated the property to her son, James when the market value of the farm was R 4 000 000. Sarah is not permitted to use market value less 30 percent in determining proceeds in respect of her disposal to James.

Result:

Sarah will have a capital gain determined as follows:

Proceeds:	R 4 000 000
Less: Base cost: ('Land Bank value'):	(R 2 000 000)
Capital gain:	R 2 000 000

Conclusion

In an environment where agricultural property values are increasing dramatically, difficulties arise when farmers disposed of their agricultural property. The complexity when agricultural property is disposed of by way of death, donation or non-arm's length transaction, coupled with the burden of an enormous capital gains tax liability upon disposal of the said property, is an area of concern.

Financial planners should carefully consider the capital gains tax implications applicable to agricultural property, since different proceeds and base costs valuations is applicable depending on when the agricultural property was acquired and which valuation method was used when the agricultural property was acquired. Financial planners should therefore endeavour to keep abreast with developments in this area to ensure that they deliver sound advice to their clients.

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Capital gains tax and limited rights created in a will

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Introduction

Limited rights on property are often created in the will of a deceased person. In many instances these limited rights will have an effect on the calculation of estate duty, capital gains tax and value added tax. The purpose of this article is to focus on the effect of such limited rights from a capital gains tax point of view with regard to the liability of the testator, the testator's estate, the holder of the limited right and the person who may eventually obtain full ownership of the property.

There are various types of limited rights that may be created via the will of a person[1]. The most common limited rights are usufructs, *fideicommissa*, *habitatio*, *usus* and the right to income linked to property. Each of these will be discussed separately below.

There are also various provisions in the 8th Schedule to the Income Tax Act[2] (hereafter referred to as "the Act") regulating limited rights, and the calculation of the value of same. As it is important to understand these provisions when dealing will limited rights, these concepts will also be dealt with independently.

Relevant Provisions of the 8th Schedule to the Act

To fully comprehend the impact of limited rights on capital gains tax when dealing with estate planning, it is essential to look at the relevant provisions in the 8th Schedule to the Act.

The first important aspect in this regard is Paragraph 40(1)(a) of the 8th Schedule to the Act, that provides the following:

"*(40) Disposal to and from deceased estate*

(1) A deceased person must be treated as having disposed of his or her assets, other than—

(a) assets transferred to the surviving spouse of that deceased person as contemplated in paragraph 67(2)(a);"

Paragraph 40(1A)(a) and Paragraph 40(2)(a) and (b) of the 8th Schedule to the Act is also of significance in this regard:

"*(40) Disposal to and from deceased estate*

(1A) If any asset of a deceased person is treated as having been disposed of as contemplated in subparagraph (1) and is transferred directly to—

[1] Paragraph 31(d) and (e) of the 8th Schedule to the Income Tax Act 58 of 1962 refers to 'a fiduciary, usufructuary or other similar interest in an asset'.
[2] Act 58 of 1962

(a) the estate of the deceased person, the estate must be treated as having acquired that asset at a cost equal to the market value of that asset as at the date of death of that deceased person;

(2) Where an asset is disposed of by a deceased estate to an heir or legatee (other than the surviving spouse of the deceased person as contemplated in paragraph 67(2)(a))-

(a) the deceased estate must be treated as having disposed of that asset for proceeds equal to the base cost of the deceased estate in respect of that asset; and

(b) the heir or legatee or trustee must be treated as having acquired that asset at a cost equal to the base cost of the deceased estate in respect of that asset, which cost must be treated as an amount of expenditure actually incurred for the purposes of paragraph 20(1)(a)."

The significance of Paragraph 40(1)(a) and Paragraph 40(1A)(a) is thus that a deceased person is regarded as having disposed of his or her assets on death (other than assets transferred to the surviving spouse of such a deceased person) to the deceased estate equal to the market value of that asset as at date of death of the deceased – the effect is thus that there may be a capital gain or loss at the stage of this disposal (depending of the base cost in the hands of the deceased). Where the asset is transferred to an heir (other than the spouse of the deceased) the estate is deemed to dispose of that asset for proceeds equal to the base cost of the deceased estate (i.e. at the market value of the asset at date of death of the deceased, thus resulting in no capital gain or loss on such disposal), and the heir acquired the asset at this base cost – Paragraph 40(2)(a) and (b).

Paragraph 67(1) and 67(2)(a) of the 8th Schedule to the Act stipulates:

"*(67) Transfer of asset between spouses*

(1)

(a) Subject to subparagraph (3), a person (hereinafter referred to as 'the transferor') must disregard any capital gain or capital loss determined in respect of the disposal of an asset to his or her spouse (hereinafter referred to as 'the transferee')

(b) The transferee must be treated as having-

(i) acquired the asset on the same date that such asset was acquired by the transferor;

(ii) incurred an amount of expenditure equal to the expenditure contemplated in paragraph 20 that was incurred by that transferor and the executor of the deceased estate of the transferor in respect of that asset;

(iii) incurred that expenditure on the same date and in the same currency that it was incurred by the transferor or the executor of the deceased estate of the transferor;

(iv) used that asset in the same manner that it was used by the transferor and the executor of the deceased estate of the transferor : and

(v) received an amount equal to any amount received by or accrued to that transferor in respect of that asset that would have constituted proceeds on disposal of that asset had that transferor disposed of it to a person other than the transferee.

(2) For the purposes of subparagraph (1)—

(a) a deceased person must be treated as having disposed of an asset to his or her surviving spouse, if ownership of that asset is acquired by that surviving spouse by ab intestato or testamentary succession or as a result of a re-distribution agreement between the heirs and legatees of that deceased person in the course of liquidation or distribution of the deceased estate of that deceased person;"

The effect of this section, from an estate duty point of view, is thus that any asset transferred to a surviving spouse of a deceased person through testamentary or intestate succession, or through a re-distribution agreement between heirs or legatees, will have the effect that capital gains tax is not paid on such an asset on the death of the deceased, but that a 'rollover' situation is created whereby the surviving spouse effectively takes over the base cost of the asset inherited from the deceased spouse.

As 'asset' is defined in Paragraph 1 of the 8th Schedule as:

"asset

includes—

(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) a right or interest of whatever nature to or in such property;"

It is thus clear from Paragraph (b) of the above definition that the term 'asset' would also include a limited right in property.

Paragraph 31(1)(d) and (e) and Paragraph 31(2) of the 8th Schedule to the Act is important in establishing the market value of limited rights and provides the following:

"(31) Market value

(1)The market value of an asset on a specified date is in the case of—

(d) a fiduciary, usufructuary or other similar interest in an asset, an amount determined by capitalising at 12 per cent the annual value of the right of enjoyment of the asset subject to that fiduciary, usufructuary or other like interest, as determined in terms of subparagraph (2), over the expectation of life of the person to whom that interest was

granted, or if that right of enjoyment is to be held for a lesser period than the life of that person, over that lesser period;

(e) any asset which is subject to a fiduciary, usufructuary or other similar interest in favour of any person, the amount by which the market value of the full ownership of that asset exceeds the value of that fiduciary, usufructuary or other like interest determined in accordance with item (d);

(2) For purposes of subparagraph (1)(d) –

(a) the annual value of the right of enjoyment of any asset which is subject to any fiduciary, usufructuary or other like interest, means an amount equal to 12 per cent of the market value of the full ownership of the asset: Provided that where the Commissioner is satisfied that the asset which is subject to that interest could not reasonably be expected to produce an annual yield equal to 12 per cent on that value of the asset, the Commissioner may fix such sum as representing the annual yield as may seem reasonable, and the sum so fixed must for the purposes of subparagraph (1)(d) be treated as being the annual value of the right of enjoyment of that asset; and

(b) the expectation of life of a person to whom an interest was granted –

(i) in the case of a natural person, must be determined in accordance with the provisions applicable in determining the expectation of life of a person for estate duty purposes, as contemplated in the regulations issued in terms of section 29 of the Estate Duty Act, 1955, (Act No. 45 of 1955); and

(ii) in the case of a person other than a natural person, is a period of fifty years."

These above provisions are to a great degree similar to the valuation method for limited rights in the Estate Duty Act[3]. It essentially provides that the value of a limited right is calculated by multiplying 12 percent of the value of the asset (the annual value of the asset) with the relevant factors provided for:

(i) in the case where the limited right is granted over for the remainder of the life of a natural person, as per the life expectancy tables applicable to the person to which such limited right was granted, published in the Government Gazette[4]; and

(ii) in the case where the limited right is granted to a non-natural person, the life expectancy of such a non-natural person is deemed to be 50 years; and

(iii) in the case of a limited right granted for a period shorter than the life expectancy of a person, over this lesser period.

[3] Act 45 of 1955; Section 5(1)(b)
[4] GNR 1942 *GG* 2533 of 23 September 1977

It must however be borne in mind that where the Commissioner of Inland Revenue is satisfied that the asset subject to the limited right is not able to produce a yield of 12 percent per year, it may fix a sum representing the annual yield as may seem reasonable, and this sum will be treated as being the annual right of enjoyment of such asset.

The value of an asset subject to a limited right is essentially the difference between the market value of such asset and the value of the limited right above.

Where a person who enjoyed such limited right dies, there is a disposal of the limited right (i.e. the asset) without any proceeds[5] (i.e. with a nil value), as per Paragraph 11(1)(b) of the 8th Schedule to the Act:

"*(11) Disposals*

(1) Subject to subparagraph (2), a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes—

(b) the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;"

Although this situation will essentially lead to a capital loss in the hands of the holder of the limited right, such a person will not be able to claim such capital loss unless the asset was used for trade purposes. In this regard Paragraph 15(c) and Paragraph 53(3)(f) of the 8th Schedule to the Act is important in this regard. Paragraph 53(3)(f) stipulates the following:

"*(53) Personal-use assets*

(3) Personal use assets do not include—

(f) any fiduciary, usufructuary or other like interest, the value of which decreases over time;"

Paragraph 15(c) provides as follows:

"*(15) Personal-use aircraft, boats and certain rights and interests*

A capital loss in respect of the following assets of a person must be disregarded in determining the aggregate capital gain or aggregate capital loss of a person, to the extent that the assets are used for purposes other than the carrying on of a trade:

(c) any fiduciary, usufructuary or other similar interest, the value of which decreases over time;"

The effect of Paragraph 53(3)(f) read with Paragraph 15(c) is thus that, although a limited right is not deemed to be a personal use asset (thus making it subject to the capital gains tax

[5] In this regard the capital gains treatment on expiry of a limited right differs from the estate duty implications on cessation of such a limited right. In terms of Section 5(1)(b) of the Estate Duty Act 45 of 1955, where the holder of a limited right dies, the value of such limited right is calculated based on the life expectancy of the person who takes over this right (including the eventual owner of the asset), or a shorter period of time where this is stipulated in the will of the person who created the right.

regime), a loss in respect of such a limited right must be disregarded for capital gains tax purposes to the extent that such asset is not used for the purpose of carrying on a trade.

Paragraph 33(1) of the 8th Schedule to the Act deals with part disposals of assets, and provides the following:

"(33) Part-disposals

(1) Subject to subparagraphs (2), (3), (4) and (5), where part of an asset is disposed of-

(a) the proportion of the expenditure attributable to the part disposed of is an amount which bears to the expenditure allowable in terms of paragraph 20 in respect of the entire asset the same proportion as the market value of the part disposed of bears to the market value of the entire asset immediately prior to that disposal; and

(b) the market value on valuation date attributable to the part disposed of is an amount which bears to the market value adopted or determined in terms of paragraph 29(4) in respect of the entire asset the same proportion as the market value of the part disposed of bears to the market value of the entire asset immediately prior to that disposal."

The effect of the above paragraph is thus essentially that where a part of an asset is disposed of, the base cost of the portion being disposed of must be in the same proportion to the total base cost of the asset, as the value of the portion being disposed of is in proportion to the total value of the asset. It is important to understand this concept, as the bequest of an asset to a person subject to a limited right in favour of another person may in some instances amount to a part disposal of that asset.

Paragraph 33(3) however goes further to exclude certain transactions from being qualified as a part disposal of an asset. For purposes of this article Par 33(3)(b) is of particular relevance:

"(3) For the purposes of subparagraphs (1) and (2) there is no part-disposal of an asset by a person in respect of -

(b) the granting, variation or cession of a right of use or occupation of that asset by that person in respect of which no proceeds are received by or accrue to that person;"

It is however submitted that in the case of a limited right being granted to a surviving spouse, Paragraph 33(3)(b) would not prevent the base cost of this limited right being allocated to such surviving spouse, as Paragraph 67 would take preference, due to it being the more specific provision[6]. One must further bear in mind that Paragraph 33(3)(b) only pertains to the granting (or variation or cession) of a right of use or occupation of an asset, and not other limited rights.

[6] South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p648, Footnote 701

With cognisance of the above legislative principles, the relevance thereof with regard to specific types of limited rights will now be explained. It is important to understand the difference between these various types of limited rights, as the creation of different kinds of limited rights via a person's will may have dissimilar effects on the calculation of capital gains tax.

Usufructs

A usufruct may be described as "*the right to use the thing of another in such a way as to preserve its substantial character*"[7]. A usufruct can also be defined as "*a real right in terms of which the owner of a thing (often referred to as the grantor") confers on the "usufructuary" the right to use and enjoy the thing to which the usufruct relates*"[8].This thing (asset) may be movable, or immovable, corporeal or incorporeal, and a usufruct may be granted over a collection of things or even over the whole estate of the grantor (testator). It also usually extends to the accessories of the asset that is subject to such usufruct, e.g. a usufruct over a farm will usually extend to livestock, farming equipment, unless a contrary intention appears from the will of the testator. The usufructuary does not acquire ownership of the asset and is only entitled to the possession, use and enjoyment of the asset. The usufructuary is thus not entitled to consume or destroy the relevant asset, but is entitled to take, consume and alienate the 'fruits' of the asset, whether these 'fruits' are natural, industrial or civil[9]. The usufructuary is also not entitled to dispose of the asset and has no vested right in it, as it vests in another person, namely the holder of the bare dominium[10].

The bare dominium refers to the right of ownership of the asset that is subject to the usufruct. The holder of the bare dominium however merely enjoys the 'naked ownership' of the property without the right to use it or its 'fruits' and only acquires full ownership on termination of the usufruct[11]. Should the holder of the bare dominium of an asset die before expiry of the usufruct, the bare dominium will form part of the estate of the bare dominium holder and may therefore be bequeathed in terms of a will, or inherited by the intestate heirs of the bare dominium holder.

Where a usufruct is granted via the will of a deceased, there will be a part disposal of the asset if the usufruct is granted to the surviving spouse of such deceased person and the bare dominium is bequeathed to another person (for example a child or an *inter vivos* trust). This will essentially amount to a disposal of the bare dominium to another person under Paragraph 40(1) of the 8th Schedule to the Act, whilst there would be a roll-over in respect of the usufruct

[7] Brundon's Estate v Brundon's Estate 1920 CPD 159 at 174; South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p648.
[8] Silberberg and Schoeman's The Law of Property, Fourth Edition, 2003, *PJ Badenhorst, JM Pienaar & M Van Rooyen*, p314.
[9] *Ibid.*
[10] Estate Duty, Principles and Planning, Second Edition, 1997, *ML Stein*, p25.
[11] Ibid.

granted to the surviving spouse under Paragraph 67(2)(a)[12]. In this regard it will be necessary to segregate the base cost of the asset in relation to the deceased by allocating a portion of the base cost of the asset to the usufruct and the balance of the base cost to the bare dominium. Where a usufruct in respect of the asset is granted to the surviving spouse, whilst the bare dominium is bequeathed to another person, the bare dominium portion of the base cost will be utilised in determining the capital gain (or loss) under Paragraph 40(1) in the hands of the deceased, whilst the surviving spouse will take over the balance of the base cost (i.e. the portion of the base cost allocated to the usufruct) to determine the capital loss on expiry of the usufruct[13]. Here it must just be borne in mind that the surviving spouse will in this instance only be able to claim a capital loss on expiry of the usufruct, if the spouse had employed the asset for purposes of trade[14].

Where a usufruct is granted via the will of a deceased and neither the usufructuary or the holder of the bare dominium is the spouse of the deceased, there will be a full disposal of the asset by the deceased: there will be a disposal of the ususfruct to the usufructuary and a disposal of the bare dominium to the holder of the bare dominium. The value of the asset minus the base cost of the asset will thus be used to determine the capital gain (or loss) in the hands of the deceased. In this regard it will however still be necessary to segregate the base cost of the asset in relation to the deceased by allocating a portion of the base cost of the asset to the usufruct and the balance of the base cost to the bare dominium. The base cost of the usufruct will be used to determine the capital loss on the death of the usufructuary where the asset was used for purposes of trade[15]. The base cost allocated to the holder of the bare dominium will essentially be the difference between the base cost of the asset and the base cost of the usufruct on date of death of the person who created the usufruct.

Example 1: Usufruct Created in Favour of Surviving Spouse

This example is taken from the SARS Comprehensive Guide to Capital Gains Tax[16].

On 31 July John Brown died and bequeathed his holiday home that he acquired in 2002 to his family trust subject to a usufruct in favour of his spouse over her remaining life. At the time of his death, John's spouse was 72 years old. The base cost of the property in John's hands is R400 000 and the market value of the property at date of death is R1 000 000.

[12] In a situation where the will of a deceased person provides that the usufruct is granted to a third person, whilst the bare dominium vests in the surviving spouse, there will be a disposal of the usufruct under paragraph 40(1) of the 8th Schedule, whilst there will be a roll-over in respect of the usufruct under paragraph 67(2)(a).
[13] South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p 648.
[14] Paragraph 11(1)(b) read with Paragraph 53(3)(f) and Paragraph 15(c) of the 8th Schedule to the Act.
[15] Ibid.
[16] Example obtained from South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p 649.

After 10 years John's wife passes away. The trust thereafter disposes of the property for R1 000 000 (assume the prices remained unchanged from date of John's death until the date of disposal by the trust). What are the capital gains tax implications for:

(i) John

(ii) John's deceased estate

(iii) John's wife, and

(iv) The John Brown Family Trust

Result:

(i) John (the deceased)

John's spouse will turn 73 at her next birthday. According to Table A[17] she has a life expectancy of 10.24 years, and the present value of R1 a year over her remaining life is 5,72222.

The property is allocated between it's different parts as follows:

Market Value (full ownership)	R1 000 000
Usufruct (R1 000 000 x 12% x 5.72222)	R686 666
Bare Dominium	R313 334

There will be a deemed disposal of the bare dominium in John's hands at market value at date of death under Paragraph 40(1). Since the usufruct has been left to his spouse there is a rollover in respect of that asset under Paragraph 40(1)(a) read with Paragraph 67(2)(a). The capital gain on the bear dominium will be as follows:

Proceeds (Bare Dominium)	R313 334
Less base cost: R400 000 x R313 334/R1 000 000	(R125 334)
Bare Dominium	R188 000

The base cost is apportioned under the part-disposal rule in paragraph 33. John will be entitled to the R300 000 annual exclusion under paragraph 5(2).

(ii) John's deceased estate

Under Paragraph 40(1) John's deceased estate will acquire the bare dominium at a market value of R313 334. Under paragraph 40(2)(b) the heir (in this case the trust) will in turn acquire

[17] Table A: 12%: Death on or after 1 April 1977, Premiums & Problems, Edition 109, 2014, *Editors: D Hands, S Cloete, T Naidoo, C Muller & G Peter*, p E31

the bare dominium at its base cost to the deceased estate (R313 334). There is therefore no gain or loss in the deceased estate.

(iii) John's wife

John's Spouse (the usufructuary) acquired the base cost of the usufruct at a rolled over base cost of R274 666 (R400 000, i.e. the base cost of the asset minus R125 334, i.e. the base cost of the bare dominium; alternatively R400 000 x R686 666, i.e. the value of the usufruct ÷ R1 000 000, i.e. the value of the asset).

When she passes away there is a disposal under paragraph 11(1)(b) (an expiry or termination) of the usufruct without any proceeds:

Proceeds (Usufruct Expiring)	R0
Less Base Cost:	(R274 666)
Capital Loss:	(R274 666)

She cannot however claim the capital loss of R274 666 if she used the property for non-trade purposes [paragraph 15(c) read with paragraph 53(3)(f)]. Assuming she let the property, she would be entitled to the loss on the grounds that the asset was used for the purpose of carrying on a trade. If she let the property and used it for a holiday home for one month of the year, she would be entitled to 11/12 of the loss. Paragraph 15(c) only limits the loss to the extent that the usufruct is not used for the purposes of carrying on a trade. Upon expiry of a usufruct, paragraph 38[18] will not operate to deem any proceeds to be received by the usufructuary, nor will the bare dominium holder obtain a step-up in base cost. There are several reasons for this.

First, a bare dominium in essence represents the future right of use after expiry of the usufruct. The bare dominium holder acquires that future right of use on day one from the person who had full ownership of the asset (the first-dying). On the death of the usufructuary the bare dominium holder cannot acquire what he or she already owns. Secondly, an expired usufruct has a market value of nil in the hands of the usufructuary. Once the usufruct expires there is nothing to pass on. Thus the usufructuary has a disposal as a result of the expiry of the usufruct, but this does not mean that the bare dominium holder acquires anything. The expiry of the usufruct is a one sided disposal, similar to the scrapping of an asset. Paragraph 38 only applies when one person disposes of an asset and another person acquires that asset.

[18] Paragraph 38(1) of the 8th Schedule to the Act provides as follows:

(38) Disposal by way of donation, consideration not measurable in money and transactions between connected persons not at an arm's length price

(1) Subject to subparagraph 2 and paragraph 67, where a person disposed of an asset by means of a donation or for a consideration not measurable in money or to a person who is a connected person in relation to that person for a consideration which does not reflect an arm's length price -

(a) the person who disposed of that asset must be treated as having disposed of that asset for an amount received or accrued equal to the market value of that asset as at the date of that disposal; and

(b) the person who acquired that asset must be treated as having acquired that asset at a cost equal to that market value, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

The capital gains tax treatment of an expiring usufruct differs from that which applies to estate duty purposes. Under section 5(1)(b) of the Estate Duty Act[19] when a usufructuary dies, the value of the usufruct based on the life expectancy of the person who takes over the right of use (or when a shorter period is stipulated, that period) is included in the usufructuary's estate.

(iv) The John Brown Family Trust

The base cost of the property in the hands of the trust is R313 334 – the market value of the bare dominium at date of death (John's death). Assuming that property values remain constant, the property the property will grow in value each year as the usufruct heads towards expiry. On expiry the property will have regained its full value in the hands of the trust. When the trust subsequently disposes of the holiday home for R1 million it will therefore have a capital gain of R686 666:

Proceeds:	R1 000 000
Less Base Cost (base cost of bare dominium of John's death):	(R313 334)
Capital Gain:	R686 666

The base cost remains unchanged at R313 334 and is not affected by the expiry of the usufruct.

Some commentators have suggested that the bare dominium holder's base cost should be increased as a result of the enhancement in value caused by the expiry of the usufruct. There is no substance in this argument. At the date of acquisition the bare dominium was worth the 'low' value placed on it because of the encumbrance of the usufruct. Furthermore, the enhanced value was obtained for no additional consideration. The bare dominium holder never disposed of the future right of use pertaining to the period after expiry of the usufruct in the first place, and cannot therefore be said to have reacquired it. While the usufructuary may have had a disposal by expiry of the usufruct, it is not a disposal that can give rise to a corresponding acquisition in the hands of the bare dominium holder. When a usufruct ends it simply ceases to exist and is incapable of being transferred to another person. Not all disposals give rise to corresponding acquisitions. For example, the scrapping of an asset does not give rise to an acquisition and the expiry of a usufruct is no different.

[19] Act 45 of 1955

(v) Reconciliation:

The reconciliation below proves the overall tax burden (R600 000) is the same as if the full property had been disposed of by the deceased on the day before he died:

	John	**John's Estate**	**John's Spouse**	**John's Trust**	**Total**
Proceeds	R313 334	R313 334	R0	R1 000 000	R1 626 668
Less Base Cost	(R125 334)	(R313 334)	(R274 666)	(R313 334)	(R1 026 668)
Gain/Loss	R188 000	R0	(R274 666)	R686 666	R600 000

The gain realised if the property had been sold (by John) on the day before his death: R1 000 000 – R400 000 = R600 000.

Example 2: Successive usufructs

This example is also taken from the SARS Comprehensive Guide to Capital Gains Tax[20].

Upon his death on 31 March 2009 Dave's last will and testament provided that his holiday cottage was to be dealt with as follows:

His eldest son Abe was to be given a usufruct for his lifetime. Upon Abe's death, a usufruct was to be granted to Abe's son Bart for his lifetime, Upon Bart's death the cottage was to be given to Bart's son, Carl. No improvements were made to the cottage from the time of Dave's death until it was sold by Carl. At his next birthday after the death of his father Abe will be 65 years of age. Abe died on 31 May 2015. On that date, Bart will be 40 years of age at his next birthday. Bart died on 30 June 2045 at which point Carl inherited the cottage.

Dave purchased the cottage for R100 000 on 1 June 2002. The market value of the full ownership of the cottage was as follows:

- On date of Dave's death – R1 000 000.
- On date of Abe's death – R1 500 000.

Carl sold the cottage for R10 000 000 on 1 February 2050.

Determine the capital gains tax consequences for Dave, Dave's estate, Abe, Bart and Carl.

[20] Example obtained from South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p 655.

Result:

(i) Dave

Under paragraph 40(1) Dave is deemed to have disposed of his holiday cottage for proceeds of R1 million. He has a capital gain as follows:

Proceeds:	R1 000 000
Less: Base Cost [paragraph 20(1)(a)]:	(R100 000)
Capital Gain:	R900 000

(ii) Dave's Estate

Under paragraph 40(1) Dave's deceased estate acquires the cottage at a base cost of R1 million. When the executor grants Abe the usufruct he triggers a part disposal by Dave's deceased estate. The portion of the base cost disposed of by the deceased estate is determined as follows:

Life expectancy (Abe) – male ages 65 = 11.77 years

Present value of R1 per annum for life = 6.13789[21]

Market Value (full ownership) as at date of Dave's death	R1 000 000
Market value of usufruct granted to Abe on Dave's death under paragraph 31(1)(d): (R1 000 000 x 12% x 6.13789)	R736 547

The bare dominium held by the estate is reduced as follows:

Market Value (full ownership)	R1 000 000
Less: usufruct granted to Abe	R736 547
Base cost after first usufruct	R263 453

Under paragraph 40(2)(a) Dave's estate makes no gain or loss on the part disposal to Abe since it is deemed to be made for proceeds equal to its base cost.

[21] Table A: 12%: Death on or after 1 April 1977, Premiums & Problems, Edition 109, 2014, *Editors: D Hands, S Cloete, T Naidoo, C Muller & G Peter*, p E31

The granting of the second usufruct to Bart triggers another part disposal by Dave's deceased estate as follows:

Life expectancy (Bart) – male aged 40 = 29.54 years

Present value of R1 per annum for life = 8.0403[22]

Market Value (full ownership) as at date of Abe's death	R1 500 000
Market value of usufruct granted to Bart on Abe's death under paragraph 31(1)(d): (R1 500 000 x 12% x 8.0403)	R1 447 254

The portion of Dave's (the person who created the usufruct) estate's base cost of the bare dominium that is disposed of:

R1 447 254 (market value usufruct granted to Bart on Abe's death)/R1 500 000 (market value of cottage on Abe's death) x R263 453 (base cost of bare dominium after first usufruct)

= R254 453

Base cost after first usufruct	R263 453
Less: portion of Dave's estate's base cost of the bare dominium that is disposed of on granting the usufruct to Bart	(R254 189)
Base cost after second usufruct	R9 264

Again there is no capital gain or loss in Dave's estate on the granting of the second usufruct (to Bart) as the proceeds are deemed to be equal to the base cost under paragraph 40(2)(a).

Upon Bart's death the executor of Dave's estate awards the cottage to Carl for proceeds equal to the remaining base cost of R9 264. Under paragraph 40(2)(a) Dave's estate makes no gain or loss and Carl acquires the cottage at a base cost of R9 264.

(i) Abe

Under paragraph 40(2)(b) Abe acquires the usufruct in the cottage at a base cost of R736 547. The base cost of the usufruct in Abe's hands will be equal to the value of such usufruct transferred to Abe from Dave's estate. Paragraph 40(2)(a) and (b) essentially provides that the asset is disposed off by the estate to the heir (Abe) equal to the base cost of the deceased estate, i.e. at the market value of the asset (usufruct) at date of death of the deceased

[22] Table A: 12%: Death on or after 1 April 1977, Premiums & Problems, Edition 109, 2014, *Editors: D Hands, S Cloete, T Naidoo, C Muller & G Peter*, p E30

(Dave), thus resulting in no capital gain or loss on such disposal, and the heir (Abe) acquired the asset at this base cost.

Upon his death the usufruct expires and there are no proceeds. Abe therefore has a capital loss of R736 547:

Proceeds (Usufruct Expiring):	R0
Less Base Cost:	(R736 547)
Capital Loss:	(R736 547)

This capital loss must be disregarded under paragraph 15(c) to the extent that the cottage was not used for the purposes of trade.

(ii) Bart

Under paragraph 40(2)(b) Bart acquires the usufruct in the cottage at a base cost of R254 189. The base cost of the usufruct in the hands of Bart will be equal to the base cost of the asset in the hands of Dave's estate. Here it must be borne in mind that on the granting of this second usufruct there is essentially again a disposal of an asset (usufruct) by Dave to his estate on his death, and then by the estate to the second usufructuary. As a result of the second disposal (granting of the second usufruct), a calculation thus has to be done in respect of the base cost of the second usufruct held by Dave's estate on transfer of the asset (usufruct) to the second usfructuary, which will also have an effect on the base cost of the bare dominium holder . As the base cost of Dave's estate at this before granting of the second usufruct is essentially the base cost of the bare dominium calculated on granting of the first usufruct, this base cost has to be proportionally adapted on this seconds disposal (i.e. granting of the second usufruct).

Upon his death the usufruct expires and there are no proceeds. Bart therefore has a capital loss of R254 189:

Proceeds (Usufruct Expiring):	R0
Less Base Cost:	(R254 189)
Capital Loss:	(R254 189)

This capital loss must be disregarded under paragraph 15(c) to the extent that the cottage was not used for the purposes of trade.

(iii) Carl

When Bart dies, Carl acquires the cottage at the remaining base cost of the asset in Dave's deceased estate of R9 264 under Paragraph 40(2)(b). Carl's capital gain on disposal of the cottage is determined as follows:

Proceeds	R10 000 000
Less: Base Cost (Paragraph 40(2)(b))	(R9 264)
Capital Gain	R9 990 736

(iv) Reconciliation:

The reconciliation below proves the overall capital gain (R9 100 000) is the same as if the full property had been disposed of by the Dave for R10 000 000 on the day before he died:

	Dave	**Dave's Estate**	**Abe**	**Bart**	**Carl**	**Total**
Proceeds	R1 000 000	R1 000 000 + R	R0	R0	R10 000 000	R12 000 000
Less Base Cost	(R900 000)	(R1 000 000)	(R736 547)	(R254 189)	(R9 264)	(R2 900 000)
Gain/Loss	R100 000	R0	(R736 547)	(R254 189)	R9 990 736	R9 100 000

The gain realised if the property had been sold (by Dave) on the day before his death for an amount of R10 000 000: R10 000 000 – R900 000 = R9 100 000.

Fideicommissa

Where a fideicommissum is granted in a will the deceased (fideicommittens) transfers a benefit on death to a beneficiary (the fiduciary or fiduciarius) subject to the provision that after a certain time has elapsed or a certain condition has been fulfilled (usually the death of the fiduciary), the benefit goes over to a further beneficiary (the fideicommissary or fideicommissarius)[23].

The right to the fideicommissary assets vests in the fiduciary once the assets are transferred to him or her. The fiduciary thus becomes owner of moveable assets on receipt thereof and the owner of immovable property on registration thereof in his or her name[24]. A fideicommissum differs from a usufruct in that the fiduciary becomes the legal owner of the assets subject to the obligation of passing them on to the fideicommissary, whereas in the case of a usufruct the legal owner is usually the ultimate heir of the property (the holder of the bare dominium). The

[23] The Law of Succession, Third Edition, 2003, *MJ De Waal & MC Schoeman-Malan*, p139; Estate Duty Principles And Planning, Second Edition, 1997, *ML Stein*, p 25.
[24] The Law of Succession, Third Edition, 2003, *MJ De Waal & MC Schoeman-Malan*, p145

usufructuary is only entitled to the control and possession of the asset during the existence of the usufruct.

The effect of the principles set out above is that, if the *fideicommissum* fails for any reason, e.g. the fideicommissary dies before the fiduciary, the fiduciary obtains ownership of the property free from any condition of the *fideicommissum*, whilst a *usufructuary usually* does not become owner of the property if the holder of the bare dominium dies before the usufructuary[25].

As the full ownership of the relevant asset is given to the fiduciary on death of the *fideicommittens* (testator), this transfer will effectively include the right of use and enjoyment as well as the bare *dominium* of the asset[26]. It is however extremely important to understand that, even if the fiducairy effectively becomes owner of the asset, such asset is still subject to a fideicommissum, the value of which is calculated in terms of paragraph 31(1)(d) of the 8th Schedule to the Act. The practical effect of this that where a *fideicommissum* is created via the will of a deceased and the spouse of the deceased is nominated as the fiduciary whilst a third party (for example a child) is nominated as the fideicommissary, there will only be a roll-over in respect of the value of the fiduciary right only transferred to such spouse under Paragraph 67(2)(a)[27], whist there will still be a deemed disposal equal to the value of the balance of the asset, as contemplated in paragraph 31(1)(e).

In this regard it will thus still be necessary to divide the base cost of the asset in relation to the deceased (testator) by allocating a portion of the base cost of the asset to the fideicommissum and the balance of the base cost to the difference between the value of the asset and the value of the fideicommissum (fiduciary interest), as the base cost allocated to the fideicommissum with be the base cost rolled over to the estate of the surviving spouse, should such spouse die before the fideicommissary. In this instance there will be a disposal of the fiduciary right without any proceeds (i.e. with a nil value) by the spouse on death, as per Paragraph 11(1)(b) of the 8th Schedule to the Act. This will result in a capital loss in the estate of the deceased spouse, but as mentioned above, this capital loss will be disregarded to the extent that the asset is used for purposes other than trade[28].

If the surviving spouse however survives the fiduciary, such spouse obtains ownership of the property free from any condition of the *fideicommissum*. On the death of the spouse there will thus be a disposal of the asset at its value, and the full roll-over amount of the base cost on the death of the *fideicommittens* (testator) will be the base cost used to determine the capital gain in respect of such surviving spouse. It will thus be treated in the same manner as if the first dying

[25] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p5-14 & p24-2.
[26] South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p657
[27] In the unlikely situation where the will of a deceased person provides that the a third person is nominated as the fiduciary, whilst the surviving spouse is nominated as the fideicommissary, there will be roll-over in an amount equal to the difference between the value of the asset and the value of the fiduciary right as contemplated paragraph 31(1)(e) read with paragraph 67(2)(a) of the 8th Schedule to the Act.
[28] Paragraph 15(c) of the 8th Schedule to the Act.

spouse had bequeathed the asset to the surviving spouse without the creation of a fideicommissum in favour of a third party.

Example 1: Fideicommissum in favour of child and grandchild

This example is also taken from the SARS Comprehensive Guide to Capital Gains Tax[29], but the sale price has of the property has been changed.

Upon his death Tom's last will and testament stated that his holiday home was to be left to his daughter Katie for her lifetime after which it was to pass to Katie's daughter, Jenny should she survive Katie. At the time of Tom's death:

- ❑ The asset had a base cost of R100 000,
- ❑ A market value of R500 000, and
- ❑ Katie was 55 years old.

Kate died at age 70 and the asset was passed to Jenny. Jenny disposed of the residence a few years later for R600 000.

What are the capital gains tax implications for Tom, Katie and Jenny?

Result:

(i) Tom (the deceased)

Proceeds (paragraph 40(1)).	R500 000
Less: Base Cost	(R100 000)
Capital Gain	R400 000

(ii) Tom's deceased estate

Under paragraph 40(2)(a) Tom's estate makes no gain or loss on the disposal to Katie since it is deemed to be made for proceeds equal to its base cost (R500 000).

[29] Example obtained from South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p 658.

(iii) Katie

The base cost of Katie's fiduciary interest is determined under paragraph 31(1)(d) and (2) as follows:

Katie's age next birthday – 56

Katie's life expectancy = 21.86 years

Present value of R1 per annum for life = 7.63363[30]

Market Value (full ownership) as at date of Tom's death	R500 000
Present value fiduciary interest granted to Katie on Tom's death under paragraph 31(1)(d): (R500 000 x 12% x 7.63363)	R458 018

Upon her death Katie has:

No Proceeds (the value of her fiduciary interest expired on her death):	R0
Less Base Cost:	(R458 018)
Capital Loss:	(R458 018)

The capital loss will be limited under paragraph 15(c) to the extent that Katie used the residence for purposes other than trade. Should Jenny die before her, Katie would be able to deal with the asset as she pleases and its value will no longer decrease over time. Consequently the loss limitation rule will no longer apply to Katie when she disposes of the asset (see Example 2 below – my own adaption of this example in respect of how this will be dealt with in these circumstances).

(iv) Jenny

Under paragraph 31(1)(e) the base cost of the residence in Jenny's hands is R500 000 – R458 018 = R41 982.

[30] Table A: 12%: Death on or after 1 April 1977, Premiums & Problems, Edition 109, 2014, *Editors: D Hands, S Cloete, T Naidoo, C Muller & G Peter*, p E31

Upon disposal of the asset Jenny will have a capital gain determined as follows:

Proceeds	R600 000
Less: Base Cost	(R41 982)
Capital Gain	R558 018

(v) Reconciliation:

The reconciliation below proves the overall capital gain (R500 000) is the same as if the full property had been disposed of by the deceased for the same purchase price on the day before he died:

	Tom	**Tom's Estate**	**Katie**	**Jenny**	**Total**
Proceeds	R500 000	R500 000	R0	R600 000	R1 600 000
Less Base Cost	(R100 000)	(R500 000)	(R458 018)	(R41 982)	(R1 100 000)
Gain/Loss	R400 000	R0	(R458 018)	R558 018	R500 000

The gain realised if the property had been sold (by Tom) for R600 000 on the day before his death: R600 000 – R100 000 = R500 000.

Example 2: Fideicommissum in favour of child and grandchild, where grandchild predeceases child.

This example is also adapted from an example in the SARS Comprehensive Guide to Capital Gains Tax[31].

Upon his death Tom's last will and testament stated that his holiday home was to be left to his daughter Katie for her lifetime after which it was to pass to Katie's daughter, Jenny should she survive Katie. At the time of Tom's death:

- The asset had a base cost of R100 000,
- A market value of R500 000, and
- Katie was 55 years old.

Jenny dies before Katie. Katie disposed of the residence a few years later for R600 000.

What are the capital gains tax implications for Tom, Katie and Jenny?

[31] Example obtained from South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p 658.

Result:

(i) Tom (the deceased)

Proceeds (paragraph 40(1)):	R500 000
Less Base Cost:	(R100 000)
Capital Gain:	R400 000

(ii) Tom's deceased estate

Under paragraph 40(2)(a) Tom's estate makes no gain or loss on the disposal to Katie since it is deemed to be made for proceeds equal to its base cost (R500 000).

(iii) Katie

On the death of Jenny, Katie becomes the owner of the property, and Jenny's estate has no enforceable right in respect of the property.

On the sale of the property by Katie, the situation is as follows:

The base cost of Katie's fiduciary interest (i.e. the right created on Tom's death) is determined under paragraph 31(1)(d) and (2) as follows:

Katie's age next birthday – 56

Katie's life expectancy = 21.86 years

Present value of R1 per annum for life = 7.63363[32]

Market Value (full ownership) as at date of Tom's death	R500 000
Present value fiduciary interest granted to Katie on Tom's death under paragraph 31(1)(d): (R500 000 x 12% x 7.63363)	R458 018

[32] Table A: 12%: Death on or after 1 April 1977, Premiums & Problems, Edition 109, 2014, *Editors: D Hands, S Cloete, T Naidoo, C Muller & G Peter*, p E31

On sale of the property Katie has the following capital gain:

Proceeds	R600 000
Less: Base Cost	(R458 018)
Capital Gain	R141 982

(iv) Jenny

The base cost of Jenny's interest in the property on Tom's death is determined under paragraph 31(1)(e) and (2) as follows:

Market Value (full ownership) as at date of Tom's death:	R500 000
Minus present value fiduciary interest granted to Katie on Tom's death under paragraph 31(1)(d): (R500 000 x 12% x 7.63363)	(R458 018)
Base cost of Jenny's interest in asset on Tom's death:	R41 982

Upon her death Jenny has:

No Proceeds (the value of her interest in the property expired on her death, as she died before Katie).	R0
Less: Base Cost	(R41 982)
Capital Loss	(R41 982)

As Jenny never had possession of the asset, she would not have been able to use the property for purposes of trade, and will thus not be able to claim the capital loss.

(v) Reconciliation:

The reconciliation below proves the overall capital gain (R500 000) is the same as if the full property had been disposed of by the deceased on the day before he died:

	Tom	**Tom's Estate**	**Katie**	**Jenny**	**Total**
Proceeds	R500 000	R500 000	R600 000	R0	R1 600 000
Less Base Cost	(R100 000)	(R500 000)	(R458 018)	(R41 982)	(R1 100 000)
Gain/Loss	R400 000	R0	R141 982	(R41 982)	R500 000

The gain realised if the property had been sold by Tom for R600 000 on the day before his death: R600 000 – R100 000 = R500 000.

Example 3: Fideicommissum in favour of spouse and child

This example is also adapted from an example in the SARS Comprehensive Guide to Capital Gains Tax[33].

Upon his death Tom's last will and testament stated that his holiday home was to be left to his wife Katie for her lifetime after which it was to pass to their daughter, Jenny should she survive Katie. At the time of Tom's death:

- The asset had a base cost of R100 000,
- A market value of R500 000, and
- Katie was 55 years old.

Kate died at age 70 and the asset was passed to Jenny. Jenny disposed of the residence a few years later for R600 000.

What are the capital gains tax implications for Tom, Katie and Jenny?

Result:

(i) Tom (the deceased)

As the asset is bequeathed to Tom's surviving spouse Katie, there will be a rollover in respect of the value of her fiduciary interest as per paragraph 67(2)(a), thus not resulting in a capital gain in Tom's hands with regards to the extent that the full value of the property exceeds the value of the fiduciary interest bequeathed to Katie. Although Katie essentially becomes owner of the property (i.e. of both the right of use and enjoyment and the bare dominium), the market

[33] Example obtained from South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p 658.

value of the fideicommissum (fiduciary interest) accruing to Katie, and thus qualifying as a rollover still has to be determined in terms of paragraph 31(1)(d) of the 8th Schedule, thus:

Katie's age next birthday – 56

Katie's life expectancy = 21.86 years

Present value of R1 per annum for life = 7.63363[34]

Market Value (full ownership) as at date of Tom's death	R500 000
Present value fiduciary interest granted to Katie on Tom's death under paragraph 31(1)(d): (R500 000 x 12% x 7.63363)	R458 018
Amount by which asset value exceeds value of fiduciary interest (R500 000 – R458 018)	R41 982

There will thus be a deemed disposal in the amount by which asset value exceeds value of fiduciary interest. Since the fiduciary right has been left to his spouse there is a rollover in respect of this fiduciary right under Paragraph 40(1)(a) read with Paragraph 67(2)(a). The capital gain on the amount by which asset value exceeds value of fiduciary interest will be as follows:

Amount by which asset value exceeds value of fiduciary interest	R41 982
Less base cost: R100 000 x R41 982/R500 000	(R8 396)
Capital Gain	R33 586

The base cost is apportioned under the part-disposal rule in paragraph 33.

(ii) Tom's deceased estate

Under Paragraph 40(1) Tom's deceased estate will acquire the portion of the asset relating to the amount by which asset value exceeds value of fiduciary interest at R41 982. Under paragraph 40(2)(b) the fideicommissary (in this case the Jennie) will in turn acquire this right at its base cost to the deceased estate (R41 982).

(iii) Katie (Tom's Wife)

John's Spouse (the fiduciary) acquired the base cost of the fideicommissum at a rolled over base cost of R91 604 calculated as follows:

[34] Table A: 12%: Death on or after 1 April 1977, Premiums & Problems, Edition 109, 2014, *Editors: D Hands, S Cloete, T Naidoo, C Muller & G Peter*, p E31

R100 000 (the base cost of the asset) minus R8 396 (the base cost of the portion of the asset in respect of which the value of the asset exceeds the value of the fideicommissum as calculated in (i) above;

Alternatively R100 000 (base cost of the asset) x R458 018 (the value of the fideicommissum) ÷ R500 000 (the value of the asset).

When she passes away there is a disposal under paragraph 11(1)(b) (an expiry or termination) of the *fideicommissum* without any proceeds:

Proceeds (expiry of fiduciary right):	R0
Less Base Cost:	(R91 604)
Capital Loss:	(R91 604)

She cannot however claim the capital loss of R91 604 if she used the property for non-trade purposes [paragraph 15(c) read with paragraph 53(3)(f)].

Should Jenny die before her, Katie would be able to deal with the asset as she pleases and its value will no longer decrease over time. Consequently the loss limitation rule will no longer apply to Katie when she disposes of the asset (see Example 4 below – my own adaption of this example in respect of how this will be dealt with in these circumstances).

(iv) Jenny

Under paragraph 31(1)(e) the base cost of the residence in Jenny's hands is R500 000 – R458 018 = R41 982.

Upon disposal of the asset Jenny will have a capital gain determined as follows:

Proceeds	R600 000
Less: Base Cost	(R41 982)
Capital Gain	R558 018

(v) Reconciliation:

The reconciliation below proves the overall capital gain (R500 000) is the same as if the full property had been disposed of by the deceased for the same purchase price on the day before he died:

	Tom	**Tom's Estate**	**Katie**	**Jenny**	**Total**
Proceeds	R41 982	R41 982	R0	R600 000	R683 964
Less Base Cost	(R8 396)	(R41 982)	(R91 604)	(R41 982)	(R183 964)
Gain/Loss	R33 586	R0	(R91 604)	R558 018	R500 000

The gain realised if the property had been sold (by Tom) for R600 000 on the day before his death: R600 000 – R100 000 = R500 000.

Example 4: Fideicommissum in favour of spouse and child, where child predeceases spouse.

This example is also adapted from an example in the SARS Comprehensive Guide to Capital Gains Tax[35].

Upon his death Tom's last will and testament stated that his holiday home was to be left to his spouse Katie for her lifetime after which it was to pass to his daughter, Jenny should she survive Katie. At the time of Tom's death:

- ❑ The asset had a base cost of R100 000,
- ❑ A market value of R500 000, and
- ❑ Katie was 55 years old.

Jenny dies before Katie. Katie disposed of the residence a few years later for R600 000.

What are the capital gains tax implications for Tom, Tom's Estate, Katie and Jenny?

Result:

(i) Tom (the deceased)

As the asset is bequeathed to Tom's surviving spouse Katie, there will be a rollover in respect of the value of her fiduciary interest as per paragraph 67(2)(a), thus not resulting in a capital gain in Tom's hands with regards to the extent that the full value of the property exceeds the value

[35] Example obtained from South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), p 658.

of the fiduciary interest bequeathed to Katie. Although Katie essentially becomes owner of the property (i.e. of both the right of use and enjoyment and the bare dominium), it is the market value of the fideicommissum (fiduciary interest) that accrues to Katie, and thus qualifying as a rollover still has to be determined in terms of paragraph 31(1)(d) of the 8th Schedule:

Katie's age next birthday – 56

Katie's life expectancy = 21.86 years

Present value of R1 per annum for life = 7.63363[36]

Market Value (full ownership) as at date of Tom's death	R500 000
Present value fiduciary interest granted to Katie on Tom's death under paragraph 31(1)(d): (R500 000 x 12% x 7.63363)	R458 018
Amount by which asset value exceeds value of fiduciary interest (R500 000 – R458 018)	R41 982

There will thus be a deemed disposal in the amount by which asset value exceeds value of fiduciary interest. Since the fiduciary right has been left to his spouse there is a rollover in respect of this fiduciary right under Paragraph 40(1)(a) read with Paragraph 67(2)(a). The capital gain on the amount by which asset value exceeds value of fiduciary interest will be as follows:

Amount by which asset value exceeds value of fiduciary interest	R41 982
Less base cost: R100 000 x R41 982/R500 000	(R8 396)
Capital Gain	R33 586

The base cost is apportioned under the part-disposal rule in paragraph 33.

(ii) Tom's deceased estate

Under Paragraph 40(1) Tom's deceased estate will acquire the portion of the asset relating to the amount by which asset value exceeds value of fiduciary interest at R41 982. Under paragraph 40(2)(b) the fideicommissary (in this case the Jenny) will in turn acquire this right at its base cost to the deceased estate (R41 982).

(iii) Katie (Tom's spouse)

On the death of Jenny, Katie becomes the owner of the property, and Jenny's estate has no enforceable right in respect of the property.

[36] Table A: 12%: Death on or after 1 April 1977, Premiums & Problems, Edition 109, 2014, *Editors: D Hands, S Cloete, T Naidoo, C Muller & G Peter*, p E31

Katie (the fiduciary) acquired the base cost of the fideicommissum at a rolled over base cost of R91 604 calculated as follows:

R100 000 (the base cost of the asset) minus R8 396 (the base cost of the portion of the asset in respect of which the value of the asset exceeds the value of the fideicommissum as calculated in (i) above);

Alternatively R100 000 (base cost of the asset) x R458 018 (the value of the fideicommissum) ÷ R500 000 (the value of the asset).

On the sale of the property by Katie, the situation is as follows:

Proceeds	R600 000
Less: Base Cost	(R91 604)
Capital Gain	R508 396

(iv) Jenny

The base cost of Jenny's interest in the property on Tom's death is determined under paragraph 31(1)(e) and (2) as follows:

Market Value (full ownership) as at date of Tom's death	R500 000
Minus present value fiduciary interest granted to Katie on Tom's death under paragraph 31(1)(d): (R500 000 x 12% x 7.63363)	(R458 018)
Base cost of Jenny's interest in property on Tom's death	R41 9820

Upon her death Jenny has:

No Proceeds (the value of her interest in the property expired on her death, as she died before Katie).	R0
Less: Base Cost	(R41 982)
Capital Loss	(R41 982)

As Jenny never had possession of the asset, she would not have been able to use the property for purposes of trade, and will thus not be able to claim the capital loss.

(v) Reconciliation:

The reconciliation below proves the overall capital gain (R500 000) is the same as if the full property had been disposed of by the deceased on the day before he died:

	Tom	**Tom's Estate**	**Katie**	**Jenny**	**Total**
Proceeds	R41 982	R41 982	R600 000	R0	R683 964
Less Base Cost	(R8 396)	(R41 982)	(R91 604)	(R41 982)	(R183 964)
Gain/Loss	R33 586	R0	R508 396	(R41 982)	R500 000

The gain realised if the property had been sold by Tom for R600 000 on the day before his death: R600 000 – R100 000 = R500 000

Usus

Usus is essentially the right to use the property of another. The person entitled to *usus* (usuary) has the same obligations as a holder of a usufruct, but his rights are more limited[37]. The right of the usuary is strictly personal and he is thus only entitled to use the asset for personal use, and not for profit. The usuary may thus take the "fruits" of the thing for his and his household's daily needs, but nothing more. He cannot sell the "fruits" or sublet a building over which he enjoys *usus*[38]. Meyerowitz also give the following example: the *usus* of animals gives the usuary the right to work them and to take their milk, but not their wool or offspring[39]. A usuary may not cede his rights or transfer it to another person.

Where a right of *usus* is granted to a the spouse of a deceased person in the will of such deceased with the ownership being granted to another person, there will be a part disposal of the asset in that there will be a rollover in respect of the value of the *usus* and an alienation of the balance of the property (i.e. the value of the property that exceeds the value of the *usus*).

As *usus* will qualify as an "other similar right in an asset", the value of the *usus* and the right to ownership will be valued in terms of paragraph 31(1)(d) and (e) of the 8th Schedule to the Act. The provisions of paragraph 31(2) must also be taken into account in this regard, i.e. that if the Commissioner is satisfied that the annual asset which is subject to a limited interest could not

[37] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p24-22; Silberberg and Schoeman's The Law of Property, Fourth Edition, 2003, *PJ Badenhorst, JM Pienaar & M Van Rooyen*, p315.
[38] *Ibid.*
[39] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p24-22.

reasonably be expected to produce an annual yield of 12 per cent, the Commissioner may fix such sum as representing the annual yield as may seem reasonable, and this sum will be treated as being the annual value of the right of enjoyment of that asset.

Meyerowitz gives the following example in respect of grazing rights for estate duty purposes[40]:

"If the deceased had the right to graze[41] cattle on a farm, the annual value of the right of enjoyment for purpose of section 5(1)(b)[42] is 12 per cent of the fair market value of the farm. What has to be determined however is the capitalised value of the annual value to the extent[43] to which the successor becomes entitled to the right of enjoyment. It accordingly does not follow that in all cases the whole annual value has to be capitalised. Thus, if A has grazing rights over B's farm, then on A's death B succeeds to the right of enjoyment only to the extent of the grazing rights (he, by virtue of his ownership of the farm, is already enjoying all the rights of enjoyment other than grazing rights) and accordingly only that portion of the annual value attributable to the grazing rights has to be capitalised. In practice where the deceased enjoyed rights less than usufruct the Commissioner determines the annual value of these rights rather than determining the annual value of the whole property and then apportioning the annual value. For example, for grazing rights the value may be taken as the yearly cost of grazing one animal in the particular district multiplied by the number of animals the deceased was entitled to graze."

It is submitted that the approach as per the example above is equitable from a practical point of view, and gives reasonable expression to the requirements and intent of the Estate Duty Act[44]. The question is whether the same approach should be followed in calculating the value of limited rights for capital gains tax purposes in the case of these type of limited rights (i.e. where the holder of the limited right enjoys less rights than the holder of a usufruct). Here it must be born in mind that section 5(1)(b) of the Estate Duty Act makes reference to the "extent" that a person becomes entitled to a fiduciary, usufructuary or other like interest in property, which makes the above interpretation sustainable. Paragraph 31(1)(d) of the 8th Schedule to the Act makes no reference to the extent that the limited right is enjoyed:

"(31) Market value

(1) The market value of an asset on a specified date is in the case of—

(d) a fiduciary, usufructuary or other similar interest in an asset, an amount determined by capitalising at 12 per cent the annual value of the right of enjoyment of the asset subject to that fiduciary, usufructuary or other like interest, as determined in terms of

[40] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p29-14.
[41] Grazing rights are not strictly speaking a limited tight in the form of *usus*, but the point of the example is to illustrate the common principle.
[42] Of the Estate Duty Act 45 of 1955.
[43] Section 5(1)(b) of the Estate Duty Act deals with the determination of the value of a "fiduciary, usufructuary or other like interest in property" and essentially provides that it must be valued "to the extent" that a person becomes entitled to such a right.
[44] See footnote 45 *supra*.

subparagraph (2), over the expectation of life of the person to whom that interest was granted, or if that right of enjoyment is to be held for a lesser period than the life of that person, over that lesser period;

In this regard paragraph 31(2) may be of importance in this regard:

(2) For purposes of subparagraph (1)(d) –

(a) the annual value of the right of enjoyment of any asset which is subject to any fiduciary, usufructuary or other like interest, means an amount equal to 12 per cent of the market value of the full ownership of the asset: Provided that where the Commissioner is satisfied that the asset which is subject to that interest could not reasonably be expected to produce an annual yield equal to 12 per cent on that value of the asset, the Commissioner may fix such sum as representing the annual yield as may seem reasonable, and the sum so fixed must for the purposes of subparagraph (1)(d) be treated as being the annual value of the right of enjoyment of that asset;

The term asset is defined as follows in paragraph 1 of the 8th Schedule:
'asset' includes—

(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) a right or interest of whatever nature to or in such property;

Although the wording of the above provisions indicates that the 12% has to be capitalised over the market value of the full ownership of the asset, and by implication that the discretion of the Commissioner is limited to the yield over the whole property, one may be able to argue that proviso (b) of the definition of property should be interpreted to have the effect that in this scenario the word "asset" only refers to the degree that there is an interest in the property, e.g. only as far as the nature of the right (i.e. the grazing rights in the example) go. If this interpretation is indeed followed, the approach would be similar to the one followed in the estate duty example of Meyerowitz discussed above.

If the Commissioner puts an annual value on such limited right, one would not have to multiply the value of the property by 12%, but one would be able to capitalise the annual value in terms of the life expectancy tables where the right is granted for the remainder of the life of the person to whom it accrues, or if the right is granted for a shorter period, over such shorter period[45].

[45] See footnote 4 *supra*.

Once the value of the right of *usus* has been established, the rest of the methodology used to calculate the capital gains tax on the death of a person would be similar to Example 1 and 2 discussed under usufructs above.

Habitatio

A person enjoying *habitatio* has the right to live in the house of another with his or her family without detriment to the substance of the property. It however differs from *usus* in that the holder of the right of *habitatio* may sublet the house[46]. The right of *habitatio* is limited to residence and not to other aspects, for example to grazing land on adjoining areas[47]. Unless otherwise provided (e.g. in the will of the deceased), the holder of habitation is responsible for charges as levied on the premises, for example water and electricity charges, but not for charges which the owner is liable for[48]. It is uncertain whether the holder of the right of *habitatio* or the owner of the property is liable for levies payable to a body corporate where the property is held under sectional title or under a share block scheme. It is suggested that the will of the deceased should indicate how these levies are to be dealt with[49].

Where *habitatio* is granted in favour of a spouse, whist another person is granted ownership of property, there would be a part disposal of the property in that there would be a rollover in respect of the right of *habitatio* as per paragraph 67(2) of the 8th Schedule to the Act, whilst there would be a disposal of the rest of the asset (i.e. to a value equal to the difference between the value of the asset and the value of the right of *habitatio*).

As is the case with *usus*, the question arises on how to value a right of *habitatio* for capital gains tax purposes. In the case of *habitatio* of a house, the value would be similar to a usufruct of the property[50]. Meyerowitz suggests that for purposes of *habitatio* of a farm dwelling rental value (i.e. the annual value of renting such a premises) would be more appropriate for estate duty purposes[51]. As was argued in the instance of *usus*, it is my view that this approach would also be suitable in determining the value of a *right* of *habitatio*, as this is the only reasonable interpretation of paragraph 31(2), read with the definition of an "asset" in paragraph 1 of the 8th Schedule to the Act. Where a right of *habitatio* of a farm house is for example granted to a surviving spouse, whilst a child becomes owner of the farm on death of the deceased spouse, it would in my view lead to absurd results and not reflect the intention of the legislature if the right of *habitatio* is calculated in the same fashion as a usufruct (i.e. by capitalising the full value of the farm at 12% over the life expectancy of the spouse) as the spouse in fact only enjoys the right to stay in the dwelling, whilst the child enjoys all the other "fruit" of the farm. Where the

[46] Silberberg and Schoeman's The Law of Property, Fourth Edition, 2003, *PJ Badenhorst, JM Pienaar & M Van* Rooyen, p315; *Arend v Nakiba* 1927 CPD 9.
[47] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p24-22; *Galant v Mahonga* 1922 EDL 69.
[48] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p24-22; *Crosbie v Cosbie's Estate* 21 SC 597 at 606.
[49] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p24-22.
[50] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p29-14.
[51] *Ibid*.

annual rental value is utilised to calculate the value of the right of *habitatio*, one would thus not have to multiply the value of the property with 12%, as the annual rental value would be the annual value used in terms of the life expectancy tables where the right is granted for the remainder of the life of the person to whom it accrues, or if the right is granted for a shorter period, over such shorter period[52].

Once the value of the right of *habitatio* has been established, the rest of the methodology used to calculate the capital gains tax on the death of a person would be similar to Example 1 and 2 discussed under usufructs above.

Right to Income of an asset and annuity charged upon asset (property)

It often happens in practice that an asset is bequeathed to one person whilst another person is granted the right to enjoy the income of the asset, or where there a duty is placed on the heir of the asset to pay an annuity from the income of the asset to another person. In both instances the right to the income or the annuity charged upon the asset may be granted for the duration of the life of the person entitled to the income or annuity, or for a shorter period. Both these types of limited rights would fall under the category of "other limited rights" referred to in Paragraph 31(d) and (e)[53] of the 8th Schedule to the Act.

The difference between a right to income and an annuity charged upon an asset is that in the case of a right to income, the holder will be entitled to the full income of the property (unless the testator specified differently), whilst in the case of an annuity over property, the income payable is limited to the amount of the annuity. It is however important to draw a distinction between an annuity charged on property and annuities (not charged on property) that may be created in the will of a deceased.

An annuity charged upon property has the characteristic that there is an asset out of which the annuity is payable (for example the profits of a business entity or the rental income from a fixed property). Where the obligation to pay the annuity is not attached to an asset, i.e. it is merely a personal obligation by a person to pay the annuity, we are not dealing with an annuity charged upon property[54]. In *CIR V Estate Hobson*[55] land was donated on condition that the donee paid an annuity, and this condition was embodied in the deed of transfer that was later amended by agreement in that the obligation by the donee should extend to his successors in ownership of the land. This was held to be an annuity charged upon property. In *Nel NO v CIR*[56] the court dealt with a similar donation, except that there was no express provision that the

[52] See footnote 4 *supra*.
[53] A right to the income of an asset could be described as a *quasi-usufruct*. On p244 of the South African Revenue Service, Comprehensive Guide to Capital Gains Tax (Issue 4), the sale of future dividend stream on shares is described as a quasi-usufruct and it is submitted that such a sale must be accounted for as a part disposal of the shares.
[54] Estate Duty, Principles and Planning, Second Edition, 1997, *ML Stein*, p28.
[55] 1933 CPD 386
[56] 1960 (1) 227 (AD)

payment of the annuity would be enforceable against the successors of the donee. The court found that the obligation of the donee was a personal one and thus not an annuity charged upon property.

The difference between an annuity charged upon property and a personal obligation to pay an annuity is thus that, in the former instance, we are dealing with a real right and in the latter instance with a personal right. To be a real right there must be a burden on the asset, i.e. a subtraction from ownership[57], whereas a mere obligation to pay a sum of money is not a burden on the asset or a subtraction of ownership, but an obligation of the person[58]. For this reason it is submitted that where we are dealing with an annuity that creates a personal obligation on a person to pay same without placing a burden on the asset in this regard, we are neither dealing with a part disposal as contemplated in paragraph 33(1), nor are we dealing with "*a fiduciary, usufructuary or other similar interest in an asset*" as contemplated in paragraph 31(1)(d) and (e) of the 8th Schedule to the Act. Where an asset is thus for example bequeathed to a child with a personal obligation on the child to pay an annuity to the spouse of the testator, there will be a full disposal of the asset to the child, without any rollover relief as contemplated in paragraph 67(2)(a) of the 8th Schedule to the Act.

Where an asset is bequeathed to a third person, whilst the spouse of the deceased is entitled to the income of the asset, or the spouse is entitled to an annuity charged upon the asset, there would be a part disposal of the property in that there would be a rollover in respect of the right to the income or annuity as per paragraph 67(2) of the 8th Schedule to the Act, whilst there would be a disposal of the rest of the asset (i.e. to a value equal to the difference between the value of the asset and the value of the right to the income or annuity) to such third person.

Where a person becomes entitled to the income of the property on the death of the testator, the value of this right will usually be established by multiplying the value of the property by 12% to establish the annual value of the property and the annual value would then be capitalised over the life expectancy of the person entitled to the income. The provisions of paragraph 31(2) of the 8th Schedule to the Act must again be borne in mind in that if the Commissioner is satisfied that the asset which is subject to this interest could not reasonably be expected to produce an annual yield of 12 per cent on the value of the asset, the Commissioner may fix such sum as representing the annual yield as may seem reasonable, and the sum so fixed will be treated as being the annual value of the right of enjoyment of the asset.

It is again submitted, for the same reasons set out under the discussion of *habitatio* and *usus* above, that the annual value of an annuity charged upon property will be calculated by establishing the annual amount of the annuity and not by multiplying the value of the asset by 12%. This annual amount will then be capitalised over the life expectancy of the person entitled to the annuity, or for a shorter period, depending on the provisions of the will of the person who

[57] *Ex parte Geldenhuys 1926* OPD 155.
[58] Meyerowitz On Administration Of Estates And Their Taxation, 2010 Edition, *D Meyerowitz*, p27-5.

granted the annuity. The provisions of paragraph 31(2) of the 8th Schedule to the Act must again be borne in mind in instances where the Commissioner is satisfied that the asset which is subject to this interest could not reasonably be expected to produce the annual amount of the annuity as provided for in the will.

Conclusion

When limited rights are created in via the will of a deceased person, there are various factors that need to be taken note of when calculating the capital gains tax consequences of such a bequest.

There are also provisions where a fair amount of uncertainty exists with regards to the interpretation thereof, namely:

(i) The creation of a *fideicommissum* where the surviving spouse is the fiduciary:

The creation of this limited right has the effect in common law that full ownership is transferred to the spouse (fiduciary), i.e. the right to enjoyment of the asset as well as the bare dominium. The effect of this is that we are in effect not dealing with a part disposal as contemplated in paragraph 33(1) of the 8th Schedule to the Act. If we look at this aspect in solitude, it could create the impression that we are dealing with a rollover of the full value of the asset in terms of Paragraph 67(2)(a) of the 8th Schedule to the Act. It is however submitted that Paragraph 31(1)(d) and (e) dictates that a fiduciary right should be valued in a similar fashion as a usufruct and other limited rights, thus having the effect that there is only a rollover in respect of the calculated value of the fiduciary right, whilst there is effectively a disposal of the balance of such asset.

(ii) Limited rights where lesser rights are granted to the holder of such limited rights and instances where limited rights are granted over a portion of the asset:

Paragraph 31(1)(d) read with paragraph 31(2)(a) of the 8th Schedule to the Act seems to indicate that the value of all limited rights are calculated by capitalising at 12% the annual value over the life expectancy of the person to whom the right was granted, or if for a lesser period, over that lesser period, and that only where the Commissioner is satisfied that the asset will be unable to produce an annual yield of 12%, he may adjust it to a sum representing the annual yield of the asset.

On first glance this only makes provision for instances where the whole asset is not able to produce an annual yield of 12%. It thus appears that these provisions do not take into account instances where the limited right is of such a nature that the right bestowed upon the holder is a lesser right than for example a usufruct, or where the right is only granted in respect of a portion of the asset, and the annual value of the right could not reasonable equated to 12% of the value of the whole asset (even if the asset as a whole could reasonably be expected to produce the annual yield of 12%). This would lead to absurd results, for example where a right of *habitatio* is granted on a farmhouse or grazing rights are granted over a small portion of a farm. The definition of an asset however refers to a right or interest of whatever nature in property, so a possible interpretation of this is that

where we are dealing with a lesser limited right, or a limited right in respect of only a portion of an asset, it could be interpreted to relate to a limited right over that specific interest in the property, and not the whole property or all the rights of enjoyment and use over the property. It is however submitted that there would be less uncertainty in this regard if the legislation is amended to provide that the calculation and discretion of the Commissioner should relate to the extent that the person becomes entitled to the right of enjoyment of the asset, i.e. in a similar fashion to section 5(1)(b) of the Estate Duty Act[59].

In the absence of relevant case law and legislative amendments on these issues, a certain degree of uncertainty with regards to the correct interpretation thereof will however remain.

[59] 45 of 1955

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Limited interests and wills

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Introduction

Limited interests are used frequently in wills, and to decide which limited interest the testator has in mind, can sometimes be a daunting task for the financial adviser or the wills drafter when taking the instructions to draft the client's will. The aim of this article is to look at the different limited interests, the actual wording in a will and the rights and obligations created for the heirs who inherited a limited interest. The truth is, sometimes even professional financial planners are confused about the rights and obligations for the holders of the limited interests. The limited interests that will be covered are the usufruct, the fideicommissum, habitatio and usus.

Limited Interest 1: Usufruct

A usufruct is a personal servitude, and one of the oldest personal servitudes. A usufruct enables the holder (called the usufructuary) to use specific property belonging to another (called the bare dominium holder) and to enjoy the fruits of the property with the responsibility to maintain the substance of the property. The usufructuary has to give the property back to the bare domium holder at the end of the usufructuary period. A usufruct may be granted for life or for a specific period or until the happening of a specific event.

The usufructuary should therefore use and enjoy the property in such a way that the substance of the property (*salva rei substantia*) is preserved for the bare dominium holder. The aim of the usufruct is therefore to provide an income for the usufructuary from the property, usually lifelong, however without ownership being transferred to him/her.

Whilst the usufructuary is alive, the bare dominium holder cannot use or enjoy any fruits from the property. When the usufructuary dies where the usufruct was given for a specified time or until the happening of a specific event, then the usufructary right will terminate, and the ownership of the bare dominium holder will grow again to full ownership.[1]

What kind of assets can be the object of a usufruct?

Since the usufructuary has the responsibility to enjoy the property in such a way that the substance of the property can still be handed over to the bare dominium holder, in the end, it makes sense that assets which are consumed through usage should not be the object of a usufruct. Where assets are consumed a *quasi-usufruct*[2] can be created, but since the assets are consumed, the usufructuary has the responsibility to hand over similar quality assets to the bare dominium holder.

[1] MJ De Waal, MC Schoeman & NJ Wiechers, Erfreg: Studentehandboek, at 115
[2] RP Pace & WM van der Westhuizen, Wills and Administration of Estates, 2013, at point 68.1

A usufruct can be created over movable or immovable property either corporeal or incorporeal.[3] In the court case of **Cooper v Boyes**[4] the court decided that there was no reason why shares could not be bequeathed by way of a usufruct. The usufructuary will be entitled to receive dividends, and on termination of the usufruct the share devolves upon the bare domium holder as the ultimate heir.[5]

How is a usufruct created ?

A usufruct is most often created by a last will and testament. It is advisable that the usufruct is created expressly and not by implication, if that is what the testator intended, or else the interpretation of the will could be problematic, and could cause unnecessary legal costs for the heirs.

The rights and responsibilities of a usufructuary[6]

The usufructuary is entitled to the possession of the property. The usufructuary must use the property with the duty of care of a *bonus paterfamilias*. Although it seems that the usufructuary is not bound to insure the property[7] it is submitted by writer that the testator should address the responsibility of insurance in the will, and that the will drafter should advise the testator accordingly.

A usufructuary is not permitted to mortgage the property and neither can the property be sold by the usufructuary or by the bare dominium holder without leave from the court. The property can however be sold if both these parties agree.[8]

The usufructuary is responsible for the maintenance of the property and is also liable to pay the rates and taxes. The usufructuary may let the property but only for the period of the usufruct. The rental income of the property would therefore be the fruit of the property. When the usufructuary makes any improvements to the property, it is doubtful whether he will be entitled to compensation for the improvement.

Wording example of a usufruct

I bequeath my immovable property situated at 26 Magnolia street, Wilropark, Roodepoort to my son, Harold Killian, subject to the lifelong usufruct in favour of my spouse, Janice. I exempt my spouse from the responsibility of maintaining the property or effecting any repairs thereto. My spouse shall be responsible for paying the rates and taxes thereon, as well as insuring the

[3] id at point 68.1
[4] 1994 4 SA 521 (C)
[5] RP Pace, supra note 2, at point 68.1
[6] RP Pace, supra note 2, at point 68.2
[7] RP Pace, supra note 2, at point 68.2
[8] Meyerowitz, The Law and Practise of Administration of Estates and their Taxation , at par 24.16

dwelling against the risk of fire. My spouse shall not be required to furnish security in her capacity as usufructuary.

Important to exempt a mother from furnishing security as usufructuary in respect of assets of which her child is the bare dominium holder, if not exempted in the will, she must furnish security. [9]

Limited Interest 2: Fideicommissum[10]

A fideicommissum is, for example, where a fixed property is bequeathed to a person (called the fiduciary) subject to the condition, that the property will pass to another person(s) (called the fideicommissary) on the happening of a specific event. The property thus vests in the fiduciary, until fulfilment of the condition, where the fideicommissary then has a successive right to the property. The fiduciary normally does not have a right of alienation, unless the will provides otherwise.

How is a fideicommissum created?

A fideicommissum is most often created by a last will and testament. It is advisable that it is created expressly and that the intention of the testator is clear, even without using the terms fideicommissum, fiduciaries and fideicommissarius. [11] An example of an expressed fideicommissum would be "I bequeath my farm, Grootpan, to my son, Alfred. At the death of my son, Alfred, then the farm should be inherited by Alfred's son, Alfred Junior."

Limitation on the duration of a fideicommissum[12]

A fideicommissum where the property goes over more than once is known as a *fideicommissum multiplex*, and where the property goes over only once, is known as a *fideicommissum simplex*. Theoretically in common law a *fideicommissum multiplex* can continue indefinitely, and the duration of the fideicommissum is determined in the testator's will. Where there is no clear expression of the duration of the fideicommissum, courts have limited it to four generations.[13] The common law right was changed significantly by Act 4 of 1965[14], and fideicommissums over immovable property is now restricted to two successive fideicommissaries, irrespective of the testators instructions in his will.

[9] Van Staden v Van Wyk 1958 2 SA 682 (O)
[10] RP Pace, supra note 2, at point 63.1
[11] RP Pace, supra note 2, at point 63.2
[12] RP Pace, supra note 2, at point 63.4
[13] RP Pace, supra note 2, at point 63.4
[14] Removal or Modifications of Restrictions on Immovable Properties Act 4 of 1965

Requirements to create a valid fideicommissum[15]

(a) The testator must show a clear intention to create a fideicommissum, therefore the words must clearly express that he wants to bequeath a property to another.

(b) There must be an effective "gift-over" of the property to the specified fideicommissary, on the fulfilment of the condition stipulated.

(c) It must be easy to identify the fiduciary, the fideicommissary and the burdened property in the will.

(d) The fideicommissary condition must not be against public morals, public policy, illegal or impossible to fulfil. In short the condition must be valid.

The rights and responsibilities of a fiduciary

The right to ownership in the encumbered property vests in the fiduciary on the death of the testator. The fideicommissary has no right to the property at this stage, and enjoys merely a *spes fideicommissi*.[16]

The fiduciary is the owner of the property, he is entitled to the use, the enjoyment and the fruits of the property. His ownership is restricted in the sense that it is normally subject to a restraint against alienation, and his use and enjoyment of the property is also limited as he is obliged to pass the burdened property *salva rei substantia*[17] (where he has maintained the substance of the property) to the fideicommissary on fulfilment of the fideicommissary condition. The aim of the fideicommissum is therefore to provide ownership to the fiduciary until the fulfilment of the condition (for example death of the fiduciary), but for the testator to maintain control on the appointment of the ultimate beneficiary of the property thereafter in terms of his will. Important that the testator indicate the ultimate beneficiary, or else the fiduciary will receive the ownership without any limitations.

Where the fiduciary has to take steps to improve or to preserve the property, he is entitled to compensation for expenses that are useful and necessary only.[18] The fiduciary will have a claim against the fideicommissary, and the right to the compensation usually occurs on the death of the fiduciary.

The fiduciary is normally prohibited from alienating the property through a sale, donation or exchange or from encumbering the property with a mortgage. The fiduciary's rights are subject to attachment, sale in execution or insolvency, unless the will has a contrary provision when the

[15] MJ De Waal, supra note 1, at 101-102
[16] MJ De Waal, supra note 1, at 110
[17] MJ De Waal, supra note 1, at 108
[18] RP Pace, supra note 2, at point 64.3

fideicommissum was created. The insolvency of the fiduciary will not affect the rights of the fideicommissary, but only the estate of the fiduciary[19].

The main responsibilities of the fiduciary can be summarized as follows:[20]

(a) Is expected to give an inventory of the fiduciary assets to the fideicommissary;

(b) Can be asked to provide security, although the testator can exempt the fiduciary from providing security in the will;

(c) Must hand over the property to the fideicommissary on the fulfilment of the condition;

(d) Must use the burdened property *salva rei substantia* (where he has maintained the substance of the property) .

Wording example of a fideicommissum where risk of insolvency exists[21]

I bequeath my property known as nr 36 Valley View, Helderkruin to my daughter, Emma subject to the condition that on her death, my named property shall be inherited equally by her children, born and alive at the date of my death. In the event of:

1) Emma being declared insolvent; or

2) Emma committing an act of insolvency as defined in the Insolvency Act, when applicable, Emma shall immediately forfeit her rights under this will, and my said immovable property shall devolve upon and vest in her children who are alive at that time.

Wording example of a fideicommissum with power of alienation

I bequeath my immovable property situated at 19 Aquila Avenue, Waterkloof Ridge to my spouse, with the power of alienation, subject to the condition that upon his/her death this bequest, or the net proceeds thereof, or the reinvestment thereof, as the case may be, shall devolve upon such of my children who are then alive, and their descendants by representation of any one of them who then might be deceased. My spouse shall not be called upon to furnish security in his/her capacity as fiduciary.

Wording example of a fideicommissum without power of alienation

I bequeath my immovable property situated at 19 Aquila Avenue, Waterkloof Ridge to my spouse, subject to the condition that upon her death my said property shall devolve upon my own daughter, Janice (as fideicommissary), born from our marriage. The said property shall not be alienated by either my spouse or my daughter during their lifetimes, nor shall it be alienated to anyone who is not a blood relation of my daughter, it being my wish that the said property

[19] RP Pace, supra note 2, at point 64.4
[20] MJ De Waal, supra note 1, at 110
[21] RP Pace, supra note 2, at point 64.4, Precedent 48

shall remain in our family as long as possible. My spouse shall not be called upon to furnish security in her capacity as fiduciary.

Limited Interest 3: *Habitatio*[22]

Habitatio means the right to dwell or inhabit. It is a personal servitude, and entitles the holder of this limited right to dwell in a house that belongs to someone else, but the holder of this personal right, has no further rights to the house. A holder of a habitatio can let his right to a third party. He stays responsible for payment of electricity and water, and if the property is held under sectional title, then he has to pay the levies to the body corporate as well, unless the will determines differently.[23] It is important that the will's drafter clearly sets out the intention of the testator, especially the rights granted to heirs, and the duties that he wants to impose on them.

Wording example of a *habitatio*

I bequeath my immovable property known as 18 Beethoven Villas, Beethoven street, Vanderbijlpark to my daughter, Cathy Brookes, subject to the condition that my spouse shall be entitled to **reside** in the house, until her remarriage or death, whichever event occurs first. I direct that my spouse will be responsible for payment of all levies due to the body corporate, as well as for the payment of electricity and water. My spouse will be entitled to let the said house to a third party, should she wish to.

Limited Interest 4: *Usus*[24]

Usus means the right to use. It is also a personal servitude and entitles the holder of this limited right to use so much fruit of the property as he requires on a daily basis for his immediate family and himself. He is not entitled to let this right, and when he passes away the right of *usus* comes to an end.

Wording example of a *usus*[25]

I bequeath my immovable property known as 70 Abelia street, Somerset West to my son, Andrew Dillon, subject to the condition that my spouse shall be entitled to the lifelong **use** of the house thereon, for the purpose of residing in the house. I direct that my spouse will not be responsible for the maintenance of the house, but she must personally reside in the house, and may not let it out. My spouse will be responsible for the water and electricity, whilst she dwells in the house.

22 RP Pace, supra note 2, at point A69
23 D Meyerowitz, supra note 8, at par 24.25
24 RP Pace, supra note 2, at A69
25 RP Pace, supra note 2, at A69, Precedent 59

Conclusion

The writer trusts that this article will be of use to wills drafters and financial advisers in order to pose the right questions to clients and to establish which limited interest would best suit the client's circumstances. It is important to also take cognisance of the responsibilities imposed on the holder of the limited right, and what the holder may or may not do. Certainty in the will remains important, and therefore it is advisable for drafters to specify in the will what the responsibilities and rights of the holder of the limited right will be, even if it means to spell out the common law position. Drafters and financial advisers should also keep possible insolvency of heirs in mind, when taking instructions from clients – remember clients are not specialists, they rely on our attention to detail to assist them in choosing limited interests that will fit their circumstances!

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The integral workings of the primary estate duty abatement

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Introduction

Estate planning is crucial to ensure that a client's taxes and costs are minimised upon their death. Upon such an event various taxes become applicable and thus SARS have allowed numerous concessions to assist a taxpayer in reducing such liabilities. Thus, the financial advisor must be aware of the deductions that are permitted. One such deduction that becomes applicable at death is section 4A of the Estate Duty Act No. 45 of 1955. The primary estate duty abatement contained in section 4A[1] thus reduces a client's dutiable estate by R3,5 million. Thus a client can bequeath assets to the value of R3,5 million to persons other than their surviving spouse without attracting any estate duty[2]. The portion of a person's estate that is subject to estate duty is determined by deducting the section 4A abatement of R3,5 million from their 'net estate'. The amount that remains is referred to as the "dutiable estate" and is taxed at 20%. This article aims to illustrate how the S4A abatement is calculated when there is more than one surviving spouse.

How do we calculate a person's dutiable estate?

Example 1[3]

Mr. Loot [married out of community of property] died and bequeathed his house to his wife. His gross estate is worth R 10 000 000.00 and his house is worth R 1 600 000.00. His dutiable estate will be :-

Gross Estate	R 10 000 000.00
Less : Section 4(q) deduction – house to wife	(1 600 000.00)
Net Estate	R 8 400 000.00
Less : Section 4A abatement	(3 500 000.00)
Dutiable Estate	**R 4 900 000.00**

Estate duty payable = 20% x R 4 900 000.00

= R 980 000.00

Is the section 4A abatement portable?[4]

The recent amendment to section 4A in 2010 allows for the portability of this rebate between spouses. The estate of the first-dying spouse is entitled to the abatement of R3,5 million and the

[1] Estate Duty Act No. 45 of 1955
[2] Section 4q of the Estate Duty Act No. 45 of 1955
[3] Notes on South African Income Tax 33rd Edition, Phillip Haupt
[4] Notes on South African Income Tax 33rd Edition, Phillip Haupt

second-dying spouse's estate is entitled to the abatement of R3,5 million plus the unused portion of the first-dying spouse's abatement [maximum of R 7 million in total].

If the predeceased spouse died when the section 4A abatement was R2 million the second-dying spouse will be entitled to an abatement of R 7 million [irrespective when the predeceased spouse died], on condition that the predeceased spouse's estate did not utilise the abatement it was entitled to.

In order to claim this R7 million abatement the second-dying spouse's executor has to submit a copy of the first-dying spouse's estate duty return to the Commissioner [section 7].

Example 2[5]

Mr. Morne passed away leaving his entire estate to his wife. Mrs. Morne dies 12 years later. Mr. Morne didn't utilise his section 4A abatement. Mrs. Morne's estate is worth R25 000 000.00 after the payment of all liabilities and debts due, but before the payment of estate duty.

Net Estate	R 25 000 000.00
Less: section 4A abatement [R3,5 million x 2]	(7 000 000.00)
Dutiable Estate	**R 18 000 000.00**

Estate duty payable = 20% x R 18 000 000.00

= R 3 600 000.00

Section 4A(2) – One deceased spouse with many previously deceased spouses states:[6]

"(2) Where a person was the spouse at the time of death of one or more previously deceased persons, the dutiable amount of the estate of that person shall be determined by deducting from the net value of that estate, as determined in accordance with section 4, an amount equal to the amount specified in subsection (1)—

(a) multiplied by two; and

(b) reduced by the amount *deducted* from the net value of the estate of *any one* of the previously deceased persons in accordance with this section."

[5] Notes on South African Income Tax 33rd Edition, Phillip Haupt
[6] Notes on South African Income Tax 33rd Edition, Phillip Haupt

The abatement is reduced by 'nil', as the deceased is permitted to use the amount deducted from the estate of any 'one' spouse. Thus the amount of 'nil' from the estate of the spouse who bequeathed her entire estate to Mr. Jaco may be utilised.

Example 3[7]

Mr. Jaco dies. Two spouses died prior to him dying. The one spouse left her entire estate to him and other to her children. The spouse who bequeathed her estate to her children had an abatement of R2,5 million. The spouse who bequeathed her entire estate to Mr. Jaco did not utilise her abatement as her net estate was nil. Mr. Jaco's net estate is R 12 000 000.00.

Net Estate		R 12 000 000.00
Less : section 4A abatement	(7 000 000.00)	
Abatement of predeceased spouse	nil	R 7 000 000.00
Dutiable Estate		**R 5 000 000.00**

Estate duty payable = 20% x R 5 000 000.00

= R 1 000 000.00

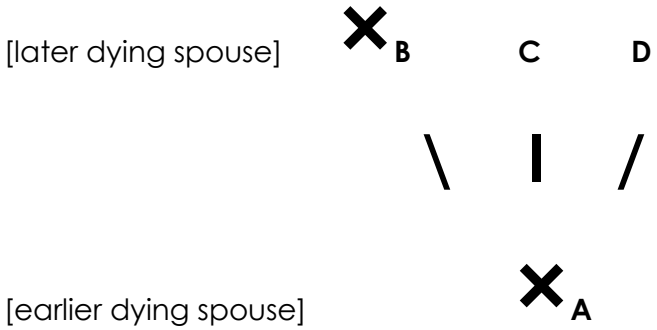
Section 4A(3) – One predeceased spouse with many surviving spouses states:[9]

"(3) Where a person was one of the spouses at the time of death of a previously deceased person, the dutiable amount of the estate of that person shall be determined by deducting from the net value of that estate, as determined in accordance with section 4, an amount equal to the sum of the amount specified in subsection (1) -

(c) the amount specified in subsection (1) divided by the number of spouses,

(d) reduced by an amount which is determined by dividing the amount deducted, in accordance with subsection (1), from the net value of the estate of the previously deceased person by the number of spouses of that previously deceased person."

[7] Notes on South African Income Tax 33rd Edition, Phillip Haupt
[9] Notes on South African Income Tax 33rd Edition, Phillip Haupt



The second-dying spouse must have been one of a number of spouses married to the first-dying spouse upon the first-dying spouse's death.

Example 4[10]

Mr. Jimmy passed away on 1 March 2012 and bequeathed the residue of his estate [except for R2 million] in equal amounts to his three wives. His estate was valued at R20 million upon his death.

Gross Estate	R 20 000 000.00
Less : section 4(q) – residue to wives	(18 000 000.00)
Net Estate	R 2 000 000.00
Less : section 4A abatement limited to net estate value	(2 000 000.00)
Dutiable Estate	**Nil**

[10] Notes on South African Income Tax 33rd Edition, Phillip Haupt

Example 5[11]

Mrs. Dolan, one of Mr. Jimmy's surviving spouses, died on 30 June 2013. She bequeathed her estate of R12 million to her children.

Net Estate		R 12 000 000.00
Less : section 4A(3)(a) abatement		(3 500 000.00)
Section 4A(3)(b) abatement		
R3 500 000.00 / 3		R 1 166 666.67
Less: portion of abatement of predeceased		
spouse : R 2 000 000.00 / 3	(666 666.67)	(500 000.00)
Dutiable Estate		**R 8 000 000.00**

Estate duty payable = 20% x R 8 000 000.00

= R 1 600 000.00

Conclusion

In order for the later dying spouse to be able to claim the portable section 4A abatement the executor of their estate must submit a copy of the earlier dying spouse's return to the Commissioner[12] When both spouses die simultaneously, the spouse with the smaller estate is deemed to have died first[13].

Taxpayers should take note of the portability of the section 4A abatement and ensure that the executor of their estates is aware what the requirements are in order to qualify for the portability of the abatement.

[11] Notes on South African Income Tax 33rd Edition, Phillip Haupt
[12] Section 4A(5) of the Estate Duty Act No.45 of 1955
[13] Section 4A(6) of the Estate Duty Act No.45 of 1955

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Considerations for an offshore trust

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Introduction

Trusts are very useful estate and financial planning tools. They allow for asset value freezing (estate planning), succession and asset protection. With the relaxation of exchange control regulations, many South Africans are now also building substantial estates abroad. Foreign assets in a South African's own name in a foreign jurisdiction form part of his personal estate on death for the purposes of estate duty and capital gains tax. The foreign estate may be subject to a tedious administration process with possible delays. South Africans with considerable offshore assets should therefore contemplate housing them in an offshore trust.

Considerations, Pros and Cons

Changes to exchange control rules makes it possible for a married couple to invest up to R10 million offshore[1]. This capital makes the setting up and administration of an offshore trust viable. To create an offshore trust one needs to first obtain a tax clearance certificate from the South African Revenue Service (Sars)[2]. The second step is to engage a reputable firm of offshore trustees and also deciding on the offshore jurisdiction in which the trust should be domiciled. The third step is transferring assets over to the offshore trust. This can be done either by way of donating or lending assets to the trustees. Donating funds to an offshore trust will attract donations tax at a rate of 20% of amounts in excess of R100 000. Founders are often advised to transfer funds on an interest bearing loan account, at a market related rate of interest. The purpose is to ensure that the anti-avoidance provisions in section 7(8)[3] and paragraph 72 of the Eighth Schedule to the Act[4] do not apply. This also ensures compliance with the transfer pricing provisions of both section 31 of the Act[5] and the South African Reserve Bank. Section 7(8)[6] states that any income which has been received by, or accrued to, any non-resident ("non-resident" could be an individual, a company or a trust) as a result of any donation, settlement or gratuitous disposition by a South African resident, is deemed to be that of the resident. Therefore if a South African resident makes an interest-free loan to a non-resident, any income which arises as a result of that interest-free loan will be deemed to be that of the resident. Founders would avoid donations tax liability but pay income tax on the interest earned instead.

[1] A tax-payer in good standing and over the age of 18 years, can invest up to R4 million in his/her name outside the Common Monetary Area (CMA-Lesotho, Swaziland and Namibia), per calendar year. A Tax Clearance Certificate (in respect of foreign investments) must be obtained. These funds may not be reinvested into the CMA countries thereby creating a loop structure or be re-introduced as a loan to a CMA resident. In addition, up to R1 million, within the single discretionary allowance facility, can be transferred abroad, without the requirement to obtain a Tax Clearance Certificate – South African Reserve Bank www.resbank.co.za

[2] Section 256 of the Tax Administration Act No. 28 of 2011

[3] 58 of 1962

[4] Paragraph 72 of the Eighth Schedule Income Tax Act 58/1962

[5] Supra at note 3

[6] Paragraph 72 of the Eighth Schedule Income Tax Act 58/1962

❑ Choice of jurisdiction

The choice of jurisdiction is as important as choosing the right trustee. Language, time zones, stability, trust law and taxation should be considered. The better known offshore centres include:

Bahamas; Bermuda; Caymen Islands; Netherland Antilles, Panama; Guernsey; Jersey; Isle of Man; Liechtenstein; Luxembourg; Monaco; Netherlands; Switzerland; Gilbraltar; Cyprus and Hong Kong.

Other than protection against creditors and estate planning advantages extended to foreign assets, tax planning can be done efficiently. Provided that the assets are transferred to a discretionary offshore trust in an appropriate manner, the future growth on those assets occurs without attracting estate duty. One of the benefits of establishing a trust in a low tax jurisdiction is the mitigation of both source and residence based taxation and the relief of double taxation. Income and capital gains received by or accrued to non-South African resident trusts are generally liable for low or no tax in South Africa. The founder is only taxed when he or she receives interest on the sum loaned to the trust or when there is a distribution of the trust's assets back to the founder as a beneficiary. To maintain these benefits, the trust must not only be established in the chosen jurisdiction but it must also be managed there. All day-to-day decisions with regard to the management of the trust will have to be taken outside South Africa. If the trust is managed by persons residing in South Africa, it will be deemed to be a South African tax resident and taxed at the higher marginal that is applicable to trusts.

❑ Political and Legal Risk

By lending one's offshore allowance to an offshore trust one can ensure that the assets are held and controlled outside of South Africa. Assets are protected against local legal and political developments and cannot be affected directly. New local legislation will therefore not have any impact on an offshore trust.

❑ Currency Hedge

An investment into a hard currency, GBP, Euro or USD ensures that the assets would be protected in international currency terms should the Rand devalue.

❑ Winding up of estate

Probate and the winding up of an estate are long and tedious procedures. An offshore trust acts as a substitute for drawing up an offshore will, provided that all of one's offshore assets are placed in the trust. In offshore trusts, even though the assets are not revealed to third parties as in the case with a will, the beneficiaries can easily trace the assets.

❑ **Relinquish control**

By donating or lending assets to a trust, one effectively gives up control of these assets. Although the trustees give effect to the founder's wishes, they are not bound by them. Failure to give up control could result in the property of the trust being deemed to be that of the founder. Thus for example, in *Badenhorst v Badenhorst*[7], a wife instituted, by way of a counterclaim, a redistribution order in terms of s 7(3) of the Divorce Act,[8] which directed the respondent (her husband) to transfer half his estate to her, as well as half of the trust assets in the Jubli Trust. The Appeal Court held that the trust was a sham trust, because the respondent had too much control over the trust. The Court said that a trust cannot be used as a "window dressing". The Court said that in some cases the evidence could show that the trust form is a mere veneer that in justice should be pierced in the interests of creditors. Creditors include suppliers, SARS and banks. The Court granted half of his estate, as well as half of the trust assets to the wife.

Conclusion

Assets held and managed as discussed above will not form part of one's estate in South Africa on death for purposes of the administration process, executor's fees or estate duty and capital gains tax. Before creating an offshore trust, one must decide what it is that one wishes to accomplish. Trusts should never be established only to gain a tax advantage. If a trust is established solely in an attempt to avoid tax, the planner may be disappointed. As discussed above, enhanced transparency, increasing regulatory requirements and aggressive changes in tax legislation needs to be factored in when establishing a trust. Choosing professional offshore trustees who understand the above complexities is therefore a crucial element. Reputable offshore trust companies are experts in safeguarding assets. They are well regulated, subscribe to annual review procedures and comply with stringent regulatory requirements to ensure the effectiveness and viability of an offshore trust.

[7] [2006] 2 All SA 363 (SCA)
[8] 70 of 1979

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Estate planning anomalies

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Introduction

This article aims to highlight some anomalous scenarios in estate planning, which can have far reaching effects on a client's estate planning. Financial planners should at all times be aware of the fact that estate planning is complex and that a competent professional should be approached to assist with estate planning for a client.

Not all debts discharged from property in the estate are deductible

In terms of section 4(b) of the Estate Duty Act 45 of 1955 (hereinafter referred to as "the Act") debts due by the deceased to persons ordinarily resident in the Republic, proved to the satisfaction of the Commissioner to have been discharged from property included in the estate, are deductible.

Section 4(b) is not strictly followed by the Commissioner in practice. Settlement of a mortgage bond would normally be deductible in terms of section 4(b). In practice, even in circumstances where the heir or legatee takes over the debt, the deduction is usually allowed notwithstanding the fact that the debt is not being discharged from property in the estate[1]. The debt has in practice even been allowed as a deduction by the Commissioner where it is not actually discharged and paid at date of assessment of estate duty[2].

A mortgage bond over a fixed property is a common debt due in a deceased estate. The question is whether the deduction for this debt due would be allowed in the estate where a deceased testator bequeaths property to a heir or legatee on condition that they take over the mortgage bond. Stein[3] submits that the deduction of the debt under section 4(b) of the Act would not be allowed since it would not have been discharged from property included in the estate.

There however appears to be a discrepancy between how the debt, and corresponding deduction, is treated depending on whether it is taken over by the surviving spouse or any other heir or legatee.

In respect of such a conditional bequest to the surviving spouse, we should firstly look at whether the immovable property will be deductible in terms of section 4(q) of the Act.

Section 4(q) provides that a deduction is allowed for so much of the value of any property included in the estate which has not been allowed as a deduction under section 4, as accrues

[1] Stein ML, Estate Duty Principles and Planning, (4th ed. 2011), 70
[2] Meyerowitz D, The Law and Practice of Administration of Estates and Their Taxation, 2010, 28-6[3] Stein, *supra* note 1, at 75
[3] Stein, *supra* note 1, at 75

to the surviving spouse of the deceased, provided that the deduction shall be reduced by so much of any amount as the surviving spouse is required in terms of the will to dispose of to any person or trust. This could lead to the interpretation that the section 4(q) deduction should be reduced if the surviving spouse is required to take over any debt. However, Stein[4] is of the opinion that the section 4(q) deduction should not be reduced as it is not an amount that the spouse is required to 'dispose of' to any other person. Thus the section 4(q) deduction would be allowed in respect of the immovable property which accrues to the surviving spouse.

It thus appears that where there is a bequest of an asset conditional upon the heir or legatee taking over the debt associated with the asset, the debt would only be allowed as a deduction under section 4(b) of the Act, if the asset is bequeathed to a person other than the surviving spouse. This is clearly an anomaly and one can only assume that it is based on practical reasons, which are probably best illustrated by way of a rather simplified example:

Example

Let's assume that the only asset in the deceased's estate is an immovable property worth R2 million and there is an outstanding mortgage bond of R1 million rand which the surviving spouse will take over. The intention is probably to prevent the estate from getting a R3 million deduction (R2 million in terms of section 4(q) and R1 million in terms of section 4(b). That is possibly the reason for the discrepancy between the deductibility of the debt where the asset is bequeathed to the surviving spouse as opposed to any other heir.

The next question to answer is: Does the situation change where the surviving spouse is bequeathed an asset conditional upon paying a bequest price to the estate?

Although the Income Tax Act[5] and the Vat Act[6] defines a "person' and includes a deceased estate in the definition of a person, the Estate Duty does not contain a definition of a 'person'. It is submitted[7] that the deceased estate would thus not be considered a 'person' and would accordingly not reduce the section 4(q) deduction in respect of the asset. Meyerowitz[8] cautions that it could be argued that the executor is a 'person' but thinks that it is doubtful that this would be accepted.

Therefore, even though the bequest price would not constitute property of the deceased as at date of death, and thus there would be no section 4(b) deduction if the debt is payable with the bequest price since the debt is not discharged from property in the estate, the estate would still get a 4(q) deduction if the asset subject to the bequest price is bequeathed to the spouse.

[4] *Id.* at 75, p75
[5] Income Tax Act 58 of 1962
[6] Vat Act 89 of 1991
[7] Meyerowitz, *supra* note 2 at 28-18; Stein *supra* note 1 at 76
[8] Meyerowitz *supra* note 2 at 28-15

The estate planner should thus ensure that there are sufficient funds in the estate to discharge the debt, so that the section 4(b) deduction would be allowed in respect of the debt associated with that asset, for the reason discussed above.

This will prevent the testator from having to utilise bequest prices to offset liabilities in the estate and having a higher estate duty liability, as the section 4(b) deduction would not be allowed for the reasons discussed above. If a testator in insistent for an heir to receive a bequest subject to a bequest price, the estate planner would need to ensure that the resultant increase in estate duty is catered for.

Does a policy fall within a joint estate where it is owned by a third party but the estate is the beneficiary?

According to Hahlo[9], all the assets and liabilities are merged into a joint estate, in which both spouses, irrespective of the value of their financial contributions hold equal shares.

It is generally accepted that policies with a beneficiary nomination do not form part of the joint estate of the deceased but that policies payable to the deceased estate, do form part of the joint estate of the deceased[10]. What then about policies owned by a third party where the deceased estate of the life assured is the beneficiary?

According to section 3(3)(a) of the Act, deemed property includes any domestic policy upon the life of the deceased. The section does not distinguish between policies owned by the deceased and policies owned by third parties. The proceeds of the policy can be reduced by 6% per annum to the extent that the premiums have been paid by the person entitled to the amount due under the policy. The only exclusions to section 3(3)(a) are policies where:-

(i) The amount due under such policy is recoverable by the surviving spouse or child of the deceased under a duly registered ante-nuptial or post-nuptial contract, or;

(ii) 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 his or partner of held any share or like interest in a company in which the deceased, on that date, held a like share or interest, and the policy was taken out or acquired with the purpose of acquiring the deceased's interest in the partnership, or with the purpose of acquiring the whole or a part of the deceased's share or like interest in the company or close corporation and any claim by the deceased against the company or close corporations, and no premium on the policy was paid or borne by the deceased. Typically this would be policies to fund buy-and-sell agreements.

(iii) Policies that were not effected by or at the instance of the deceased; and no premium was paid or borne by the deceased; and no amount due or recoverable under the policy has been or will be paid into the estate of the deceased; and no amount had been or will be

[9] Hahlo HR, The South African Law of Husband and Wife, 5th edition, 157-8
[10] Premiums and Problems, Old Mutual PFA, Edition 109, E50

paid or utilised for the benefit of any relative of the deceased, or any person who was wholly or partially dependent on the deceased, or any company which was at any time a family company in relation to the deceased.

According to Stein[11], the criterion for inclusion of a policy as deemed property is not whether the deceased was the owner of the policy, but whether the policy was on his or her life.

So would the policy form part of the joint estate because the deceased's estate, although not the owner of the policy, as beneficiary on the policy would become entitled to the proceeds upon death? The general method is that where parties are married in community of property and the deceased was the contracting party of a policy without a beneficiary nomination, then the proceeds are part of the joint estate.

It is trite that upon death, the deceased estate is entitled to the proceeds of the policy. There is however the reasoning in Danielz N.O. v De Wet and Another[12], that the policy proceeds would not form part of the joint estate as the deceased estate as beneficiary would only become entitled to the proceeds after death and the joint estate is dissolved upon death. This is however not the generally accepted method and it is also contrary to the method followed by the University of Free State in its Postgraduate Diploma in Financial Planning and the Advanced Postgraduate Diploma in Financial Planning.

It is my submission that because the deceased estate becomes entitled to the policy, irrespective of ownership of the policy and the policy is not expressly excluded from the joint estate by way of legislation, the policy will fall into the joint estate[13].

Are bequests to Public Benefit Organisations always exempt from Capital Gains Tax?

In terms of paragraph 62 of the 8th Schedule to the Income Tax Act, if any person bequeaths an asset to an approved public benefit organisation, that person does not have to account for any capital gain or capital loss on the donation or bequest.

It is important to note that the wording of paragraph 62, lends itself to the interpretation that where the assets are reduced to cash by the executor and the proceeds bequeathed to the public benefit organisation, the bequest will not be exempt from capital gains tax. It would appear that the exemption would only apply where the executor transfers the actual asset to the public benefit organisation.

[11] Stein, *supra* note 2 at 38
[12] 2009 (6) SA 42 C at para 43
[13] Meyerowitz also does not exclude life policies from his list of exclusions to the joint estate. Meyerowitz, *supra* note 1 at 15-46

A testator should however compare the possible capital gains tax saving versus the practical implications should the executor transfer the assets to the public benefit organisation. Possible questions that should be asked prior to making this decision are, whether the organisation has the capacity to deal with the assets and will the organisation be able to reduce the assets to cash in the best possible way.

When is the Section 4(e) deduction allowed for foreign assets?

Section 4(e) of the Act provides for a deduction of the amount included in the total value of the property of the deceased as representing the value of any right in or to property situated outside the Republic acquired by the deceased-

(iv) Before he became ordinarily resident in the Republic for the first time; or

(v) After he became ordinarily resident in the Republic for the first time, by-

(aa) any donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the Republic; or

(bb) inheritance from a person who at the date of his death was not ordinarily resident in the Republic; or

(vi) Out of the profits and proceeds of any such property proved to the satisfaction of the Commissioner to have been acquired out of such profits or proceeds

This deduction is only allowed as long as the property or proceeds remain outside the country. According to Davis,[14] this deduction is one that will be lost if foreign property acquired by inheritance which qualifies for a deduction, is realised and the proceeds remitted to the Republic as the property or proceeds will no longer be situated outside the country.

Conclusion

The above scenarios clearly illustrate how complex estate planning can be and that a testator's plans may be thwarted if a competent specialist is not approached to assist with estate planning.

[14] Davis, Beneke and Jooste, Estate Planning, 2.5.6

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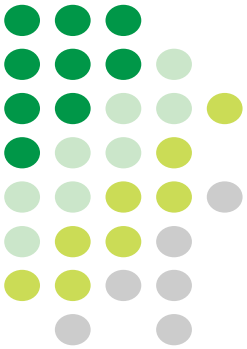

General

The deduction of maintenance orders from a member's pension benefits in terms of Section 37D of the Pension Funds Act

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Introduction

As a general rule a member of a pension fund has certain protection of his pension benefits in terms of the Pension Funds Act[1] (the Act). Section 37A of the Act provides that a member's fund benefits may not be:

- ❑ Reduced;
- ❑ Transferred or otherwise ceded;
- ❑ Pledged or hypothecated;
- ❑ Attached or subjected to any form of execution under a judgment of order of court; or
- ❑ Taken into account in the determination of a judgment debtor's financial position in terms of section 65 of the Magistrate' Court Act2 for an amount exceeding R3 000 per annum.

Section 37A(3) of the Act however does provide for certain exceptions where pension benefits may be reduced.

What can be deducted in terms of Section 37D of the Pension Funds Act?

(a) Income Tax on a member's benefit and any arrear tax where applicable[3].

(b) Divorce orders to be paid by the fund to a non-member ex spouse[4].

(c) Maintenance orders as per valid court orders[5].

(d) Compensation for damages caused to an employer due to theft, dishonesty, fraud or misconduct by employees or members[6].

(e) Medical Aid Contributions of a member or beneficiary[7].

(f) Insurance Premiums of a member or beneficiary[8].

(g) Housing or home improvement loans or mortgage bond guarantees granted to members by a fund[9].

(h) Housing or home improvement loans or mortgage bond guarantees granted to members by an employer[10]

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[1] S37A of Act 24 of 1956
[2] Act 32 of 1944
[3] S37D(1)(a)
[4] S37D(1)(d)(i)
[5] S37D(1)(d)(iA)
[6] S37D(1)(b)(ii)
[7] S37D(1)(c)(i)
[8] S37D(1)(c)(ii)
[9] S37D(1)(a)(i) & (ii)

However it seems that in practice there is some uncertainty around when and how a maintenance claim should be entertained by the fund and what it the tax position on such payments out of the fund.

Deduction from a member's pension benefits – Enabling Legislation

As mentioned above section 37D(1)(d)(iA) and Section 37D(e) (as amended by Act 45 of 2013) of the Act allows for maintenance claims against the member of the fund to be deducted from the member's individual reserve.

From this it is clear that an administrator is able to make deductions from a member's benefit held in the fund. The Act also allows for the deductions of the arrear maintenance and also the tax that may be payable due to the deduction made from the fund. It is however important to discuss the maintenance order in more detail to get a better understanding of what such an order should entail.

What is seen as a binding maintenance order

A maintenance order is defined in the Maintenance Act[11] as:

"*any order for the payment, including the periodical payment, of sums of money towards the maintenance of any person issued by any court in the Republic, and includes, except for the purposes of Section 31, any sentence suspended on condition that the convicted person make payments of sums of money towards the maintenance of any other person*"

Such an order will be binding on the fund provided:

(a) The fund/administrator/insurer has been clearly named or identified in the order[12].

And if the order is one of the following:

(b) In the case of a pensioner, an order for the deduction of a monthly amount from his or her pension in respect of arrear maintenance or in respect of current monthly maintenance payments[13].

(c) Where a person is an active member of a fund, an order for the deduction of a lump sum amount in respect of arrear maintenance[14].

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[10] S37D(1)(b)(i)
[11] S1 of Act 99 of 1998
[12] S16(2) & S16(3) of the Maintenance Act
[13] Soller v Maintenance Magistrate, Wynberg & Others [2006] 1 BPLR 53 (C) (At page 59, paragraphs 21 – 23). This refers to an order in terms of S16(2) of the Act.
[14] An order in terms of S30(1) read with S26(2)9a(iii) read with S26(4) of the Maintenance Act.

(d) Where a member is exiting a fund before his or her benefits have been paid, an interim order that all or part of the accrued benefit in the fund must be withheld until a final decision by the court concerned. The order will also stipulate how the lump sum must be applied to give effect to periodical future maintenance payments[15].

Non-binding maintenance orders

(a) An order where neither the fund nor the administrator has been cited in the order[16].

(b) An Emoluments Attachment Order[17].

(c) An order for the deduction of a lump sum which exceeds the monthly pension amount in respect of a pensioner whose pension has been purchased from an insurer. There is no lump sum available for attachment. Only the monthly pension payable may be attached.

(d) An order for the deduction of a lump sum amount in respect of future maintenance where the member is still an active member of the fund[18].

(e) Where the member has already exited the fund and has been paid out.

Now that we know that a valid maintenance order can be enforced against a fund and can be deducted from the member's fund benefit the tax implications of such a deduction need to be discussed.

Tax implications of maintenance deductions

As discussed above, the Act allows for a deduction of tax from a member's benefit, if it is required[19].

In terms of Section 7(11) of the Income Tax Act[20] any such amount that has been deducted is deemed to be income of the person from whose minimum individual reserve the deductions have been made. The 4th schedule of the Income Tax Act also defines such income to be remuneration and thus subject to PAYE.

[15] Mnagadi v Beacon Sweets 2004 (5) SA 388 (D) (at 392F)
[16] S16 of the Maintenance Act provides that an administrator may be ordered to make a payment which means that it is not necessary that the fund must be cited.
[17] S28 read with S16(2) of the Maintenance Act. This is an order which orders an employer to make maintenance deductions from an employee's salary. Such an order cannot be made against a fund as a fund is not an employer.
[18] The Maintenance Act does not allow for such an order.
[19] S37D(e) of Act 24 of 1956
[20] S11 (a) & (b) of Act 58 of 1962

Remuneration is defined in the Income Tax Act as:

"any amount if income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument pension, superannuation allowance, retiring allowance or stipend, whether in cash or otherwise and whether or not in respect of services rendered, including –

(a) Any amount referred to in paragraph (a), (c), (cA), (d), (e), (eA) or (f) of the definition of "gross income" in section one this Act;" [21]

Gross income is defined in the Income Tax Act as:

"in relation to any year of period of assessment, means,

During such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely-

(e) a retirement fund lump sum benefit or retirement fund lump sum withdrawal benefit"[22]

From the above it is then clear that any deduction made from a fund, whether pension, provident or retirement annuity would form part of the member's gross income and would therefore be subject to income tax.

Conclusion

Fund administrators are obliged to give effect to binding maintenance orders issued by a court against a member's fund benefit. The court order needs to adhere to certain requirements to be binding as discussed above. If a lump sum is deducted from a member's individual reserve then such a lump sum is seen as remuneration in the hands of the member and will form part of his or her gross income for the year in which the withdrawal has been made and will thus be subject to income tax. The fund administrator will hold the amount of tax back based on the member's tax rate and will pay the tax over to SARS.

[21] Paragraph 1(f) of the definition of remuneration in 4th Schedule to Act 58 of 1962
[22] Section 1 of Act 58 of 1962

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E-mail written by Zulpha Karriem-Toll (Legal Adviser OMEM CST) to writer dated 16 April 2014

Special thanks to Zulpha Karriem-Toll (OMEM CST Legal Adviser) for information supplied by her.

"Resident" for purposes of income tax v "resident' for purposes of estate duty

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Introduction

While the Income Tax Act[1] (The Act) defines what is meant by a 'resident' for purposes of Income Tax, the Estate Duty Act[2] (The ED Act) merely refers to persons who are not 'ordinarily resident'. 'Resident' for purposes of the Act includes, but is not limited to, someone who is 'ordinarily resident'

The effect of this that a person who is 'resident' in South Africa for purposes of the Act, will be taxed on their worldwide income but for purposes of estate duty that person needs to be 'ordinarily resident' in South Africa for their worldwide assets to be subject to estate duty.

This article will discuss the definition of "resident" and its respective application in terms of the afore-mentioned acts.

A 'resident' for purpose of the Income Tax Act

As we are aware, South African 'residents' are taxed on their worldwide income. In terms of the Act, a 'resident' is defined as a natural person who is either 'ordinarily resident' in South Africa, or who complies with the requirements of the physical presence test.

The starting point to determining residency is to determine whether the person is 'ordinarily resident' in the country or not. The rules that determine what constitutes 'ordinarily resident' are embodied in case law and a lengthy discussion thereof is not relevant for purposes of this article. Put as simply as possible, a person's ordinary place of residence is the country to which he or she returns from their wanderings[3] or the place to which he or she would normally return – a continuous physical presence is not required[4].

If a person is 'ordinarily resident', the person is a resident for income tax purposes and no further investigation is required. If not 'ordinarily resident', the physical presence test is applied.

[1] Income Tax Act 58 of 1962
[2] Estate Duty Act 45 of 1955
[3] SARS Guide on the residence basis of Taxation for individuals (2008/09)
[4] Interpretation Note No 3: Resident: Definition in relation to a natural person – Ordinarily resident (4 February 2002)

The physical presence test[5] deems a person to be a resident of South Africa if they are physically present in South Africa for a period or periods exceeding:

- 91 days in aggregate during the tax year under assessment; and
- 91 days in total during each of the five years of assessment immediately preceding the year under assessment; and
- 915 days in aggregate during those five years immediately preceding the year under assessment.

A person who is not 'ordinarily resident' in South Africa will thus still be a 'resident' for income tax purposes if they comply with the 'physical presence test'.

A 'resident' for purpose of the Estate Duty Act[6]

Unlike The Income Tax Act, the Estate Duty Act does not include a definition of 'resident', it merely provides for certain 'property' to be excluded from the estate of the deceased if the deceased was not 'ordinarily resident' in South Africa.

If not 'ordinarily resident' in South Africa, there is no further test (such as the physical presence test under the Income Tax Act) to determine whether the 'property' should be excluded or not for purposes of Estate Duty.

The deceased estate of a person who is 'ordinarily resident' in South Africa at date of death will consist of worldwide property and deemed property. The only exclusion allowed is in respect of property outside South Africa that was acquired before the person became 'ordinarily resident' in South Africa for the first time, or acquired the property after becoming 'ordinarily resident' but by way a donation by or inheritance from a person who was not 'ordinarily resident' in South Africa at the date of such donation or inheritance and the exclusion extends to assets acquired with the proceeds of such property.[7]

[5] Interpretation Note No 4 (Issue 3): Resident: Definition in relation to a natural person – Physical presence test (8 February 2006)
[6] Act 45 of 1955
[7] Section 4(e) of the Estate Duty Act 45 of 1955

The deceased estate of a person who is 'not ordinarily resident' in South Africa will be subject to Estate Duty but in terms of the Estate Duty Act, certain assets will not be included as 'property' – namely:

(i) any right in immovable property situated outside South Africa;[8]

(ii) any right in movable property situated outside South Africa;[9]

(iii) any debt not recoverable or right of action not enforceable, in the Courts of South Africa;[10]

(iv) any goodwill, licence, patent, trade mark copyright or similar right not registered or enforceable in, or attached to any business or trade in South Africa;[11]

(v) any stock or shares held in a body corporate that is not a company and any stocks or shares held in a company if the ownership of such shares or stocks is not required to be registered in South Africa;[12]

(vi) any income rights produced by or proceeds derived from the property referred to in (iii), (iv) or (v) above.[13]

It thus follows that a person can be 'resident' for purposes of income tax, but not for purposes of estate duty, unless they are 'ordinarily resident'. Should one be 'ordinarily resident' for purposes of estate duty, the respective deceased estate will qualify for the deductions allowed under the ED Act, in respect of offshore assets when determining the estate duty liability of their deceased estate

Conclusion

A person who is not 'ordinarily resident' in South Africa, but who complies with the 'physical presence test' for income tax purposes is regarded as a 'resident' for purpose of income tax and will be liable for income tax on their worldwide income.

For purposes of estate duty, the deceased estate of a person who is 'ordinarily resident' in South Africa at death includes their worldwide assets. If they are not 'ordinarily resident' their estate will qualify for the exclusions mentioned above – even if they comply with the 'physical presence test' requirements and are regarded as a 'resident' for purposes of income tax.

[8] Section 3(2)(c)
[9] Section 3(2)(d)
[10] Section 3(2)(e)
[11] Section 3(2)(f)
[12] Section 3(2)(g)
[13] Section 3(2) (h)

The effect of this is that income earned from offshore assets, belonging to someone who is not 'ordinarily resident' but who complies with the 'physical presence test', will be subject to income tax in South Africa, but at death, these offshore assets will not form part of their estate for purposes of estate duty since they were not 'ordinarily resident' here.

One can thus not assume that an offshore asset, which generates income that is subject to income tax in South Africa, will be subject to estate duty. One first needs to determine the basis on which the income is taxable – i.e. is it because the tax payer is 'ordinarily resident' here or because they comply with the requirements of the 'physical presence test'. If it is for the latter reason, the asset will not be subject to estate duty.

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Estate Duty Act 45 of 1955

Can trustees resign from their positions as trustee and, if so, what are the consequences thereof?

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Introduction

A trust deed will normally make provision for a trustee's resignation from office as a trustee. What if, however, the trust deed is in fact silent on this issue? Is a trustee entitled to resign and if so, how would a trustee affect his or her resignation from office? This article will discuss the common law position, the process set out in section 21 of the Trust Property Control Act, the formalities involved with the resignation of trustees, as well as recent case law that has affected the current position.

What circumstances will lead to a Trustee vacating office?

Trustees can cease to be trustees through the following:

- the death of the trustee;
- the vacating of the office of trustee by a trustee appointed *ex officio*;
- the revocation of the constitution under which the trustee was appointed;
- the vacating of the office of trustee in accordance with the terms of the trust; or
- the termination of the trust.[1]

The trustee may also resign or may be removed from office on application by the Master or any person having an interest in the trust property, if the court is satisfied that such removal will be in the interest of the trust and its beneficiaries.

In *Tijmstra NO v Blunt-Mackenzie NO and Others*[2] it was made clear that a trustee may be removed even if his conduct complained of was *bona fide* (good faith)[3]. Whenever trust assets are endangered, a trustee should be removed. Certain circumstances which justify the removal of a trustee by a court in terms of section 20(1) of the Trust Property Control Act[4] include the following:

- where a trustee, without giving explanations for his conduct, removes trust funds from a safe investment with a financial institution and transfers them into his own account;
- where a trustee deliberately fails to inform another trustee of a decision to be made in respect of trust assets, especially in cases where the trust deed specifically provides that notice must be given to all trustees when a sale of immovable property is contemplated;
- where a trustee treats the trust and its assets as his own, for example, by selling trust assets without informing other trustees or obtaining their approval as required in the deed; and

[1] The South African Financial Planning Handbook 2013, Page 822.
[2] Tijmstra v Blunt – McKenzie and Others 2002 (1) SA 459 TPD.
[3] Page 27 of [2001] JOL 8725 (T).
[4] The Trust Property Control Act 57 of 1988.

- where the trustee expresses no independent views about matters affecting the trust, but relies entirely upon a dominant co-trustee.[5]

The above are examples of circumstances leading to a trustee's removal from office by the Master of the High Court.

The resignation of a Trustee: the formalities for a valid resignation

Prior to the promulgation of the Trust Property Control Act, if a trust deed did not make provision for a trustee's resignation, the trustee would still be bound by his office and would only be able to resign from his office with relief from the courts, and with good reason. Hence an attempted resignation did not relive a trustee of liability[6].

With the introduction of this Act, the position changed. In terms of section 21[7] a trustee is entitled to resign from office whether or not the trust instrument has made provision for resignation or not. This section states further that "Whether or not the trust instrument provides for the trustee's resignation, the trustee may resign by notice in writing to the Master and the ascertained beneficiaries who have legal capacity or to the tutors or curators of the beneficiaries of the trust under tutorship or curatorship". Therefore if the Trust Deed is silent, this is the process that must be followed by a trustee wishing to resign.

The Act is however silent on when the resignation of a trustee actually takes effect, namely whether it is the date of resignation or the date on which the notice of resignation is received by the Master or only after the Master has removed the name of the trustee from the letter of authority and issued a new letter of authority. This is confirmed in *Soekoe NO & Others v Le Roux*[8], where Rampai J at [50] held that:

"I have already found that the respondent's resignation on 10 October 2006 did not legally relieve him of his duties as a trustee. He remained legally accountable to his fellow for the entire period until the Master of the High Court officially removed him from the office as a trustee. The respondent's duties did not fall away when he resigned, but when he was replaced with the third applicant".[9]

In the recent unreported case, *Meijer NO & Another v Firstrand Bank Ltd & Another*[10] it was held that the resignation should take effect not only upon it being shown that the written notice was

[5] Supra footnote 1.
[6] Wills & Administration of Estates [R.P. PACE & W.M. VAN DER WESTHUIZEN 2013], Alexander v Opperman 1952 1 SA 609 (O) 617; Soofie v Hajee Goolam Mahomed Trust 1985 3 SA 322 (N) 330 and Boyce NO v Bloem 1960 3 SA 855 (T) 859.
[7] Supra footnote 3.
[8] Case no 898/2007 OFSPD delivered on 29 November 2007.
[9] Supra.
[10] [2013] JOL 30560 (WCC) (unreported WCHC case no. 2123/2010).

sent to the Master and the ascertained beneficiaries, but upon an acknowledgement by the Master of the receipt thereof"[11].

The more flexible approach adopted in the *Meijer* case can form a good base for determining when a resignation of a trustee actually takes effect, even in the case of alternative methods of resignation as prescribed by a specific trust deed.

For instance, if the trust deed prescribes that the notice of resignation be given to the co-trustees, it is submitted that it can only take effect not only upon it being shown that the written notice was sent to the co-trustees and the Master, but upon an acknowledgement by the Master of the receipt thereof (as per the *Meijer* case). It is suggested that this be the case, whether it be a notice to the ascertained beneficiaries and the Master as required by section 21 or a notice only to the co-trustees as required by, for instance, a particular trust deed.

It is submitted that the Master's acknowledgement of receipt of the notice of resignation should be the trigger to cause the resignation to take effect and not the removal of the name of a trustee from the letter of authority. The resigning trustee has a more direct involvement in the process by, for instance, delivering a notice to the Master's office and getting a date stamp on a copy of the letter of resignation, as opposed to waiting for the removal of his name from the letter of authority, which due to possible delays in the Master's office, a resigning trustee could be unfairly prejudiced.[12]

In the event that the deed does make provision for the resignation of a trustee in a certain manner, compliance with that provision should suffice. It might be worthwhile to include a clause in a trust deed stating that a trustee's resignation will be effective from the date upon which the Master of the High Court receives notice of such resignation.

Conclusion

Section 21 of the Trust Property Control Act and the Meijer case has therefore brought great relief to trustees and trust practitioners pertaining to the resignation formalities of trustees. Trustees must also ensure that all the other formalities, as discussed above, are duly complied with in order for a resignation from office to be valid.

[11] Paragraph 11 of the judgment.
[12] Supra footnote 10.

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Undesirable business practices in the medical profession

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Introduction

Estate planning involves both the business affairs and the personal affairs of a client. Personal affairs of a client include, inter alia, retirement planning, tax planning and the drafting of a will, whereas business affairs include business succession planning. When a financial advisor meets with a client for the purpose of doing estate planning, it is very important to determine what business interests the client has, and in what profession these interests are. The reason for this is that some professions have rules and regulations specifically applicable to that profession, which rules and regulations affect the way a business can be constituted and run.

This article will focus on the medical profession: the rules pertaining to desirable and undesirable businesses practices in this profession and the effect that these rules have on business succession planning. An advisor will not be able to give proper estate planning advice to a client without understanding any limitations placed on medical professionals and the way in which they are able to run their businesses.

Structure of a Medical Practice

In terms of clause 2 of the policy document issued by Health Professions Council of South Africa ("HPCSA") relating to undesirable business practices (the "Policy"), a medical practice can only take one of the following forms:

- solo practice;
- partnerships;
- associations;
- incorporated practices; or
- any of the above mentioned that outsourced their administration or established a close corporation to manage the administration provided that the practitioner does not permit or allow the Administrators to operate in violation of the establish ethical rules of the Council.

Practicing as a medical practitioner in any entity other than those mentioned above, would lead to prosecution by the HPCSA.

Notwithstanding the Policy's limitation on what entities can be used as a business vehicle by medical practitioners, it should also be kept in mind, when doing estate planning for a medical practitioner, that only medical practitioners registered with the HPCSA may, either directly or indirectly, have corporate ownership of a professional medical practice.[1]

[1] Health Professions Council of South Africa: Policy document on undesirable business practices.

The Policy defines "corporate ownership" as allowing a person (whether a natural person or a juristic person) who does not otherwise qualify as a shareholder or partner of a professional practice in terms of the Health Professions Act[2] or the ethical rules issued by the HPSCA, to directly or indirectly, in any manner whatsoever, share in the profits or income of such a professional practice and which, without limiting the generality of the a foregoing, may take the form of-

(1) transferring the income stream (or any part thereof) generated in respect of patients from the practice to such a person; or

(2) giving (directly or indirectly) shares or an interest similar to a share in the professional practice to such a person; or

(3) transferring income or profits of the professional practice to a service provider through payment of a fee which is more than a market related fee for the services rendered by the service provider.

(4) paying or providing a service provider with some or other benefit which is intended or has the effect of allowing the service provider or persons holding an interest in such a service provider to share, directly or indirectly, in the profits or income of such a professional practice or to have an interest in such a professional practice.[3]

Death of a Medical Practitioner: Business Succession Planning

The challenge for financial advisors, when doing estate planning for a medical practitioner, is to plan as to whom will inherit the medical practitioner's business interests after his death as only medical practitioners registered with the HPCSA may hold an interest in or own, directly or indirectly, a medical practice. The wife or husband of a registered medical practitioner may, for example, not inherit the deceased medical practitioner's medical practice business interests in the event that he or she is not a registered medical practitioner.

A trust, a vehicle often used with estate planning, may also not hold an interest in a medical practice as a trust cannot register as a medical practitioner.

More often than not, a medical practitioner passes away bequeathing his or her medical profession business interests to someone who is not a registered medical practitioner with the effect that the executor of the estate of the deceased medical practitioner has no other option but to sell the medical business interest to a registered medical professional. Selling the medical business interests, due to the fact that only registered medical practitioners may acquire the interests, may take years and could delay the winding up of the estate.

[2] Health Professions Act 56 of 1974.
[3] Health Professions Council of South Africa: Page 4.

A buy and sell agreement or a share buyback agreement is a useful mechanism, when financed with life insurance policies, to address the challenge of disposing of the medical business interests in an association, partnership or incorporated company.

When drafting a buy and sell agreement or a share buyback agreement with respect to a medical business interest in an incorporated company, it is important that the financial advisor determine whether there are any provisions in the company's memorandum of incorporation ("MOI") prohibiting the shareholders and company to enter into a buy and sell agreement or a share buyback agreement or, in the event that the MOI does not prohibit it, whether the MOI prescribes any requirements that need to be met in order to enter into a valid buy and sell agreement or share buyback agreement.

The MOI is in essence the constitutional document of the company that sets out the rights, duties and responsibilities of shareholders, directors and others within and in relation to a company, and other matters as contemplated in section 15 of the Companies Act [4] (hereinafter referred to as "the Act").

In the event that the company's MOI states that the company must buy back the shares on the death of a shareholder or that the shareholders of the company must buy and sell each other's shares on the death of a shareholder, it is not necessary to draft a buy and sell agreement or a share buyback agreement.

In the event that the MOI does not make provision for a share buyback or buy and sell on date of death a shareholder, the financial advisor has two options, namely:

(1) Amend the MOI to make provision for a share buyback or buy and sell on date of death a shareholder or,

(2) Draft a buy and sell agreement or a share buyback agreement.

When amending the MOI of a company or drafting a share back agreement as contemplated above, the financial advisor should take note of the provisions of section 114 of the Act. Section 114 has specific requirements that need to be met for a share buyback by the company to be valid.

The proceeds realised in the estate of the deceased medical practitioner through the disposal of his medical practice business interests, either through a buy and sell agreement or a share buyback agreement, can then be inherited by the heirs of his or her estate even though they are not registered medical practitioners. It is very important that the financial advisor advises

[4] Companies Act 71 of 2008

the client that the business interest will be an asset in his or her estate and subject to estate duty and capital gains tax, which may give rise to a liquidity problem in the estate.

The financial advisor must also ensure that the life insurance policies used to finance the transaction are structured correctly in terms of Section 3(3)(a)(iA) of the Estate Duty Act[5] to avoid double estate duty, that is duty on both the value of the life cover and the value of the business interest itself.

Conclusion

Estate planning does not only consist of the drafting of a will or the calculation of the estate duty payable or the liquidity needs of an estate, but also business succession planning. A financial advisor requires a sound knowledge and understanding of the particular industry or profession the client is in and the law, rules and regulations governing this industry or profession. In the case of a client holding shares in a company, this will require the financial advisor to be able to advise the client in respect of the Companies Act, the MOI of the company and any shareholders agreement between the shareholders of the company.

[5] Estate Duty Act 45 of 1955

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The removal of an executor from a deceased estate.

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Introduction

It is not pleasant to think about one's death, but it is very important to do so, and a key question that must be considered when looking at one's estate planning is "who would I trust to handle my personal affairs and distribute my assets according to my wishes in the event of my death?". An important aspect of estate planning is having a valid will in place, so that you may nominate a person (i.e an executor) who is trusted and competent to oversee the administration process of winding up your estate and who represents the best interests of your beneficiaries and your loved ones. The appointment of your choice of executor is not automatic and the person or entity nominated will have to apply to the Master of the High Court to be granted the power to "step into your shoes" and finalise the administration of your estate. However, what recourse do the beneficiaries have when the appointed Executor does not perform his duties satisfactorily or at all, causing loss to the estate?

An executor's functions are the following:

- to oversee the administration process of winding up the estate;
- to control and protect the assets in the estate;
- to identify heirs and ultimately distribute the assets to them;
- to draw up accounts that reflect all assets, claims against the estate and how the residue, if any, will be distributed;
- to pay all debts of the estate; and
- to file the final tax return.

Therefore, when nominating an executor for your estate you have the right to expect your executor to behave with proper care and diligence and in the best interests of your estate and beneficiaries.

During the lifetime of a testator[1], should he for whatsoever reason change his mind as to whom he wants to appoint as executor of his will, he can easily re-execute his will with an amended executor nomination or make use of a codicil to his will. After the death of a testator, it becomes more difficult to have the executor removed but not impossible.

When a testator dies testate (i.e. has a valid will) the powers and functions conferred onto an executor are given to him by the Administration of Estates Act[2] (hereinafter referred to as "the

[1] For ease of reference can also be a "testatrix".
[2] 66 of 1965.

Act"). Section 26(1) of the Act confers upon the executor the power of custody and control of property in the estate.

*"Immediately after **letters of executorship** have been granted to him, an **executor** shall take into his custody or under his control all the **property**, books and documents in the estate and not in the possession of any person who claims to be entitled to retain it under any contract, right of retention or attachment."*

The executor shall then proceed to liquidate and / or distribute the assets in the deceased estate in accordance with the provisions of the will or the law of intestate succession.

Should it at any point in the administration process become apparent that the executor is not fulfilling his or her duties as required by the Act or not acting in the best interest of the deceased estate or beneficiaries there are processes to have him removed.

The option available to the beneficiaries of the estate is that they can, in terms of the Act, apply to the Master of the High Court for the removal of the executor. They should, however, on written motivation show good cause why he should be removed. It is not a difficult process to have the executor removed but careful consideration should be given for wanting to do so.

The removal of the executor by the Master of the High Court[3].

Reasons for the removal could be the following:

- gross negligence on the part of the executor;
- actions causing damage to the estate;
- if the executor is convicted of theft, fraud, forgery or perjury and is sentenced to imprisonment without the option of a fine or a fine exceeding R2000;
- if at time of his appointment he was incapacitated or becomes incapacitated to act;
- continuously not complying with time frames or requests from the Master;
- failure to exercise due diligence; and
- where the executor has been nominated by will and the will has been declared invalid by the Master or void by the court, or revoked in as far as it relates to the nomination.

[3] Section 54(1)(b) of the Act.

Before the removal of the executor can take place, the Master shall forward to the executor, by registered post, a notice setting forth the reasons for such intended removal, and give the Executor time to rectify his behaviour or comply with the Master's requests, as the case may be. The Executor must be informed that he may apply to the court within thirty days from the date of such notice for an order restraining the Master from removing him from his office[4]. If the Executor is in fact removed by the Master, the Executor must return the Letters of Executorship to the Master.

Once an executor has been removed, the executor's fees that he or she were entitled to charge is forfeited. In addition, when the executor has been guilty of mismanagement or waste, he or she is responsible for the loss that the estate has sustained.

The removal of the executor by the courts[5].

As discussed above, should an executor fail to perform his or her duties as required the Master of the High Court or anyone with an interest in the estate – such as an heir, a legatee or creditor – can approach the relevant High Court for help[6]. Any interested party may bring a court application but "if the Master has not thought it fit to make the application himself", the applicant runs the risk of being unsuccessful in court and of carrying the legal cost of the court action.

It is advisable that the interested party should first consult with the Master before an application is made and obtain the Master's view, if not approval of, the application. Successful efforts for the removal of an executor will depend on specific facts and the discretion of the court. However, before an application can be made the executor needs to be given an opportunity of at least one month's notice to get his affairs in order.

Section 54(1)(a) of the Act also provides for the following:

(ii) "if the executor has at any time been a party to an agreement or arrangement whereby he has undertaken that he will, in his capacity as executor, grant or endeavour to grant to, or obtain or endeavour to obtain for any heir, debtor or creditor of the estate, any benefit to which he is not entitled.;

(iii) If he has by means of any misrepresentation or any reward or offer of any reward, whether direct or indirect, induced or attempted to induce any person to vote for his recommendation to the Master as executor or to effect or assist in effecting such recommendation;

[4] Section 54(2) of the Act.
[5] Section 54(1)(a) of the Act.
[6] Section 36(1) of the Act.

(iv)if he has accepted or expressed his willingness to accept from any person any benefit whatsoever in consideration of such person being engaged to perform work on behalf of the estate; or

(v) if for any other reason the Court is satisfied that it is undesirable that he should act as executor of the estate concerned."

an executor can be removed from his office.

The functions and duties of an executor, and the failure to comply therewith, will determine the grounds in which the court would consider removing an Executor. One of the functions of the executor is to carry out the intent of the will by acting in good faith and within the best interests of the beneficiaries. The standard of "best interest" will be determined by the courts[7]. For example where the executor is blatantly wasting the estate's assets this may qualify for the removal of the executor, but where the executor makes an investment that the beneficiaries do not agree with, this will probably not warrant the removal of the executor.

Subsection (v) states that "undesirability" of the executor could also be a ground for removal by the court. This might be more difficult to prove as the determination of undesirability is within the courts discretion. An example of where an Executor was successfully removed in terms of Section 54(1)(v) is in the case of Van Niekerk v Van Niekerk[8]. In this case, the former spouse of the deceased was appointed as the executrix of the deceased estate. The executrix resisted a claim of the deceased surviving spouse. It should be noted that the executrix was the sole heir of the deceased estate and it would obviously be to her benefit to ensure that the claim of the surviving spouse was dismissed or accepted in a much lower amount. Wallis J (as he then was) stated that the attitude of the executrix constituted good cause for her removal in terms of section 54(1)(v) as "the office of the executor should not be used in order to pursue a private agenda".

Where the nominated executor is legally ineligible[9] to act as such, for example where the executor has past convictions; is mentally incompetent[10] or is involved in other complex litigations, this may also be grounds for removal of the executor. Where there is a conflict of interest between the executor in his personal capacity and his fiduciary capacity this could also be seen as a reason for removal of the executor. In Reichman v Reichman and Others[11], where the applicant and the first respondent are brothers, the first respondent acts in his personal capacity and as the second respondent, as the executor of the deceased estate of their mother. The applicant brought an application claiming relief that the first respondent be removed as the executor in the deceased estate. The applicant averred amongst other things

[7] Die Meester v Meyer en Andere 1975 (2) SA 1 (TPD) at 17E-F.
[8] 2011 (2) SA 145 KZP.
[9] Section 14(1)(b) of the Act.
[10] Ex parte Hodgins 1951 1 All SA 301 (O); 1951 1 SA 286 (O).
[11] (2011/15348) [2011] ZAGPJHC 177; 2012 (4) SA 432 (GSJ).

that deceased had made loans to his brother and sister during her lifetime and these are not reflected in the Liquidation and Distribution Account. The applicant brought the application on the basis that the first respondent, in his capacity as executor, finds himself in the untenable position that personally as a debtor of the estate he must defend for his claim, and on the other hand in his capacity as executor of the estate he must fight for the same claim. Therefore, it is undesirable for the first respondent to continue to retain such office.

In Grobbelaar v Grobbelaar[12]*, van Blerk JA* stated that *"it is obvious that there is a material conflict of interest between the personal interest of the respondent and that of the estate whereby a situation is created where the respondent in his capacity as executor cannot be impartial. The situation can only be rectified by removing the executor from office.*[13] *It is a well established rule of our law that a party occupying a fiduciary position must not as such engage in a transaction by which he will personally acquire an interest adverse to his duty."*[14] Judge Scholtz found that it is undesirable for the first respondent to continue to act as the executor of the estate of the deceased in terms of Section 54(1)(a)(v) of the Act and that the first respondent should be removed from office.

The court can also make a ruling that by removing the executor it may also declare him incapable, during the period of his life or such other period as it may determine, of holding office as an executor[15].

In Oberholster NO and others v Richter [16] it was stated that frivolous reasons such as disagreement between the executor and the heirs, or a breakdown in the relationship between the parties or hostility between the executor and other interested parties, is not a basis to have the executor removed in terms of section 54(1)(a)(v) of the Act. A dissatisfied heir cannot be allowed to circumvent the administration process by unduly applying pressure on the executor to give in to his demands. The actions of both the executor and heir needs to be considered, as a heir should not frustrate the process of winding up the estate through unreasonable or wrong conduct. The test for the removal of the executor is whether the continuance of the executor in office will prejudicially affect the future welfare of the estate placed in his care.[17] The actions of both the executor and heir needs to be considered, as a heir should not frustrate the process of winding up the estate through unreasonable or wrong conduct.

[12] 1959 (4) SA 719 (A).
[13] At page 724G – 725A.
[14] Colonial Banking and Trust Co. Ltd v Estate Hughes and others, 1932 AD 1 at page 16.
[15] Section 54(4) of the Act.
[16] (A515/11) [2013] ZAGPPHC 99; [2013] 3 All SA 205 (GNP) at page 9.
[17] Sackville West v Nourse 1925 AD 516 527 (page 528).

If an application is brought before a court and a cost order is awarded in favour of the Master or another person bringing the application, the executor is personally liable to pay the cost unless directed otherwise by the courts[18].

Not all estates will have an executor appointed to administer the winding up process. This would typically be the case with small estates where the value of the assets does not exceed R125 000. In these circumstances the Act allows the Master to dispense with the appointment of an executor and instead give direction as to the way the estate is to be liquidated and distributed[19] by appointing a Master's representative. Of importance to note is the Act affords the Master of the High Court a wide range of powers to act against an executor who fails to comply with their duties, but does not afford any protection to the beneficiaries to have the Master's representative's removed. The office of the Chief Master says that the Act contains no express powers to act against a person (i.e. a Master's representative) given direction under these terms. It is advised by the office of the Chief Master that the Act should be amended to provide for the appointment of an executor in each estate that has assets[20]. The Master "may", in accordance with guidelines issued by the Chief Master, dispense with compliance by an executor with any of the requirements of the Act. Master's representatives should no longer be appointed to deal with estates in a summary manner as this might not be in accordance with the best interest of the beneficiaries.

Conclusion

Therefore, a person should not take the decision of who to appoint as the executor of his or her estate lightly. The person should be confident that the chosen executor will act in the best interests of their estate and beneficiaries and cause the estate to be administered and finalised in the quickest possible time. However, if the appointed Executor proves to be unscrupulous or negligent, beneficiaries do have the option to proceed to have the Executor removed either by the Master of the High Court or the High Court itself.

[18] Section 36(2) of the Act.
[19] Section 18(3) of the Act.
[20] Personal Finance Article: "Choose the right executor" 2 February 2011.

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Policies and insolvency

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Introduction

In today's economic climate it is not surprising that clients find themselves in the unfortunate position of having their estates sequestrated. It is during this time that the slightest measure of protection, as afforded by law, of certain assets against the creditors of the insolvent estate becomes of significant value to the insolvent.

Legislation

In terms of the Insolvency Act[1], a sequestration order divests the insolvent of his estate and vests this estate in the Master until the appointment of a trustee. Upon the appointment of the trustee, the estate of the insolvent vests in the trustee. [2] Subject to certain exceptions and laws contained in other legislation, the estate consists of all property of the insolvent, moveable or immoveable, wherever situated, as well as all property that accrues to the insolvent during the sequestration process. [3] This article will focus on the protection afforded to policies in terms of the Long Term Insurance Act (hereinafter referred to as the LTIA).[4] These policies include assistance, life, disability or health policies.[5] A life policy includes an endowment. Sinking funds are not life policies and therefore do not enjoy any protection.

The old Section 63

Policy benefits enjoyed protection under the LTIA against creditors of an insolvent or deceased estate to the amount of R50 000 if certain requirements were met. Section 63 prior to the amendment by the Financial Services Laws General Amendment Act[6] provided as follows:

63 Protection of policy benefits under certain long-term policies

1) Subject to subsections (2) and (3), the policy benefits provided or to be provided to a person under one or more assistance, life, disability or health policies in which that person or the spouse of that person is the life insured and which has or have been in force for at least three years (or the assets acquired exclusively with those policy benefits) shall, other than for a debt secured by the policy-

(a) during his or her lifetime, not be liable to be attached or subjected to execution under a judgment of a court or form part of his or her insolvent estate; or

(b) upon his or her death, if he or she is survived by a spouse, child, stepchild or parent, not be available for the purpose of the payment of his or her debts.

[1] 24 of 1936
[2] Section 20 (1) of Act 24 of 1936
[3] Hockly's Insolvency Law
[4] Act 52 of 1998
[5] Section 63 of Act 52 of 1998
[6] Act 45 of 2013

2) The protection contemplated in subsection (1) shall apply to-

(a) assets acquired solely with the policy benefits, for a period of five years from the date on which the policy benefits were provided; and

(b) policy benefits and assets so acquired (if any) to an aggregate amount of R50 000 or another amount prescribed by the Minister.

3) Policy benefits are only protected as provided in-

(a) subsection (1) (b), if they devolve upon the spouse, child, stepchild or parent of the person referred to in subsection (1) in the event of that person's death; and

(b) subsection (1) (a) and (b), if the person claiming such protection is able to prove on a balance of probabilities that the protection is afforded to him or her under this section

The requirements that had to be met were thus the following:

(i) The policy must have been a life policy (not subject to a security cession in respect of a debt) on the life of the insolvent or his/her spouse, and must have been payable to the insolvent.

(ii) The policy must have been in existence for a period of three years.

(iii) The protection that was afforded during the life time of the insolvent was a total of R50 000 in respect of the policy proceeds and any assets acquired solely with the policy proceeds within a period of five years from when it was paid. The R50 000 did not apply per policy but in total to both the policy proceeds and any asset acquired solely with those proceeds within a period of five years from which it was paid.

(iv) Upon the death of the insolvent if he was survived by a spouse, parent, child or a step child who would be entitled to a benefit in terms of his estate, the protection above would apply.

(v) The onus was on the person claiming the protection above to prove on a balance of probabilities that the policy enjoys the protection under this section.

Cases

Cases like Shrosbree[7] and Warricker are among the leading cases in insolvency matters. In terms of the Shrosbree case, it was held that Section 63 had no application where the policy holder nominated a beneficiary on the policy. In the Pieterse v Shrosbree case it was held that

[7] Pieterse v Shrosbree and Others; Shrosbree NO v Love and Others [2006] 3 All SA 343 (SCA)

policies generally entitle a policy holder to nominate a beneficiary on condition that the nomination will confer no rights to the beneficiary while the policy holder is alive. The legal nature of the nomination is known as a *stipulato alteri* (contract for the benefit of a third party) and the right to the policy benefits accrues to the beneficiary once he/she has accepted the benefits and therefore does not accrue to the insolvent estate.[8] The *stipulatio alteri* continues to be of importance not just from an insolvency point of view but also from a financial planning or an estate planning point of view where a saving of executor's fees is brought about by the nomination of beneficiary on a life policy or an endowment.

In the Warricker case, the court held that where the insolvent had a policy on which a third party has been named beneficiary, but where the insolvent has a right to surrender the policy prior to death and to obtain the surrender value, the policy becomes an asset in the insolvent estate to the extent that it could be surrendered and payment for the surrender value be obtained.[9]

The new Section 63

The Financial Services Laws General Amendment Act[10] which became effective 28 February 2014 brought about significant changes to amongst others, the LTIA.

The changes to section 63 of the LTIA bring a welcome measure of protection to individuals who for legitimate reasons, example investment purposes or saving towards a certain goal, take out policies like endowments and later find themselves in the unfortunate situation of having their estates sequestrated. Endowment policies in addition to retirement funds or a trust (provided the trust is administered correctly and is not used as a "guise") now provide even more welcomed protection against creditors. It must however be noted that each vehicle comes with its own restrictions in terms of accessing the capital and/or controlling the asset.

Section 63 of the LTIA as amended by the Financial Services Laws General Amendment Act now reads as follows:

63 Protection of policy benefits under certain long-term policies

1) Subject to subsections (2), (3) and (4), the policy benefits provided or to be provided to a person under one or more assistance, life, disability or health policies in which that person or the spouse of that person is the life insured and which has or have been in force for at least three years (or the assets acquired exclusively with those policy benefits) shall, other than for a debt secured by the policy—

a) during his or her lifetime, not be liable to be attached or subjected to execution under a judgment of a court or form part of his or her insolvent estate; or

[8] Para 8, 9 and 10 of the judgment
[9] Para 13 of the judgment
[10] Act 45 of 2013

b) upon his or her death, if he or she is survived by a spouse, child, stepchild or parent, not be available for the purpose of the payment of his or her debts.

2) The protection contemplated in subsection (1) shall apply to policy benefits and assets acquired solely with the policy benefits, for a period of five years from the date on which the policy benefits were provided.

3) Policy benefits are only protected as provided in—

a) subsection (1)(b), if they devolve upon the spouse, child, stepchild or parent of the person referred to in subsection (1) in the event of that person's death; and

b) subsection (1)(a) and (b), if the person claiming such protection is able to prove on a balance of probabilities that the protection is afforded to him or her under this section.

4) Policy benefits are protected as provided for in subsection (1)(a) and (b), unless it can be shown that the policy in question was taken out with the intention to defraud creditors.

Therefore effective 1 March 2014 in order to enjoy the protection under Section 63, requirements (i), (ii), (iv) and (v) as discussed above of s63 stays the same and still have to be met.

The significant changes that have been brought about by the above is that the limitation of R50 000 has been removed and the full amount payable in terms of the policy is protected and any assets acquired solely with the policy proceeds is protected for a period of five years from when the proceeds were provided. Very importantly, is the addition of a new subsection, i.e. subsection 4, which states that protection afforded under this section will not apply in instances where the policy was taken out with the intention of defrauding creditors.

The addition of the new subjection aligns the provisions of the Insolvency Act, which considers what the intention of the insolvent was when performing certain acts or entering into certain transactions and provides the court with the power of setting those actions aside. Sections 26, 29, 30 and 31 of the Insolvency Act are known as the provisions dealing with voidable dispositions.[11] A voidable disposition is refers to a disposition that may be set aside by the court if it made for no value[12], has the effect of preferring one creditor above another[13], is intended to

[11] Hockly's Insolvency Law
[12] Section 26 of Act 24 of 1936
[13] Section 29 of Act 24 of 1936

prefer one creditor above another[14] or is made in collusion with another person and having the effect of prejudicing creditors or preferring the one above another[15].

Conclusion

As discussed above, with the changes to the LTIA, investors considering investing in endowments (without the intention to defraud creditors as discussed above) can now enjoy the protection as discussed above and are no longer only limited to enjoying protection from trusts and retirement vehicles. Once again each vehicle comes with it owns limitations and restrictions and the circumstances, needs and objectives of each client will have to be taken into account in deciding what would ultimately be the most suitable vehicle.

[14] Section 30 of Act 24 of 1936
[15] Section 31 of Act 24 of 1936

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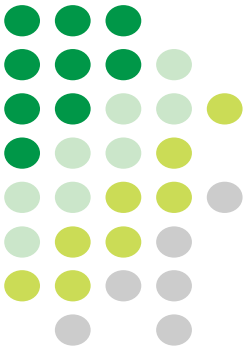

Retirement

Protection of retirement benefits after death

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Introduction

Clients as members of Pension Funds are often concerned about the protection of their retirement benefit after they have passed away.

Unfortunately the reality in South Africa is, that at the death of a minor's parents, responsibility for care of a minor is often passed to a caregiver who was not deliberately chosen as a guardian. [1] Even if a guardian was chosen, that person may not be financially competent to handle funds that need to be managed effectively to provide for minor beneficiaries.

The focus of this article is to identify different options members of a retirement fund can consider to protect their retirement benefit on death for their dependants, with reference to the The Financial Services Law General Amendment Act which has brought about amendments to the Pension Fund Act[2] with specific reference to the amendments that affects beneficiary funds.

Understand the difference between approved frisk benefits and unapproved risk benefits in relation to retirement funds

Group life risk benefits can be incorporated into a retirement fund on an approved basis, and become part of the benefit paid by the retirement fund. This means that the employee's premiums and risk benefit are treated exactly the same for tax purposes as contributions and benefits from a retirement fund. The premiums therefore receive a tax deduction and the life cover benefit is taxed as part of the retirement fund benefit when it is paid out.

It is important that a client in this situation is made aware of the fact that even though he or she has group life cover attached to his or her retirement benefit, this money is not paid out separately to the fund credit and there may be a long delay in payment of the benefit, this may become a very difficult situation if money is required to support a minor. Alternatively, the employer can elect to have an unapproved Group Life risk benefit for his employees.

Premiums form part of an employee's taxable income and so are taxed at the prevailing SARS rate, however the lump sum benefit paid out is tax-free. There is therefore no connection with employee's retirement fund benefits.

[1] Brendan Peacock , Beneficiary funds bring Peace of mind January 2012
[2] 24 of 1956

Protection of retirement benefits payable to minor beneficiaries on death of member

In terms of section 37 C (2) of the Pension Fund Act [3], if payment is made to –

(i) "a trustee contemplated in the Trust Property control Act, 1988, nominated by-

(aa) the member;

(bb) a major dependant or nominee, subject to subparagraph (cc); or

(cc) a person recognized in law or appointed by a Court as the person responsible for managing the affairs or meeting the daily care needs of a minor dependant or nominee, or a major dependant or nominee not able to manage his or her affairs or meet his or her daily care needs;

(ii) a person recognized in law or appointed by court as the person responsible for managing the affairs or meeting the daily carte needs of a dependant or nominee; or

(iii) a beneficiary fund."

The payment by the fund for the benefit of a dependant or nominee shall be deemed to be a payment to such dependant or nominee. Therefore it is clear that a death benefit on a retirement fund can be paid:[4]

1) Directly to a dependant or a nominee nominated by the member prior to his death. (This is not advisable where the dependant or nominee is a minor)

2) Directly to a trust, if the trust is nominated by the member prior to his death, or if a major beneficiary or guardian or caregiver nominate a trust for the payment.

3) Directly to a guardian or caregiver

4) Directly to a beneficiary fund

When a member of a retirement fund dies , leaving dependants behind, the trustees of the retirement fund have a duty to establish who the member' s dependants are. They then have to decide how best to divide and allocate the death benefit.

Payment directly to a dependant or nominee nominated by the member

The death benefit is taxed according to the retirement tables, applicable to the deceased. The after tax payment will be done directly into the bank account of the dependant.

[3] Pension Fund Act 24 of 1956
[4] Hettie Joubert, supra note 4, at 2

Previously no fund was allowed to make any payment of a benefit to anybody except the member or beneficiary or trust on behalf of a beneficiary. Often beneficiaries do not have a bank account and banks are reluctant to allow the opening of a bank account for the sole purpose of receiving a benefit and immediately withdraw the whole amount.

From 28 February 2014, the situation has changed and funds will be permitted to pay a beneficiaries death benefit into a bank account of a third party. The payment to the third party will be regarded as a payment made directly to the beneficiary and the fund will have discharged its duties in relation to that beneficiary.[5]

Payment directly to a trust

Payment of approved benefits received in terms of Section 37C of the Pension Fund Act to a trust is possible, if the trust is a fully vested trust in other words the beneficiary is the owner of the capital and income and the trust was nominated by the member prior to death or a major beneficiary, guardian or caregiver has nominated a trust.

The benefit will be taxed as discussed above when it is paid to the trust and any benefit payments made to the beneficiaries will be not be taxed again. Any income earned on that amount will be taxed in those beneficiaries' hands.

Payments directly to a guardian or caregiver

If a spouse has been left behind and is financially competent, it is possible to pay the funds to him or her to manage on behalf of the minor children. If the surviving spouse as guardian is not financially competent to manage the minor dependants benefit, the trustees have the option to pay it into a beneficiary fund. If both parents are deceased and the children are cared for by a caregiver, the trustees will consider paying the funds into a beneficiary fund. This is because the chances are that there will be a different caregiver at some stage of the minor's life, for example a grandmother may die and someone else will take over the care of the minor.[6] The benefit will have the same tax treatment as applicable when being paid to a trust.

Payment directly to a Beneficiary Fund

Section 37C of the Pension Fund Act[7] governs the allocation of the benefit due as a result of death of a member of a retirement fund. If part or all of the benefit due as a result of the death of a retirement fund member is allocated to a minor child and the child's caregiver is unable to administer the benefit on behalf of the child, the benefit may be transferred to a beneficiary fund.

[5] Section 37A of the Pension Fund Act No. 24 of 1956
[6] Jargon Buster, Beneficiary Trusts, 17 March 2011
[7] Section 37C of the Pension Fund Act No. 24 of 1956

The Pension Fund Act[8] defines a beneficiary fund as a fund referred to in paragraph(c) of the definition of ' pension fund organisation.

Under the definition of 'pension fund organisation' in the Pension Fund Act, paragraph (c) reads "*any association of persons or business carried on under a scheme or arrangement established with the object of receiving, administering, investing and paying benefits that became* ***payable in terms of employment*** *of a member on behalf of beneficiaries, payable on the death of more than one member of one or more pension funds.*"

Therefore the beneficiary fund can now accept death benefits payable by a retirement fund as well as benefits payable under a free – standing, employer - owned death benefit (unapproved) policy to a beneficiary fund. This however creates a problem as trustees of retirement annuities and preservation funds cannot transfer minor beneficiaries benefit to a beneficiary fund on death of a member, because the beneficiary fund cannot receive a death benefit that did not become payable in terms of the member's employment.

When a death benefit is allocated to a minor beneficiary and transferred to a beneficiary fund, the minor becomes a member of the beneficiary fund. The structure is the same as that of a defined contribution retirement fund, with each member's benefit and investment growth being to the sole credit of that member. If the minor as a member of the beneficiary fund passes away the proceeds will be paid to the member's estate, alternatively into the Guardians Fund.

In terms of the Income Tax Act, the beneficiary fund receives after tax benefits[9], tax on investments in the beneficiary fund will be taxed in the hands of the beneficiaries. The beneficiary fund must have a Investment policy in place and all investments in the fund must comply with Regulation28 of the Pension Fund Act.

The beneficiary fund has the following benefits:

- Protection of beneficiaries
- Board of Trustees and Principal Officer
- Control and regulation by the FSB
- Annual audited financial statements submitted to the FSB and compliance with FSB'S accounting and reporting requirements.

[8] The Pension Fund Act 24 of 1956
[9] Section 10(1)(gE)

Protection of retirement benefits for beneficiaries of an unapproved fund

As mentioned above death benefits of a freestanding insurance policy or a death benefit from unapproved group life policy now fall under the provisions of Section 37C. Due to the amendments to the Pension Fund Act, these benefits that pay out to beneficiaries can know be paid into the beneficiary fund. Other possibilities can also be considered.

Direct nominations resulting in payments to guardians

The guardian could make poor financial decisions in respect of the minor's benefit causing loss. Another danger is that the minor's funds could be invested together with the guardian's personal funds. This could result in the minor beneficiary's funds becoming exposed to the guardian's creditors or the funds may not be exclusively used for the interest of the minor beneficiary.

Testamentary Trusts

A Trust can be established in a will to hold, invest and administer the beneficiary's funds on behalf of the beneficiary. The beneficiaries circumstances and the value of the benefit going to the minor beneficiary will determine whether it is the best decision to create a Testamentary Trust.

The testamentary trust can either be directly nominated as beneficiary on the death benefit or the deceased estate can be nominated as beneficiary. By nominating the estate as the beneficiary of the death benefit, will make the benefit subject to executor's fees of 3.99% (including VAT) and the proceeds will be temporarily frozen while the estate is being administered, leaving the beneficiary without cash flow. There will also be a delay if using a trust, as the trust will need to be constituted and registred with the Master's office.

Inter Vivos Trust

Another option is to nominate a discretionary inter vivos trust as beneficiary on the benefit. Depending on the trustees of the trust, who is nominated as beneficiaries in the trust and what is stipulated in the trust deed, the inter vivos trust can also be considered and nominated to receive the funds.

Umbrella Trusts[10]

Before beneficiary funds were introduced in 2009 death benefits could be paid into umbrella trust. Beneficiary funds was specifically introduced to replace umbrella trust, because

[10] Beneficiaries Trust Fund (BTF"), Standard Bank Information on ("BTF") , August 2012

previously umbrella trust was unregulated and the abuse of the umbrella trusts led to scandals like Fidentia, that affected thousands of beneficiaries around the country. [11]

The umbrella trust industry is now better regulated and many minors still have funds in umbrella trust, an umbrella trust can assist a clien in protection of unapproved pension benefits paid to beneficiaries. The benefit of an umbrella trust is that it is ready and available to receive and hold the funds on behalf of a beneficiary, until the beneficiary attain majority or the age the client indicated.

The funds belong to the beneficiary, it is vested in the beneficiary and managed on behalf and to the best benefit of the beneficiary. Payments can be made out of this trust for expenses such as maintenance, school fees, education, medical expenses, extra – mural activities depending on the instruction and the amount held in trust.

The specific umbrella trust must be nominated on the beneficiary nomination forms in order for funds to be paid into the umbrella trust on behalf of a beneficiary. Tax paid in the umbrella trust is taxed at the personal rate of the beneficiary.

The member of the fund already has the answer

Whether the payment of an approve pension benefit should be paid to a guardian or to a beneficiary fund and whether the proceeds of an unapproved pension benefit should be paid to a testamentary trust or an umbrella trust, the member will know the circumstances, possible caregivers and guardians and there will know the suitable way to protect the proceeds.

Trustees often resolve to pay the benefit in respect of a minor beneficiary into a trust instead of directly to a guardian of the minor child. Often the competency of the guardian to administer the financial affairs of the minor was never assessed. The Pension Fund Adjudicator has criticised trustees for following a rigid policy in terms of which all death benefits in respect of minors are paid to trusts.

In the compliant of MM Ramanyelo against the Mine Workers Provident Fund in 2004, the adjudicator summarised the factors that must be considered by the board in determining whether a guardian should administer a minors funds or not. The factors that must be taken into account are:

- The amount of the benefit;
- The ability of the guardian to administer the funds of the minor;
- The qualifications of the guardian to administer the minors funds

[11] Jargon Buster, Beneficiary Funds, 17 March 2011

- The benefit should be utilised in such a manner that it can provide for the minor until they become adults.

The principle is, it is a common law right for a guardian to administer the financial affairs of a minor child and that only in an event that the trustees find that the guardian is incompetent, there would be grounds from depriving the guardian of this right.[12]

If a client makes an informed decision, that for example the beneficiary fund would be the best way in which to protect the approved pension benefit for the beneficiary's when the member pass away, the client should stipulate on the nomination form that the trustees should consider using a beneficiary fund for the children.

The retirement fund trustees allocate the death –claim lump sum according to Section 37 C of the Pension Fund Act, who are legal and factual dependants, level of dependence on the deceased , but an indication of the wishes of the member on how and if the lump sum benefit must be protected, can strengthen the decision of the trustees when payments are made to a beneficiary fund.

As discussed above, death benefit from unapproved pension funds do not fall under the provisions of Section 37C, therefore if a clients informed decision is that a testamentary trust should be the best option to protect the unapproved pension benefit for the beneficiaries the client must stipulate on the nomination form that the death benefits should be paid to the testamentary trust as created in the will.

Conclusion

The reality is that the payment of pension benefit to a beneficiary fund or as in the case of the unapproved benefit the payment to a testamentary trust doesn't happen automatically and without difficulty as is clear from the compliant of MM Ramanyelo against the Mine Workers Provident Fund in 2004.

Therefore the member must be advised on the different options available to protect pension benefits and then the member must ensure that the correct nomination is made on nomination document.

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GEPF: To retire or to resign - A case study

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Introduction

One of the most important decisions which members of the Government Employees Pension Fund (GEPF) have to make is whether to retire and remain as a pensioner of the fund or to resign, transfer their benefits and retire from private retirement funds.

It is often said that GEPF members are better served retiring within the fund as opposed to transferring their benefits to private retirement funds. This article explores the accuracy of this notion by means of a case study. The intention of the article is not to be prescriptive but to offer some guidance to financial planners about some of the most pertinent factors that they should consider when advising their clients in this 'retire or resign' dilemma.

Client Profile

Name: Mr. WT Brown

Pension fund: GEPF

Date of birth: 1/1/1954

Commencement date: 1/1/1976

Proposed Exit date: 1/1/2014

Years of service: 39 years

Final Average Salary: R524,716.98

Marital status: Married

Dependants: 2 (his grandchildren from his deceased son)

Mr Brown's Options

Three possible options available to Mr. Brown have been identified for discussion in this article:

1) He could choose to retire and receive a pension from the GEPF
2) He could resign and transfer his retirement benefits to a private retirement fund
3) He could resign and invest his after tax lump sum in a voluntary purchased annuity.

Option 1 : Retirement: GEPF

If Mr Brown chooses to retire and stay with the GEPF, he will become entitled to a monthly annuity as well as a gratuity (lump sum payment). These benefits will be calculated as follows:[1]

Gratuity		**R 1,375,178.26**
6.72% X final salary X years of service	R1,375,178.26	
Early retirement penalty	R 0.00	
Annuity/ Income per year *1/55 X final salary X years of service + 360*	R 372,432.04	**R 372,432.04**
Penalty	R 0.00	
Monthly Salary		R31,036.31

According to the calculation above, Mr. Brown will receive a gratuity payment of R1 375 178.26 and a monthly pension of R31 036. The lump sum will be taxed as follows:

Total Current Lump sums:	R 1,375,178.26
Less	
Exempt portion[2]	R 775,741.58
Taxable portion of current lump sum: (17/39 X 1,375,178.26)	R 599,436.68
Paragraph 5 Deductions	R 0.00
Plus	
Previous Lump sums	R 0.00
Taxable Lump sum:	R 559,436.68
Tax on Lump sum:	R 17,898.60
Tax on previous L/sum (at current rates)	R 0.00
TAX PAYABLE	R 17,898.60
After tax lump sum	R1,357,279.66

One of the drawbacks of retiring with the GEPF is that members who have pre- 1998 service lose out on a bigger tax free payout. This is because of the prescriptive manner in which the gratuity is calculated (6.72% X final salary X years of service). In the example above, Mr. Brown will only enjoy a tax free amount of R775,741.58 in respect of his pre- 1998 service. As will be shown in a later calculation, members who opt to resign enjoy a greater tax free portion as a result of

[1] Members with 10 years of pensionable service and more at retirement qualify for both a pension and a gratuity (lump sum)
[2] R1,375,178.26 – R599,436.68 (i.e. the total lump sum less the taxable portion)

being able to elect a bigger lump sum. It is imperative however to ensure that selecting the bigger lump sum will not be detrimental to your retirement planning provision.

Summary (Assuming that the client also uses his voluntary capital to purchase an annuity)

Although the income paid by the GEPF is guaranteed to pay for the life of the pensioner, the following factors must be taken into account:

Voluntary Capital	R 1,357,279.66
Income from the GEPF)	R372,432.04 (R31 036.31)
Annual tax payable on income (assuming the client does not receive any other income)	R73,796.49 Net Income: R298,635.18 (R24,886.26)
Income from voluntary income	R95,346.12 (R79,45.51pm)
Tax payable on voluntary income: R1,357,279.66 X R95,346.12= R81,430.27 R95,346.12 X 16.668 The taxable portion= R95,346.12 – R81,430.27= R13,915.85	Section 10 A exemption: Tax free: R81,430.27 Taxable: R13,915.85
Total Income R372,432.02 + R95,346.12= R467,778.14	R467,778.14 **Less** Tax free portion: R81,430.27 Taxable Income: R386,347.87 Tax payable: R78,416.25 After tax income: R307,931.62 (R25,660.97 pm)

1) Although the fund has been consistent in providing inflation linked increases to its pensioners, these increases are not pre-determinable and accordingly vary from year to year. The Rules of the Government Employees Pension Fund (GEPF), as well as its Pension Increase and the Funding Level Policies provide the framework used for determining the annual increase in pensions. According to these documents, the Board of Trustees of the GEPF (the Board) may approve a pension increase if, after the increase has been granted, the Fund's funding level is higher than the prescribed minimum funding level. The minimum funding level currently stipulates that the Fund's assets must cover at least 90 percent of its liabilities.

The table below highlights that in the last five years GEPF salaries have increase at an average of 5.2%[3]. With government's inflation targets set at 3% to 6% it is unlikely that GEPF pension increases will consistently increase beyond the upper bracket of 6%.

Year	%Increase
2010	5.6%
2011	4.5%
2012	4.8%
2013	6%
2014	5.3%
Average increase	5.24%

2) The income is only guaranteed for the first 5 years of retirement. If the pensioner who is unmarried dies after this guaranteed term there no further capital disbursement will be made to the payable to his or her dependants. Pensioners who are unmarried but have dependants (e.g. grandchildren) will be negatively affected by this rule.

3) With the exception of the orphans pension which is payable to qualifying dependants[4], the spouse's pension is only payable to a spouse and not to any other dependants. This may not be ideal for members who are single and have dependants who do not qualify as orphans in terms of the rules of the fund.

4) The income is fully taxable at the client's marginal rate of tax. As will be seen later, voluntary purchase annuities enjoy a favourable income tax exemption.

5) The spouse's pension is restricted to either 50% or 75%. In the example above, Mrs Brown will only receive R15,518.00 on Mr. Brown's death (or R23,276.98 if the 75% option is chosen)

[3] This information is sourced from the GEPF Annual reports for the years 2010 to 2014
[4] Only children under 18 (or under 22 if they are still studying) qualify for this pension

Option 2: Resignation and Transfer

If Mr. Brown decides to resign[5] and transfer his benefits to a private retirement fund his benefits will be calculated as follows:

Gratuity/Lump sum		
7.5% X final salary X years of service		**R 1,534,797.17**
Increased by		100%
Total Gratuity/ Lump sum		**R 3,069,594.34**
Actuarial Interest (over 55 years)		
G+[(AxA(X)]		**R 5,524,071.19**
G= 6.72% X final salary X years of service	R1,375,178.26	
A= 1/55 X final salary X years of service + 360	R 372,432.04	
A(X)= factor	11.14	
Lump sum payable or to be transferred		**R5,524,071.19**
The greater between the gratuity and the actuarial interest		

For income tax purposes, the total amount of R5,524,071.19 will be deemed to have accrued to Mr Brown on the date that it is transferred to the private fund.[6] As a result of this, Mr. Brown will enjoy a much bigger pre-1998 tax free portion (R3,116,140.39) due to receiving a greater lump sum. Mr Brown will however only be allowed to withdraw up to one-third of his translocation benefit (R1,841,357.19) with growth thereon. No tax will be payable on the lump sum since it is below the R3,116,140.39 tax free threshold.

[5] Please note that members of the GEPF are not allowed to resign after they have attained their contractual retirement age.
[6] Paragraph 2(b) of the Second Schedule to the Income Tax Act

The remaining two- thirds of R3 682 711.37, with growth, will then be applied towards purchasing a compulsory annuity.

Public Sector Fund (E.G GEPF) Withdrawal	
Date Joined Fund	01/01/1976
Date of Exit	01/01/2015
Total Years of Service:	39
Year of service post 1998:	17
Lump sum Payable:	R 5,524,071.19
17/39 X R5,524,067.06=	
Taxable Portion of Lump sum:	R 2,407,928.47
Tax free Portion of Lump sum:	R 3,116,142.72
Actual Lump sum	R 1,841,357.19
Tax free Portion of actual Lump sum:	R 1,841,357.19

Summary**: Resignation and transfer**

Voluntary Capital	R1,841,357.19
Compulsory Capital	R3,682,714.00

To match the income paid by the GEPF (R31,036.00 per month), Mr. Brown would have to select a 10.11% draw down rate from his private living annuity. This is however excessive as it could erode his capital in the long run. He could however take a lower and more conservative drawdown of 8% and utilise his full tax free lump sum to purchase a voluntary purchased annuity. The effect of this is demonstrated below:

	Projected Income
Income from voluntary capital Old Mutual Income for life with: ❑ Joint life ❑ Guaranteed term of 15 years (Old Mutual Max annuity rates for week ending 28 November 2014.)	R129,487.32 (R10,790.61pm) **<u>Section 10A exemption</u>** Tax free: R110,472.59 Taxable: R19,014.73[7]
Income from compulsory capital Projected income from an Old Mutual Max Income living annuity drawing 8%	R289,578.96 (R24,131.58pm) (net of costs).
Total Income	R419,066.28 (less the tax free portion): R110,472.59 Taxable Income: R308,593.69 Tax payable: R54,645.11 After tax income: R253,948.58 (R21,162.38)

[7] 1841357.19/129487.32 X 16.668 X 129487.32

Option 3 : Full resignation

Mr. Brown could also consider withdrawing all his money from the GEPF and investing the net proceeds privately. This option will enable him to enjoy the full tax free benefit of R3,116,140.39 and leave him with a voluntary lump sum of R4,810,213.46 available for investment. The resignation benefit will be taxed as follows:

Total Current Lump sums:	**R 5,524,067.06**
Less	
Exempt portion (pre- 98)	R 3,116,140.39
Taxable portion of current lump sum	**R 2,407,926.67**
Less	
Paragraph 5 Deductions	R 0.00
Plus	
Previous Lump sums	R 0.00
Gross taxable lump sum:	R 2,407,926.67
Tax on Lump sum:	R 713,853.60
Tax on previous Lump sum:	R 0.00
TAX PAYABLE	R 713,853.60
Voluntary capital after tax	R 4,810,213.46

Although the net lump sum can be invested in a myriad of investment options, it is suggested for purposes of this article that the funds be invested in a voluntary income for life annuity. The projected income from this capital is as follows:

Source of Income	**Projected income**
Income for life from voluntary capital (annuity rates valid to week ending 28 November 2014) ❑ single life annuity, with ❑ 20 year guaranteed term ❑ Escalating annually at 4%	R307,214.76 (R25,601.23 pm)
Tax on income: Section 10A exemption: (R4,810,213.46 / R307,217.76 X 16.668) x R307,217.76 = R288,589.72) Taxable portion: R18,625.04	Taxable Income: R18,625.04 Tax payable: R0 Net Income: R307,217.76 (R25,601.48 pm)

The Medical Subsidy

Much is often made of the medical aid subsidy which the government pays on behalf of pensioners to the Government Employees Medical Scheme (GEMS).

According to the Determination on Medical Assistance for Public Service,[8] the government will continue to provide medical assistance to employees who exit the public service because of retirement, death and discharge.[9] The benefit is therefore not available to employees who exit the public service through resignation.

Although the precise amount of the subsidy payable to a member depends on his or her age at the time of retirement and their years of service, the subsidy is subject to a maximum amount of R1,014 per month. A financial planner advising a client to transfer their money to a private fund will therefore have to ensure that this loss of R12,168 per annum can be adequately replaced. Although this is a very significant factor, it should not be an overarching consideration in favour of the retirement option, as there are other private medical aid schemes offering benefits akin to those of the Government Employees Medical Scheme (GEMS) at competitive rates. Consideration should also be given to the fact that the medical subsidy payable by the government is included in a pensioner's gross income and has the effect of increasing his or her marginal rate. Medical contributions made to an external fund on the other hand do not have the same effect on a pensioner's marginal rate.

Final Comparison

	Retirement	**Resignation and Transfer**	**Resignation and exit**
Voluntary lump sum	R 1,357,279.66	**R 1,841,357.19**	R 4,810,213.46
Tax free lump sum	R 775,741.58	**R 1,841,357.19**	R 3,116,140.39
Total net Income from compulsory and voluntary capital	R467,778.14 (R38,981.51)	R253,948.58 (R21,162.38)	R307,217.76 (R25,601.48)

It is clear from the above example that it is difficult (not impossible) to match the annuities payable by the GEPF. It would be overly simplistic (if not imprudent) however to dismiss the other options merely on the basis of the income alone. As explained above, factors such as capital preservation for dependants, income escalations and spouse's pension and guarantees have to be taken into account. In most cases the variance in income levels between the GEPF and private retirement funds is basically the cost for having:

- A guaranteed income equal to 100% for the pensioner's spouse.
- Guaranteed capital preservation of capital for dependant through a 20 - 25 year guaranteed terms
- An guaranteed income payable regardless of whether the pensioner is alive or not

[8] Made by the Minister for the Public Service and Administration, March 2011
[9] Discharge as a result of ill health or injury on duty

Another important consideration should be the fact that the GEPF does not offer any annuity options apart from the guaranteed income for life. Members are therefore deprived the opportunity to invest their retirement capital in external, professionally managed risk appropriate funds to bolster their savings. All retiring members in the GEPF are, despite their varying risk profiles and financial circumstances treated the same. This 'one size fits all' approach is founded on the incorrect assumption that all members' needs are the same at retirement.

While the GEPF offering is ideally suited for most of its members, it is submitted that the fund offerings may not be ideal for the following class of pensioners:

1) Pensioners who retire after contracting a terminal illness and whose life expectancy is reduced(this is because capital in the GEPF is only guaranteed for the first five years of retirement)
2) Pensioners with other sources of income and who is willing to take market risks to maximise their retirement capital.
3) Members who have dependants[10](e.g. grandchildren)
4) Single parents such as widows (or widowers), divorcees.
5) Members who wants to be in control of their retirement capital

Divorce Debt

Another important consideration in the "retire or resign" debate came by way of the recent amendments to the Government Employees Pensions Law[11] regarding the payment of divorce claims. In 2012, the Act and the GEPF rules were amended to provide for the clean break principle[12]. Prior to this amendment, divorce awards against a member- spouse's divorce interest could only be paid out when the member exited the fund (either on retirement or withdrawal). The clean break principle allows for the immediate payment of the portion of the pension interest allocated by a court[13].

Pension interest is defined in the Act as, "*the amount to which the member would have been entitled in terms of the rules of the Fund if the member's membership of the Fund were to be terminated on the date of divorce...on account of the member's resignation from the service of the employer*"

[10] Other than disabled children and children under the age of 18 (or 22 if still studying)
[11] Act 21 of 1996
[12] Section 24A
[13] Section 24A (2)(a)

A profound consequence of the extension of the clean break principle to the GEPF is the introduction of a 'divorce debt'. The payment of the allocated portion to a non-member spouse creates a debt which must be repaid by the member spouse on exit from the fund. This is because the GEPF is a defined benefit pension fund. Unlike a defined contribution fund, members of a defined benefit pension fund, members do not have separate 'ring fenced' accounts. Therefore when the GEPF is obliged to make a payment in terms of a divorce order, it is settling the debt on behalf of the member (i.e. the payment is not funded from the member's separate account but from the fund itself). It is this resultant loss of income by the fund which creates the divorce debt. Although the member is not obliged to repay the debt immediately, interest is charged on the outstanding amount (the current rate is the repo rate (currently 5.75%)[14] plus 3). The debt plus the interest will be deducted from the eventual pension benefit payable to the member.

The Fund will initially attempt to recover the debt from the member's gratuity (if any). However if the amount of the divorce debt exceeds the amount of the gratuity payable to the member then the debt will be recovered from both the gratuity and annuity (the gratuity and the annuity will be reduced pro rata).[15]

The repayment of a divorce debt can have a debilitating impact on a person's retirement. To preserve their annuities, members with divorce debts hanging over them may be better served by taking resignation rather than retirement benefits. As in the example above, if Mr. Brown resigns he will become entitled to a greater tax free lump sum than if he retires. This lump sum can then be used to repay the debt, without affecting his annuity.

Conclusion

There is no doubt that the GEPF offers very competitive solutions which are ideally suited for most of its members. Unlike private funds these benefits are guaranteed and provide a great measure of certainty to pensioners. This however should not be a deterrent to a financial planner from exploring other possible external investment options for their clients. The decision whether a member of the GEPF should retire or resign should however not be taken lightly. A careful analysis of the client's financial circumstances and possible tax implications must be conducted before any recommendation is furnished.

[14] As of the 22nd of October 2014
[15] Rule 14.10.9

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Pension Funds Act amendments

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Introduction

The "clean break principle" with regard to pension interests and divorce was introduced into our law on 13 September 2007[1]. It allowed non-member spouses to access, on the date of divorce, retirement monies awarded to them from the member spouse's retirement fund and to either receive it as a cash benefit or to transfer it to another fund. There have been many difficulties however with the implementation of this laudable intention, not least due to badly drafted legislation, or amendments in one piece of legislation conflicting with other legislation. Added to this were difficulties in the sense that the clean break principle only applied to a certain group of persons to whom the Divorce Act[2] applied, and to a narrowly defined "pension interest "[3]. Many people therefore were not able to use this legislation, which led to further cases being taken to court or the Pension Funds Adjudicator to obtain redress. This has led to further amendments to the Pension Funds Act[4] (hereafter referred to as the "PFA") by the Financial Laws General Amendment Act[5] to protect the rights of people in these situations. This article will discuss two of the cases that led to the amendments; why these amendments should not be given effect to by the industry as drafted at the present time and lastly why the position with regard to member owned post retirement benefits and divorce remains unchanged notwithstanding the amendments.

What does the Divorce Act allow?

Pension interests do not form part of a person's estate during lifetime or on death. Therefore the Divorce Act introduces a deeming provision[6] whereby a member's pension interest is part of his or her estate for purposes of working out a financial settlement on divorce. Pension interest in respect of a pension and provident fund means the benefit that a member would have been entitled to if he had resigned from employment and withdrawn from the fund on the date of divorce[7]. Pension interest with regard to a retirement annuity means total contributions to the fund plus simple interest (9% per annum as from 1 August 2014[8]) on the contributions as at the date of divorce[9].

Without this provision, pension money of an active member of a retirement fund could not be taken into account for the purposes of a divorce and would remain for the benefit of the member only.

1 Section 37D(1)di Pension Funds Act 24 of 1956 as amended by the Pension Funds Amendment Act 11 of 2007
2 Act 70 of 1979
3 Section 1 Act 70 of 1979
4 Act 24 of 1956
5 Act 45 of 2013
6 Section 7(7) Act 70 of 1979
7 Section 1 Act 70 of 1979
8 Government Gazette Volume 589 No 37381 18 July 2014
9 Section 1 Act 70 of 1979

To whom does the Divorce Act apply?

The Divorce Act only applies to people whose marriage is registered in terms of the Marriage Act[10], the Civil Union Act[11] and the Recognition of Customary Marriages Act[12], and who have to use the mechanism of the Divorce Act to terminate their relationship. The marital property regime must be one of community of property, out of community with the accrual system, or out of community of property and entered into prior to 1984, which is when the Matrimonial Property Act[13] became effective.

Therefore:

- People who are in a long term relationship whether homosexual or heterosexual and who have not entered into a civil marriage, and
- People who have been married according to the tenets of a religion (Islamic/Hindu) and have not entered into a civil marriage

cannot use the provisions of the Divorce Act to terminate their relationship. Therefore the deeming provision in the Divorce Act pertaining to pension interest does not apply to the afore-mentioned classes of relationships, and the "normal" position of pension interest not being part of a person's estate applies on termination of these relationships, with the result that the pension interest cannot be shared.

What did the PFA allow prior to the 2013 amendments:

Section 37A[14] of the PFA does not allow a pension benefit to be reduced, except in the circumstances listed in section 37D.

Section 37D(1)(d)(i) of the PFA allows "*any amount assigned from a member's interest or member's individual reserve in terms of a decree granted under section 7(8) of the Divorce Act 70 of 1979*", to be deducted by the Fund and paid to the non-member spouse.

10 Act 25 of 1961
11 Act 17 of 2006
12 Act 120 of 1998
13 Act 88 of 1984
14 37A. Pension benefits not reducible, transferable or executable: (1) Save to the extent permitted by this Act, the Income Tax Act, 1962 (Act No. 58 of 1962), and the Maintenance Act, 1998, no benefit provided for in the rules of a registered fund (including an annuity purchased or to be purchased by the said fund from an insurer for a member), or right to such benefit, or right in respect of contributions made by or on behalf of a member, shall, notwithstanding anything to the contrary contained in the rules of such a fund, be capable of being reduced, transferred or otherwise ceded, or of being pledged or hypothecated, or be liable to be attached or subjected to any form of execution under a judgment or order of a court of law, or to the extent of not more than three thousand rand per annum, be capable of being taken into account in a determination of a judgment debtor's financial position in terms of section 65 of the Magistrates' Courts Act, 1944 (Act No. 32 of 1944), and in the event of the member or beneficiary concerned attempting to transfer or otherwise cede, or to pledge or hypothecate, such benefit or right, the fund concerned may withhold or suspend payment thereof: Provided that the fund may pay any such benefit or any benefit in pursuance of such contributions, or part thereof to any one or more of the dependants of the member or beneficiary or to a guardian or trustee for the benefit of such dependant or dependants during such period as it may determine

The Income Tax position

The Income Tax Act[15] also must be taken into consideration with regard to the payment of divorce awards from retirement funds to non-member spouses. Any lump sum received from a retirement fund is taxable in terms of the Second Schedule. Accordingly the taxation of awards to non-member spouses is provided for. The taxation provisions refer specifically to an amount assigned in terms of a divorce order made after 1 September 2007 in terms of section 7(8) of the Divorce Act to the extent that the amount so assigned constitutes a part of a pension interest, as defined in section 1 of the Divorce Act[16].

The application of the Divorce Act and section 7(7), section7(8) and the definition of "pension interest" to the divorce provisions in the PFA affecting retirement benefits led to the following cases:

Eskom Pension and Provident Fund v Elizabeth Krugel[17]

This case deals with whether a deferred pensioner's benefit in a fund could be a deemed asset on divorce as contemplated in section 7(7) and section 7(8) of the Divorce Act and whether section 37D(1) of the PFA would allow the non-member spouse to obtain payment of a share of this benefit.

Pension interest is defined in the Divorce Act (as pertaining to an occupational pension fund) as follows:

"the benefits to which that party as such a member would have been entitled in terms of the **rules** of that fund if his membership of the fund would have been terminated on the date of the divorce on account of his resignation from his office"

Accordingly the SCA held that by terminating his membership of the fund PRIOR to the divorce by resignation, his pension interest had already become payable to him. He no longer had an interest in the fund to which section 37D of the PFA could apply as he was no longer a member. Once the pension interest has been converted into an accrued pension benefit to the member, section (7)7 and section (7)8 of the Divorce Act is no longer applicable and "the member simply no longer had a pension interest for the purposes of sections 7(7) and 7(8) of the Divorce Act and 37D(4)(a) of the PFA".

The SCA noted obiter that the non-member spouse may have a right of recourse against the "member" spouse when he reached the age at which he took the deferred benefit.

15 Act 58 of 1962
16 Second Schedule Paragraph 2(1)(b)(iA) Act 58 of 1962
17 2011 ZASCA 96

Tyron v Nedgroup Defined Contribution Pension and Provident Funds and Old Mutual Life Assurance Company[18]

The Complainant was married to the member spouse of the respondent fund by the tenets of Islamic religion. They were divorced in 2007 in terms of Islamic religion and a deed of financial settlement was entered into. In terms of this settlement agreement, the complainant would be entitled to 50% of the member spouse's pension interest in the fund from date of marriage to date of divorce. This settlement agreement was also made an order of court. The complainant claimed her award, but the pension fund refused to pay.

The fund said the reasons they refused to pay was:

- The settlement agreement was not a divorce order in terms of section 7(8) of the Divorce Act
- In terms of the Divorce Act a pension interest will only form part of a person's assets on divorce if the person is married in community of property or out of community of property, but including the accrual system or married pre-1984 out of community of property
- The settlement agreement was only binding between the parties

The adjudicator held that the complainant should be considered as a spouse for the purposes of pension interest, and the award amount could be calculated and the respondent fund was ordered to pay the complainant her share.

Amendments to the PFA by the Financial Laws General Amendment Act[19] in 2013 (effective 28 February 2014)

Section 37D(1)(d)(i) of the Pension Funds Act has now been amended and now a fund may deduct from a member or deferred pensioner's benefit, member's interest or minimum individual reserve or the capital value of a pensioner's pension after retirement, as the case may be, any amount assigned from such benefit or individual reserve to a non-member spouse in terms of a decree granted in terms of section 7(8) of the Divorce Act or in terms of any order made by a court in respect of the division of assets of a marriage under Islamic law.

Problems with the amended Section 37D(1)di

Islamic marriages

The Divorce Act does not apply to the dissolution of Islamic marriages. Therefore there is no deeming provision in respect of pension assets for the purpose of any financial settlement. The pension assets cannot therefore be divided as they are not part of the party's estates in the first instance. The amendments to the PFA do not change this position, or in some way link the court

18 2012 JOL 28588 PFA
19 Act 45 of 2013

order obtained when an Islamic marriage is terminated to the Divorce Act. Further, the Income Tax Act makes specific reference to divorce awards in terms of the Divorce Act and so these awards will not be able to be taxed in terms of the Second schedule.

Deferred Pensioners

A deferred pensioner is a member of a fund, who has not yet retired, but who has left the service of the employer concerned prior to normal retirement date leaving his rights to such deferred pension as may be defined in the rules in the fund.[20]

The reasoning in the Kugel decision[21] is sound, a deferred pensioner does not have an interest in the fund as defined in the Divorce Act for the purposes of divorce. Therefore a deferred pensioner's benefit cannot be deemed to be part of his assets on divorce and therefore cannot be shared in the first instance. The amendments to section 37D(1)(d0(i) do not permit a court to make an order apportioning a deferred benefit in a fund as there is no applicable enabling provision in the Divorce Act.

Post Retirement benefits

The definition of pension interest in The Divorce Act refers to pre-retirement benefits in respect of a pension fund and provident fund (that is what would have been available to the member had he resigned on the date of divorce) and a retirement annuity. The only extension to this definition is section 37D(6) of the PFA, which extends same to include amounts held by a member of a preservation fund. Consequently sections 7(7) and 7(8) of the Divorce Act and 37D(6) of the PFA only permit a court of law to issue a divorce order within the confines of these provisions – that is against a member's pension interest in a pension or provident fund, a retirement annuity and preservation fund as defined in section 1 of the Divorce Act. As neither of these provisions provide for the underlying capital value of a pensioner's pension to fall within the definition of "pension interest" in the Divorce Act, a court lacks authority in terms of the Divorce Act to grant an order that awards a percentage of such underlying pension capital to the non-member spouse of the pensioner.

On retirement, and should the fund rules permit it, one of the options that a member has, is to purchase a member owned compulsory annuity from an insurer. On purchase of this annuity, the member's membership of the fund is terminated and the fund's liability to the retiring member is terminated. The member has no further interest in the fund. There certainly is no "capital value of a pensioner's pension after retirement" in the fund that section 37D(1)d can apply to in this instance. In addition the definition of "member" in section 1 of the PFA specifically states that member does not include a former member who has received all the

20 Section 1 Act 24/1940
21 2011 ZASCA 96

benefits due to him from the fund and whose membership has been terminated in accordance with the rules of the fund.

Further, member owned annuities purchased from an insurer are governed by the Long Term Insurance Act[22] and GN18 and not the Pension Funds Act. GN18 states quite clearly that:

"The annuity so purchased, as is the case with an annuity purchased in the name of a retirement fund or paid directly by such a fund, must be compulsory, non-commutable, payable for and based on the lifetime of the retiring member and may not be transferred, assigned, reduced, hypothecated or attached by creditors as contemplated by the provisions of sections 37A and 37B of the Pension Funds Act, 1956."

Non-member spouses whose former spouses benefit from fund owned annuities and pensions paid by the fund are on marginally firmer ground as these pensions are at least subject to the Pension Funds Act. A pensioner is defined in section 1 of the Pension Funds Act as a person who is in receipt of a pension from a fund, but the fundamental problem that there is no pension interest as defined in the Divorce Act still remains.

Therefore the position therefore relating to the inability of people on divorce to access their ex-spouse's pension which is already in payment has not therefore changed by the amendments to section 37D(1)(d)(i). Further a fund cannot be compelled to act upon a divorce order that is not drafted in accordance with sections 7(7) and 7(8) read with section 1 of the Divorce Act.

It will be interesting to see how divorce orders dealing with deferred benefits and the capital value of a pension must be drafted in order to be binding on a fund. There have been many Adjudicators decisions upholding a fund's decision not to pay a non-member spouse because of a non-compliant divorce order due to no reference to "pension interest" as required by the Divorce Act. A recent decision is Areias v Momentum Retirement Annuity Fund and Another[23] where the Adjudicator stated as follows:

"Secondly, the order does not mention pension interest. Therefore, it is not in compliance with sections 7(7) and 7(8) of the Divorce Act No. 70 of 1979 as well as the definition of pension interest in section 1 of the Divorce Act. The order states that the complainant shall be entitled to 50% of the maturity value of the policy at retirement date. It does not stipulate that the non-member spouse will be entitled to her share of the pension interest as at the date of divorce. For these reasons the order does not comply with the definition of pension interest in section 1 of the Divorce Act. The second respondent submitted that it can still not ascertain the amount it can legally pay out to the complainant without contravening the Divorce Act. Based on the above, this Tribunal is satisfied that the order as it stands is only binding between the complainant and her former husband, but it is not enforceable against the first respondent."

22 52 of 1998
23 2013 JOL 30007 PFA page 7.

Conclusion

It is a pity that the legislators have amended the Pension Funds Act without the necessary amendment to the deeming provision in the Divorce Act and Income Tax Act. This means that instead of resolving an inequitable situation in our law, and the difficulties faced by people going through a divorce, they have created more confusion, and the necessity for yet another piece of legislation before there is certainty in the law.

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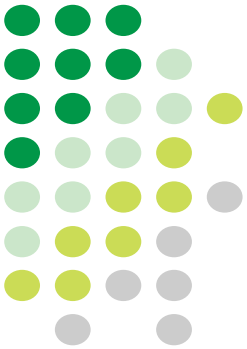

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Binding Private Ruling 156

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Introduction

This article will discuss Binding Private Ruling 156 (the Ruling) which was issued by SARS to deal with the taxability of pension annuities and retirement fund lump sums received by or accrued to a non-resident from a South African registered retirement fund. In order for us to understand this ruling, one has to consider the definitions of gross income, non-resident and source.

Gross Income

The definition of gross income according to paragraph (a) of the Income Tax Act (the Act) includes an amount received by or accrued to an individual by way of "an annuity, a living annuity or an amount contemplated in the definition of 'annuity amount' in section 10A(1)."[1] A "retirement fund lump sum" and a "retirement fund lump sum withdrawal benefit" are also included in the definition of gross income.[2]

Non-resident

A resident is subject to tax on his or her worldwide income i.e. a residence based tax system is applied, whereas a non-resident is taxed on a source based system. A non- resident is subject to tax on income received or accrued from a source within the Republic. Double tax agreements exist between South Africa and foreign countries to ensure that a non-resident is not subject to the double taxation on the income earned in South Africa i.e. not subject to tax both in South Africa and his or her country of residence.

Source

The word source is defined in terms of case law and the Act. In CIR v Lever Brothers & Unilever Limited[3] (cited in Stiglingh et al)[4] the court stated that one must consider the "originating cause of the income and the location of this originating cause." It was held in Rhodesian Metals Ltd v COT[5] (cited in Stiglingh et al)[6] that source "means not a legal concept but something which the practical man would regard as a real source of income."[7]

Section 9 of the Act contains the source rules in respect of various categories of income. Section 9(2)(i) considers pensions and annuities received or accrued in respect of services rendered within the Republic. The source of the pension must be considered in relation to the

[1] Section 1 of the Income Tax Act No. 58 of 1962
[2] Paragraph *(e)* of the section 1 of the Income Tax Act No.58 of 1962
[3] 1946 AD 441 14 SATC 1 at 13
[4] M Stiglingh et al, Silke: South African Income Tax 2013 (Lexis Nexis, 2013) at 65
[5] 1938 AD 282, 9 SATC 363 at 379
[6] M Stiglingh et al, Silke: South African Income Tax Act 2013 (Lexis Nexis, 2013) at 66
[7] M Stiglingh et al, *Silke: South African Income Tax 2013* (Lexis Nexis, 2013) at 66

place where the services are rendered in terms of section 9(3). The source of a pension or annuity that relates to services rendered in South Africa will be taxed in South Africa.[8]

Application brought to SARS

The Ruling was issued in consequence of an application brought to SARS regarding the taxability of a pension annuity received by a non-resident from a pension fund registered in South Africa.

The applicant was employed by a South African resident company and resigned from employment from the company in South Africa in 1999. He joined a company based outside South Africa which was part of the same group of companies as the South African company. In time he became a resident of that foreign country where he was based. During his employment in South Africa he contributed to the pension fund registered in South Africa. This continued even after he left South Africa after which he ceased to be a resident of South Africa.

SARS had to consider the tax liability of the pension annuity received by the applicant. The applicant qualified as a non-resident and on the face of it the source of the income was South Africa. SARS made its determination based on section 9(2) and held that where an amount is received or accrued in respect of services rendered partially within and partially outside the Republic only the amount calculated in respect of the services rendered in South Africa will be subject to tax in South Africa.[9]

In light of this ruling, it can be argued that the portion of the pension or annuity and retirement fund lump sum benefit relating to services rendered outside South Africa will not be subject to tax in South Africa. This will be the position even though the pension annuity and lump sum are paid from a South African registered pension fund.

Conclusion

The Ruling was issued in terms of the Tax Administration Act[10] and it is only valid for a period of 5 years commencing on the 13th August 2010.[11] This ruling is of benefit to non-residents who are in receipt of pension annuities from a South African source. Pension annuities from a South African source will not be subject to income tax in South Africa, where the services in respect of that pension annuity (or part thereof) were rendered outside South Africa.

[8] Section 9 of the Income Tax Act No. 58 of 1962
[9] SARS Binding Private Ruling 156
[10] Section 78(1) of Tax Administration Act No.28 of 2011
[11] SARS Binding Private Ruling 156

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