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For her contribution entitled

The One Year Wonder

and

Stephan Van Zyl

For his contribution entitled

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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.

General

Suretyship and Trusts-The risks for trustees and creditors

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Introduction

Family trusts have for many years been a well-known estate–planning tool within the South African estate planning landscape. Unfortunately, because the family trust is by its very nature an intimate part of the financial and personal lives of a family, the planner often loses sight of the fact that the trust, represented by the trustees, and the planner are separate entities. This is often the case where the planner is also a trustee of the trust. The result is that the other trustees, who may be his spouse or other family members, often defer to the planner and tend to treat the trust assets as those of the planner.

In many such instances the trust is drawn into the business dealings of the planner and the trustees are required to sign surety on behalf of the trust. It is therefore important for the trustees to understand what they are signing. It is also important for third parties or institutions relying on such suretyships signed by the trustees to implement a checklist in order to ensure that the trust will be bound by the deed of suretyship.

The two most important questions that need to be answered are the following:

- ❑ Do the trustees have the power to sign surety on behalf of the trust?
- ❑ Is the suretyship to the benefit of the trust or the beneficiaries?

Liebenberg v MGK Bedryfsmaatskappy (Edms) Bpk NO 2003 (2) SA 2224 (SCA)[1]

In the case of Liebenberg v MGK Bedryfsmaatskappy (Edms) Bpk[2] in the Supreme Court of Appeal, the common law principle that trustees are not allowed to subject the assets of the trust to business or farming related risks unless the trust deed expressly affords them the power to do so. In this case the trustee of the testamentary trust (the spouse of the testator) was the only trustee of the trust and she signed an unlimited deed of surety on behalf of one of the trust beneficiaries for debts incurred in respect of the respondent.

The judge found that it would be impossible to find a provision in the trust deed which allows for an implied “reading in” to the effect that the trustees are afforded the power to allow the trustees to enter into an unlimited deed of surety in the name of the trust, on behalf of one of the trust beneficiaries, which could result in a debt which completely overshadows the total value of the assets held in the trust. Consequently, the judge found that the trustee did not have the power to sign such a deed of surety in respect of the debt of the relevant trust beneficiary and that the final sequestration order of the trust fund should not be issued.

[1] Liebenberg v MGK Bedryfsmaatskappy (Edms) Bpk NO 2003 (2) SA 2224 (SCA)
[2] Liebenberg v MGK Bedryfsmaatskappy (Edms) Bpk NO 2003 (2) SA 2224 (SCA)

The Standard Bank of South Africa v Suzette Koekemoer and Others NO 2004 (6) SA 498 (SCA)[3]

The facts of the case were as follows:

- The applicant, Standard Bank, granted two home loans to the value of approximately R 1 300 000 in total to the trust.
- These loans were secured by way of registering mortgages over the trust assets.
- The trust in turn loaned these funds to a third party.
- The majority of these funds were used to support business initiatives of the third respondent who was the son of the second respondent.
- The second respondent was the founder of the trust. Both the second and third respondent were trustees of the trust but the third respondent was not a beneficiary of the trust.
- The trust deed provided that the trustees may take out loans but specifically prohibited that loans may be granted to persons who were not beneficiaries of the trust.
- In 1997 the banks instituted action for the repayment of the loan together with interest on the amount.
- The respondents opposed this action and averred that these loan agreements were made *ultra vires* the provisions of the trust deed and the agreements were therefore unenforceable.
- The argument raised by the respondents was that the bank had a copy of the trust deed in its possession, and was aware of the provisions contained in the trust deed, notwithstanding that they still proceeded to issue the loans to the trust.
- The arguments were accepted in the court a quo and the court found in favour of the trust. Understandably this judgement sent shockwaves through the banking community.
- The case was taken on appeal and the judgement was turned around in favour of the bank. The bank was allowed to claim the money loaned to the trust contractually from the trust.
- The Supreme Court of Appeal emphasised that that the bank should have had "actual knowledge" of the prohibitive provisions in the trust deed.
- The court was unwilling to accept that the mere submission of the trust deed to the bank would have made them aware of the particular provision.
- No evidence in support of this averment could be submitted to the court.

Although the banking community probably let out a collective sigh of relieve after the appeal was decided in their favour, they are still not in a satisfactory position. If banks or for that matter any other third party are not fully aware of the provisions of the particular trust deed they are dealing with, they are entering a legal minefield. They will not know whether the trustees have the legal capacity to act on behalf of the trust, or even if a given transaction will fall within the ambit of activities which a given trust is authorised to enter into. If the banks on the other hand

[3] The Standard Bank of South Africa v Suzette Koekemoer and Others NO 2004 (6) SA 498 (SCA)

undertake an extensive and detailed investigation of a trust deed, they are deemed to have "actual knowledge" of the provisions contained in the trust deed they are dealing with, in such a case, the contract as envisioned in the above-mentioned case would have been unenforceable. Any third party entering into an agreement/transaction with a trust should therefore be extremely careful.

It is a known fact that many people sign documents without thoroughly reading the contents thereof. Most documents signed in this manner are harmless and won't cause any problems but what happens when you sign a document and immediately thereafter discover that you would not have signed it in the first place, had you been aware of the contents of this document?

Slipknot Investments 777 (Pty) Ltd v Du Toit (1647/2011) [2012] ZAGPPHC 254 (7 November 2012) [4]

The facts of the case were as follows:

- Mr. Du Toit signed a document and later discovered that he had bound himself in his personal capacity for any debt incurred by the trust.
- Mr. Du Toit, his brother and nephew were the only trustees of the trust.
- Mr. Du Toit and the other two trustees signed a document which would allow the trust to borrow R6 million from the applicant. The trust defaulted on the terms of repayment and the Applicant issued summons against the trust and the trustees, on the strength of the surety they had signed, for the repayment of this amount.
- Mr. Du Toit averred that his brother and nephew had failed to advise him of the contents of the documents that he was signing at the time and that he could not be bound because it was never his intention to act as surety for the debts incurred by the trust.
- Mr. Du Toit claimed the mistake was unilateral.
- The Supreme Court of Appeal considered the judgement in the case of Overseas Distributors Corporation (Pty)Ltd v Potato Board[5] where the court made the following comment in respect of unilateral mistakes:

"*our law allows a party to set up his own mistake in certain circumstances in order to escape liability under a contract into which he has entered. But where the other party has not made a misrepresentation and has not appreciated at the time of acceptance that his offer was being accepted under a misrepresentation the scope for a defence of unilateral mistake is very narrow, if it exists at all. At least the mistake (error) would have to be reasonable (justus) and it would have to be pleaded.*"

- The Supreme Court of Appeal had to determine whether the mistake by Mr. Du Toit was reasonable and therefor had to determine whether the applicant played any part in the mistake. The court found that the mistake was not reasonable and, furthermore, there was no

[4] Slipknot Investments 777 (Pty)Ltd v Du Toit (1647/2011)[2012] ZAGPPHC 254 (7 November 2012)
[5] Overseas Distributors Corporation (Pty)Ltd v Potato Board 1958 (2) SA 473 (SCA)[Page 3-42(3)]

indication that the applicant knew or ought to have known that Mr. Du Toit had made a mistake in this regard.

- Mr. Du Toit together with his co-trustees was held liable for the debts of the trust in terms of the deed of suretyship they had signed.

Prior to the Slipknot Investments 777-judgement, the legal position was unsure and riddled with contradictions which were mostly caused by the application of the *iustus* error doctrine. The *iustus* error doctrine revolves around the concept that, in certain cases, parties who entered into a contract would be absolved of their contractual obligations where they entered into a contractual obligation by mistake, which was spurred on by the fraudulent representation which was made by a third party; while in other instances, cases were resolved in a completely contrary manner. The Slipknot– case provided a measure of legal certainty in this regard.

Investec Bank Ltd v Adriaanse and Others NNO 2014 (1) SA 84 (GNP)[6]

The Plaintiff, Investec Bank, issued summons against the Defendants, in their capacity as trustees of the Kudu Trust, based on a suretyship executed by the Kudu Trust in favour of a company named Scarlett Ibis.

Scarlet Ibis, represented by the Second Defendant, Mr Adriaanse, applied for a loan from Investec in order to develop a vacant piece of land. Investec granted the loan against certain measures being put in place to secure the loan. This included a suretyship entered into by Adriaanse, in his personal capacity, as well as a suretyship by the Kudu Trust, having the first and second defendants as trustees and beneficiaries thereto.

The defendants argued that the trust was not competent to execute such suretyship based on the following:

- The trustees of the Kudu Trust were not duly authorized to bind the trust as surety for any debts that fell outside the scope of the powers of the trustees ,as it was not to the advantage or benefit of the beneficiaries or the trust; and
- That even if the trust could have stood surety for debts, it was not executed with the consent of all trustees, based on the fact that the third trustee, Mr Kleingeld, had not signed the resolution to enter into such suretyship.

At the time when the surety was signed (15 November 2006), Mr & Mrs Adriaanse were the only two trustees of the trust. It was in dispute whether one of the former trustees, Mr Kleingeld, was indeed a trustee at that point in time.

[6] Investec Bank Ltd v Adriaanse and Others NNO 2014 (1) SA 84 (GNP)

The court had to decide: whether the execution of the suretyship was to the advantage of the trust and the beneficiaries, as was required by the trust deed; if so, whether all of the trustees consented to such suretyship; and, further, whether they were empowered to do so in terms of the trust deed.

Held

Advantage to the trust and beneficiaries:

In determining the scope and extent of the role that is expected from an outsider in dealing with a trust, the court held that one must ensure that outsiders are seen as observing the trust provisions and not acting in deliberate violation of such provisions.

Kollapen J made the following findings with regards to duties and obligations of third parties when dealing with trusts:[7]

"[12] In determining the scope and extent of the role that is expected from an outsider in dealing with a trust, one must on the one hand ensure that outsiders by their actions are seen to be observing the provisions of the trust deed and should not act in flagrant violation of the trust deed.

[13] In NIEWOUDT AND ANOTHER NNO v VRYSTAAT MIELIES (EDMS) BPK 2004 (3) SA 486 (SCA) HARMS JA (as he then was) remarked that 'this case should consequently serve as a warning to everyone who deals with a trust to be careful.' (at 495A)

[14] On the other hand it is trite that trustees have the primary responsibility to act in accordance with the dictates of the trust deed and one should guard against the unintended consequence of developing a quantitatively higher standard of diligence and care on the part of outsiders dealing with a trust than on the part of the trustees themselves.

[15] In LAND AND AGRICULTURAL BANK OF SOUTH AFRICA v PARKER AND OTHERS 2005 (2) SA 77 (SCA), CAMERON JA (as he then was), expressed the view that 'while outsiders have an interest in self-protection, the primary responsibility for compliance with formalities and for ensuring that contracts lie within the authority conferred by the trust deed lies with the trustees.' (at 89F)

[16] In my view the stance of the defendants in persisting that more was required of the plaintiff [INVESTEC] when it sought and accepted the suretyship from Kudu Trust to satisfy itself that it was for the benefit of the trust and the beneficiaries has precisely such an effect. Its import would seek to absolve the trust from the assessment it made regarding the profitability of the venture and hold the plaintiff culpable for its failure to, as it were, second guess the trust's own projections and motivations. Such an approach militates against simple logic and the dictates of business efficiency which should characterize the dealings between a trust and the outside world."

It is clear from the above that the obligation to determine whether a transaction is to the benefit of the trust and the beneficiaries of the trust, primarily rests on the trustees of the trust.

[7] [Page 3-42(4)]

Was there sufficient consent to conclude the suretyship?

Based on the facts before the court it was accepted that the third trustee had resigned from holding such office and, therefore, at the time of signing the suretyship agreement in question, the Kudu Trust only had two trustees, namely the First and Second Defendant, both of whom had duly signed the authorising resolution and had consented thereto.

Were the trustees empowered to conclude the suretyship?

Notwithstanding the fact the trust deed required there to be three trustees at all times, looking at the plain language construction in the trust deed, the court found there to be no limitation on the remaining trustees' powers in respect of executing the deed of suretyship. The court found that the trustees were accordingly empowered, according to the trust deed, to do so.

The Defendants were ordered to pay the Plaintiff together with interest at a rate of 9% and costs on the attorney and client scale.

Conclusion

The decision in the Adriaanse-case provided welcome relief for banks and other third parties (moneylenders) alike. Although the primary responsibility to observe and comply with all the formalities of its trust deed and ensure that contracts fall within the authority conferred by such deed lies with the trustees,it is recommended that before institutions or moneylenders enter into any suretyship agreements with any trust, they should have the following checklist in place to ensure that the trust will be bound by the deed of suretyship:

- ❑ Is the trust deed a valid trust deed?
- ❑ If the trust deed was amended prior to entering into the suretyship agreement, is the amendment valid?
- ❑ Does the letters of authority issued by the Master of the High Court, reflect the trustees representing the trust and entering into the suretyship agreement with the bank/institution?
- ❑ Are the minimum trustees, as required by the trust deed, in office?
- ❑ Does the trust deed authorise the trustees to enter into such an agreement?
- ❑ Has a resolution been signed granting/authorising the particular action by the trustees and did all the trustees participate in the decision?
- ❑ Does the trust deed contain any limitations or prohibitions on the signing of surety by the trust?

One needs to avoid placing a higher standard of diligence on outsiders in their dealings with a trust, than on the trustees themselves when administering their trust duties and powers but it is suggested by GPJ Van Den Berg that trustees provide a bank or institution with an affidavit confirming the above checklist and that the relevant people (credit managers) approving the loan/suretyship at the institution/bank do whatever possible to ensure the validity of the actions of the trust.

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BEE Trusts

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Introduction

A broad-based black economic empowerment ("BEE") trust is one of the mechanisms that gives effect to the objectives of the Broad-Based Black Economic Empowerment Act 2003 ("the Act"). The Act entrenches equality, in the South African workplace, by being a catalyst for effective participation of black people in the economy. Section 9 (1): Codes of Good Practice ("the Code")[1] provides different methods of allowing for economic participation, with one such method being a BEE trusts, it further specifies measurement principles applicable to trusts.

Definitions:

BEE means "*broad*-based *black economic empowerment*"[2];

Broad-Based Ownership Scheme means "*a collective ownership scheme constituted with the view to facilitating the participation of specified natural persons in the benefits flowing from the ownership by that scheme or by its fiduciaries of an Equity Interest in an Enterprise;*"

Economic Interest means "*a Participants Claim against the Enterprise representing a return on ownership of the Enterprise, measured in accordance with the Flow-Through and Modified Flow-Through Principles. In this regard, a Participant's entitlement to receive any payment or part payment on the Participant's Claim from a Measured Enterprise that is not in the nature of a return on ownership in that Measured Enterprise, will be treated as an Economic Interest if such payment is*:

- *not arms-length;*
- *not market-related;*
- *mala fide; or*
- *without a commercial rationale; or*
- *intended to circumvent the provisions of this statement or the objectives of the Act*";

Enterprise means "*a natural or a juristic person, or any form of Co-operative, conducting a business, trade or profession in the Republic of South Africa*";

Equity Interest means "*the entitlement of a Participant to receive an Economic Interest and to exercise a Voting Right in an Enterprise*";

Participant's Claim means "*any claim to payment that a Participant enjoys in relation to a Measured Enterprise, including claims enjoyed through one or more other Enterprises*";

[1] Broad-Based Black Economic Empowerment Act 2003 ["the Act"] Section 9(1): Codes of Good Practice published in Government Gazette 36928 of 11 October 2013 ["the Code"], section 1: Definitions.
[2] *Id*, often broad-based black economic empowerment is referred to as B-BBEE, however, use will be made of the acronym BEE in this article seeing as the definition of BEE encompasses B-BBEE as per the Code.

Voting Right means "*a voting right attaching to an instrument owned by or held on behalf of a Participant, that may be exercised at a general meeting of the shareholders of a company having share capital or any similar rights in any other form of Enterprise measured in accordance with the Flow-Through Principle or the Control Principle."*[3]

The concept of a BEE trust is not defined in the definitions section in the Act or Code. However, there are elements that need to be met in order for the trust to qualify as a BEE trust and achieve its goal.

Qualification criteria for BEE trust

The Code looks at whether the BEE trust achieves the requisite level of black participation in the Economic Interest and Exercisable Voting Rights of a Measured Enterprise. The following requirements must be complied with:

- ‘the entitlement of a black beneficiary to receive distributions or benefits from the trustee(s) of the trust must vest, provided that if such entitlement does not vest, but the trust deed is so structured as to allow the trustee(s) no discretion as to the identity of the black beneficiaries and as to the proportions in which such black beneficiaries will share in Economic Interest received by the trustee(s), this requirement will be deemed to have been met in the absence of vesting;
- the identity of black beneficiaries may be expressed either by reference to
  - the person’s name; or
  - the person’s membership in a specified class of natural persons;
- the proportion in which black beneficiaries will share in the Economic Interest flowing from a trust may be expressed either:
  - as fixed percentage; or
  - as a result of a formula against which that proportion may be determined;
- save to the extent that the trust is a family trust, all the black beneficiaries as identified in terms of the above paragraph must be entitled and able to participate in the appointment of the trustee(s) to the full extent permissible by law;
- the trust deed must be so structured as to require the payment of all accumulated Economic Interest to the beneficiaries of the trust at the earlier of:
  - a date or event specified in the trusts deed; or
  - the termination or winding-up of the trust.’[4]

[3] Section 9(1): Codes of Good Practice, Supra note 1.
[4] I*d* at 100-16.

In essence a BEE trust would be a *bewind* trust[5] as the beneficiaries acquire ownership of the trust assets, as per the trust deed, and the trustees control and administer the trust and assets as per the trust deed.[6]

When setting up a BEE trust is it important to note that the Code is very specific in that the trustees have no discretion in terms of the trust deed. Further, the trustees need to be identified or identifiable in terms of the trust deed as well as the proportions of what they would be entitled to. The reason for the very specific requirements is to ensure that a BEE trust is not used as a veil to achieve certain BEE scores where the beneficiaries will ultimately not benefit from the trust by virtue of the trustees coming to a different decision as to the identity of the beneficiaries or what the beneficiaries are to receive.

In terms of a family trust the identified or identifiable beneficiaries must be entitled and able to participate in the appointment of the trustees; this adds another element to the requirements that need to be kept in mind when dealing with a family that wants to set up a trust for BEE purposes. The Code does not define a family trust and therefore it is assumed that the ordinary meaning of family trust will apply.[7]

To ensure that the beneficiaries obtain all of the Economic Interest they are entitled to, the Code does not leave room for discretion or deviation in that the benefits need to be paid to the beneficiaries as per the trust deed or upon termination and winding-up of the trust.

In terms of how a BEE trust can add to the overall ownership scorecard the following should be noted:

- Black participants in a trust holding rights of ownership in a Measured Entity may contribute:
  - a maximum of 40% of the total points on the ownership scorecard of the Measured Entity if the trust meet the qualification criteria for trusts;
  - 100% of the total points on the ownership scorecard of the Measured Entity if they meet the additional qualification criteria set out for trust.

The maximum of 40% would be attained if the aforementioned qualifying criteria is met. It should be noted that there are a lot of grey areas in the legislation and sometimes meeting those criteria is not as simple as it might seem.

[5] Pace and Van der Westhuizen, Wills and Trusts, LexisNexis Butterworths, Durban latest version, Division B Trusts, B4, 4.2.2.1.
[6] Botha et al, The South African Financial Planning Handbook 2017, Lexis Nexis Durban, at page 825.
[7] *Supra* note 5

The additional qualifying criterion that needs to be met in order to attain 100% ownership points is that the trust must provide a certificate issued by a competent person that:

- ❑ The trust was created for a legitimate commercial reason, which is disclosed on the certificate; and
- ❑ The terms of the trust do not circumvent the Act or the Codes.

A competent *person* is defined "*as an individual who has acquired the requisite knowledge and skills to undertake any task assigned to them under the Codes*."[8]

Conclusion

When considering setting up a BEE trust it is important that it is done for a reason that is in keeping with the ambit of the legislation. Further, it must be done for proper commercial reasons. It is important to note that there are many grey areas in the legislation and therefore it is best to strictly adhere to the qualifying criteria in order for the trust to be considered a BEE trust.

[8] Article by BEE SEESA, "5 Benefits of a BEE Trust: How your business can benefit from registering a BEE trust and how it is structured to boost your BEE rating" from the Essential BEE Series page 3.

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Essential BEE Series "5 Benefits of a BEE Trust: How your business can benefit from registering a BEE trust and how it is structured to boost your BEE rating"

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Introduction

Making decisions about our lives is a very important part of our lives. The ability to enter into legal transactions or agreements and to be able to litigate independently is very closely related to one's mental state of health. Diseases, such as Alzheimer's and dementia or even a stroke, can result in a person having diminished mental capacity.

The general rule is that all major individuals are presumed mentally and legally competent to manage their own affairs until such time as the contrary is proved.

The issue however is how one addresses the problem of a major individual that has been diagnosed to have a diminished mental condition, to be able to sort out their financial affairs. There are various options available each with their own advantages and challenges and this article will try to focus on describing which of these options is the correct choice or choices to suit the individual and the family concerned.

Will

For instance, once a person is diagnosed with Alzheimer's disease, it is vital that a will is drafted as soon as possible. As it is probably the last will and testament the affected person will be able to draft legally. It is important that professional assistance be obtained to ensure that the will complies with all the legal requirements. Not only is the will of this person important but also the will of the spouse. It might even be necessary for the spouse's will to allow for the setting up of a testamentary trust, with competent trustees, to ensure the smooth administration of the deceased estate in the event of the unaffected spouse's untimely death.

It is important for the person advising the testator or testatrix to ensure that they not only understand the content of the will and the effects thereof, but to establish that the person is making the disposition without any undue influence from anyone else.

As the mental state of an affected person may fluctuate a will may be drafted during a "lucid interval". It is recommended that this will be signed with a medical practitioner present as the practitioner will be able to issue a report confirming that the affected person was of sound of mind at the time of signature and understands the implications and nature of the document. This recommended procedure should be followed in conjunction with the normal legal requirement of two independent witnesses being present at the time of signature and will play a big role should the last will and testament be contested on death.

It is important to note that the criteria for assessing testamentary abilities are legal and not clinical and therefore are decided by a Court.[1]

Power of Attorney

A Power of Attorney has become a very general and popular document used in recent times. Older and frail people often give a power of attorney to one of their children or a trusted person to transact on their behalf. These transactions normally include banking, insurance, tax and investments but can also include the buying and selling of shares, movable assets and fixed property.

The most important fact regarding a Power of Attorney is that South African common law determines that the power of attorney only remains valid for as long as the person who grants this power is still capable of appreciating the concept and consequences of granting another person his or her power of attorney. The moment a person becomes mentally incapacitated and is no longer capable of managing their own affairs, the power of attorney lapses immediately.

One of the recommendations made in 2004 by the South African Law Reform Commission was that an enduring power of attorney should be implemented, but more than 12 years later the matter is still not addressed and there are currently no expectations that anything will change in the near future.[2]

In the light of this, it is unfortunately clear that having a Power of Attorney will not solve any problems and has very little value once it is determined that a person has diminished mental capacity. The only other options available, where there is a lack of mental capacity, are discussed below.

Curator Bonis

The appointment of a *curator bonis* requires a High Court application and the procedure is set out in the Mental Health Care Act.[3] The cost of such an application may vary between R60 000 and R120 000 and is usually borne by the estate of the affected person.

The court will firstly appoint a *curator ad litem*, normally an advocate, whose duty is to investigate the affected person's assets and liabilities and report back to the High Court and the Master of the High Court. This report will include a nominee as *curator bonis* and will list the powers of the *curator bonis* and the amount of the security bond required. The nominee will

[1] Professor T Zabow: Decision-making in adults with impaired capacity. Testamentary capacity and curatorships SA Journal of Bioethics and Law 2008 1(2): 1-3
[2] Lize de la Harpe: Power of Attorney in South Africa – The shortfalls Legal Matters 10 January 2014 Volume 38.
[3] Act 17 of 2002

only be able to act once formally appointed by the Master of the High Court. Thereafter the *curator bonis* is obliged to lodge a curatorship account with the Master of the High Court accounting for the income and expenses on an annual basis.[4] The *curator bonis* is allowed an annual fee of 6% on gross revenue accrued in the estate from dividends, pension, interest and rental agreements etc. and there is also a once-off fee of 2% on capital available in the estate on the date the curatorship ends, which normally happens on death.[5] The deceased estate will then be handed over to the executor appointed in the will, who then winds up the deceased estate charging their fees as per tariff.[6]

It is important to remember that a *curator bonis* may not institute an action for divorce or draft a will on behalf of the affected person.

The challenge however is that these applications can take months to obtain the necessary court orders. In some instances the person nominated as *curator bonis* does not necessarily have to be a court appointed professional person. A family member can be appointed in such a capacity as long as the court waives the bond of security requirement, but where this happens it leaves the affected person exposed to risk and potential abuse of funds with very little recourse.

Administrator appointed by Master of the High Court

The Mental Health Care Act provides for the Master of the High Court, after receiving an application and after conducting their investigations, to appoint an administrator to administer the property of a person with a mental incapacity.[7]

This is a far less costly procedure than applying for a *curator bonis*. The applicant can lodge the application directly with the Master of the High Court and does not need to work through an attorney. There is also no application fees charged for processing such application.

Should the value of the person's assets be below R200 000 and the annual income below R24 000 then the Master can appoint an administrator without any further investigations. If the value of the assets and income of the person however is more than figures mentioned above, the Master must appoint an interim administrator to investigate the assets and liabilities before a final administrator is appointed. In such an instance the costs of the investigation, normally between R2 500 and R15 000 will be borne by the estate of the affected person.

The challenge here is still one of time as it can take up to 5 months to appoint an administrator. Another disadvantage is the file at the Master's office is a public document and is therefore

[4] Section 83(1) Administration of Deceased Estates Act 66 of 1965
[5] Section 84(1) Administration of Deceased Estates Act 66 of 1965
[6] Regulation 8(3) Administration of Deceased Estates Act 66 of 1965
[7] Sections 59 – 60 of the Mental Health Act 17 of 2002

available for perusal by members of the public. A further major shortfall in using the administration route is that according to the rules of the Mental Health Care Act this process is available only to "*a mentally ill person or a person with severe or profound intellectual disability*". Therefore, an older frail person of sound of mind but not in a position to manage their own affairs, fall outside of this narrow definition and may not make use of the administration procedure, but fortunately in most of these instances a power of attorney should suffice.[8]

An administrator must also account annually to the Master of the High Court, using the same fee structure as that of the *curator bonis*.

The powers given to an administrator are less comprehensive than that of a *curator bonis* and therefore it is important to take note of the type of assets the client has when deciding to go this route. The Master of the High Court does not have the authority to consent to any speculative investments where there is risk and uncertainty and only condones investments where the capital is guaranteed.[9]

Trusts

Another option to consider is for the affected person to set up an Inter Vivos trust to transfer assets into. This will have to take place while the person is still able to manage and understand the significance of what they are doing.

Once again there is a cost implication of approximately R10 000 in setting up the trust. Some of the disadvantages are the time it takes to register a trust with the Master of the High Court and complying with the statutory requirements. Only once these requirements are complied with, can the affected person transfer assets to the trust. Other issues that need to be considered before deciding to set up a trust are that, depending on the type of assets held, whether there are sale agreements to be signed in the future or various other tax implications[10] which need to be taken into consideration as well as the costs associated with the running and administration of the trust, which might, depending on the facts of the relevant case, lead to it not making financial sense to go this route.

Conclusion

One of the recommendations that were made in the 2004 report by the Law Reform Commission was that a legal framework be put in place to govern informal day to day decisions made by family members. This will enable people to give advance instructions as to how they would like their affairs to be managed when they are no longer capable of doing so themselves. This recommendation will offer a more accessible alternative to the current curator systems in place

[8] M King: When someone must act for you. Personal Finance 9 May 2015
[9] Ex Parte Ewing NO: In Re Sheridan 1995 (4) SA 101 D &CLD
[10] Tax implications such as capital gains tax, transfer duty, interest on loan accounts, donations tax

by using simple and inexpensive measures, but unfortunately parliament has not yet taken this further.[11]

From the above one can see that it is vital that people that are either diagnosed with an illness that leads to diminished mental capacity or become old and frail and not able to manage their own affairs, get their affairs in order sooner rather than later. They need to update their financial and health care arrangements utilising the services of a professional to advise and assist them in the drafting of their wills, a living will, setting up of trusts and giving advanced instructions such as "*do not resuscitate if required*" and as to who and in what format their assets should be managed.

[11] B Bertrand: The need for enduring powers of attorney for older persons with impaired decision-making capacity De Rebus, 2011 (May) DR38.

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GEPF and the Clean Break Principle

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Introduction

In 2011 the Government Employees Pension Laws of 1996 was amended by the Government Employees Pension Law Amendment Act [1] hereinafter referred to as GEPL Amendment Act and introduced the clean break principle to align the pension fund with private sector pension funds, the latter having been introduced to the clean break principle 3 years earlier through an amendment to the Pension Fund Act[2] and the Financial Services Laws General Amendment Act, which took effect on 1 November 2008.

What is the clean break principle? The clean break principle applies in the event of a divorce and gives a non-member spouse (of a retirement fund) a right to immediate payment or transfer to an approved fund, in his or her own name, an allocated portion of the pension interest from a retirement fund of which his or her spouse is a member. This right is enforceable by the non-member spouse shortly after divorce provided it has been recorded in the divorce order which has been endorsed by the court.

There is often a misunderstanding about the usage of the words 'pension interest' and 'fund value'. These words may not be used interchangeably because it is not one and the same value. A non-member spouse may share in the pension interest of the member spouse's retirement fund and not the fund value. Incorrect usage of these words in divorce orders and settlement agreements cause unnecessary delays in the process of giving effect to the clean break principle.

Section 7(7) of the Divorce Act[3] provides that pension interest is deemed to be part of the assets in determining the patrimonial benefits in a divorce action. However the pension interest may be reduced by previous awards made against the pension interest. It is important to note that Section 7(7) does not apply to a divorce action in respect of a marriage out of community of property entered into on or after 1 November 1984 in terms of an antenuptial contract by which community of property, community of profit and loss and the accrual system are excluded.

The Government Employees Pension Law,[4] defines pension interest as follows:

"'pension interest' in relation to a member of the Fund who is party to an action for divorce or for the dissolution of a customary marriage, means the benefits 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 or the dissolution of a customary marriage on account of the member's resignation from the service of the employer"

[1] 19 of 2011
[2] Pensions Fund Amendment Act, 11 of 2007
[3] 70 of 1979
[4] As amended by the Government Employees Pension Laws Amendment Act 19 of 2011, section1 (b)

This definition is in keeping with the definition of pension interest in terms of the Divorce Act[5] as well.

Section 7(8) of the Divorce Act makes provision for the courts to grant an order that any part of the pension interest of a member is due and assigned to the other party to a divorce action. Read with the amendment to section 37D of the Pensions Fund Amendment Act[6] the benefit referred to in section 7(8) of the Divorce Act is deemed to accrue to the member on the date a decree of divorce is granted. Section 24A (2) of the Government Employee Pension Law[7] aligns itself with the section 37D amendment for the purposes of section 7(8) of the Divorce Act.

The GEPF implemented the clean break principle through section 24A read with Rule 14.10 of the Government Employee Pension Fund[8].

However the manner in which clean break principle is applied by the GEPF has come under much scrutiny and criticism.

MC Marumoagae, an attorney wrote in his article regarding the divorce debt "*the GEPF board of trustees took a unique decision to establish a procedure within GEPF rules which allows the fund to comply with the clean break principle by effecting payment to the non-member spouse to satisfy the divorce order, but in the process unjustifiably creating a "debt" for it divorcing members. However, the fund does not assign portion of its divorcing member's pension interest to the non-member spouse. Instead, the fund pays such an amount from its reserves without interfering with the member's pensionable service generally or the pension benefits specifically of its divorcing member[9].*"

The provision of Rule 14.10.9 and Rule 14.10.10 are somewhat contentious rules. Reference is made to the "divorce debt" created by a payment to the member in terms of Rule 14.10 and the reduced benefits which the member subsequently becomes entitled to.

"14.10.9 When a benefit becomes payable to the member in terms of these rules-

14.10.9.1 The amount of the gratuity, if any, then payable to the member must be reduced by the amount of the divorce debt; and

14.10.9.2 If the amount of the divorce debt exceeds the amount of the gratuity and there is an annuity payable to the member then-

(a) The capital value of the annuity must be determined by the actuary;

[5] 70 of 1979
[6] 11 of 2007
[7] Government Employee Pension Law Amendment Act 19 of 2011
[8] General Note 276 of 20 June 2012
[9] Marumoagae MC, " Concern regarding the "Debt" created by Rule 14.10.9 of the Government Employees' Pension Fund Rules, *PER/PELJ* 2016(19)- DOI page 4

(b) The value determined by the actuary must be reduced by an amount equal to the balance of the divorce debt then remaining; and

(c) The *capital* value that results from this calculation must be annuitised by the *actuary on a basis determined by the board in consultation with the actuary to determine the amount of the annuity which will then be payable.*

14.10.10 The balance of the gratuity, if any, and the annuity, or annuity adjusted in terms of rule 14.10.9 as applicable will be the benefit or benefits to which the member will be entitled in place of the benefit or benefits to which he or she would have been entitled, but for the operation of this rule."[10]

The above is the law as it stands currently.

In MC Marumoagae's opinion the above approach is rather prejudicial towards divorcing members of the fund because the fund *lends* its divorcing members money to settle the non-member spouses' claim, while its members already have resources in the form of their pension interests which would enable them to satisfy such claims[11]. Section 7(8) of the Divorce Act clearly makes reference to "pension interest" to be assigned to the non-member spouse and by the fund creating a "debt" for the divorcing member through rule 14.10.9 this appears to be against the spirit of section 7(8) of the Divorce Act.[12]

Furthermore these loans or "debt" as they are referred to by the fund accumulates interest. If the interest is high, the "divorce debt" can eventually exceed the benefit the member is entitled to. The latter defeats the very purpose of having a pension fund.

The Public Service Co-ordinating Bargaining Council (PSCBC) have signed an agreement with the State ("the employer") [13] in June 2017 to amend the application of the clean break principle from a debt approach to a "service adjustment approach" by doing away with the debt approach and instead there would be an adjustment of the members service following payment of the divorce settlement by the Fund [14]

Further details about this approach is yet to be established such as whether it would be retrospectively applied, how to deal with members currently paying off divorce debt and pensioners who have been adversely affected by the debt approach.

The agreement will only come into effect after the GEPF Rules have been amended and gazetted.

[10] *Id.* at 8
[11] *Id* .at 7
[12] *Id* at 9
[13] Public Service Co-ordinating Bargaining Council Resolution 1 of 2017
[14] *Id* at 13, page 4

Options available to the non-member spouse

Rules 14.10.1 to rule 14.10.7 of the GEPF rules deal with the election of the options the non-member spouse has in respect of the pension interest and the time frames, the manner of payment of his or her portion in accordance with the divorce order and the recording of the "divorce debt" by the fund.

The non-member spouse has two options available to him or her in respect of their allocated portion of the pension interest. He or she may elect to have the amount:-

(1) Paid directly to themselves as a cash lump sum. The cash lump sum will be taxed on the lump sum withdrawal tax scale[15]. There will however be no tax payable for divorce orders granted prior to 13 September 2007, irrespective of the date of payment;

(2) Transferred to an approved retirement fund. The transfer will be tax neutral. When the non-member spouse eventually retires from the transferee retirement fund he or she will be entitled to a cash lump sum up to one third and a minimum of two thirds must be utilised to purchase an annuity. The cash lump sum will be taxed on the lump sum retirement tax scale[16] and the annuity will be taxed in accordance with the marginal tax rate of the former spouse.

Pre-1998 tax free benefits:

In the event that the member spouse has pre-1 March 1998 years of service, both spouses are to retain the tax free benefits of the member's pre-1998 years of service.[17]

Example[18]

Facts: Mr A joins Government in 1990. He remains in service until 2014. In 1992 he marries Ms D. They get divorced in 2008. According to the divorce order, Ms D is entitled to 40 per cent of Mr A's retirement interest as at the date of divorce. On the date of divorce, Mr A's retirement interest is valued at R2 000 000. Ms D is therefore entitled to R800 000. In 2012, Ms D elects to receive the benefit, and the retirement fund pays Ms D R800 000 less any tax liability.

[15] Income Tax Act
[16] *Id*
[17] Hotline No5/2013, at 2
[18] Explanatory Memorandum Taxation Laws Amendment Bill 2012, at 8

Results: With regards to the application of the relief in respect of pre -1998 years, the calculation of the taxable amount will be:-

Completed years of service of the member post-1998 as at date of the lump sum becoming payable (1998-2012)	14 years
Total completed years of service of the member as at date of the lump sum becoming payable (1990-2012)	22 years
Value of lump sum becoming payable	R800 000

$$\frac{14 \text{ years}}{22 \text{ years}} \times \text{R800 000}$$

= **R509 091 (taxable lump sum)**

We can see from the above example that Ms D retains R290 909 (R800 000 *less* R509 091) as the pre-1998 tax relief to her portion of the pension interest and the amount of R509 091 will be the taxable portion only.

The member spouse will also retain the pre- 1998 tax free relief but in proportion to the cash lump sum or gratuity to which he becomes entitled.

Conclusion

The current 'divorce debt' which the GEPF creates for its divorcing member to satisfy the payment to the non-member spouse is a setback for them in terms of their retirement financial security. GEPF is the only fund which implements a debt system for its divorcing members.[19]

The Agreement signed between PSCBC and the State regarding an impending amendment of the application of the clean break principle by the GEPF appears to be a positive step but we await further details about the new approach.

It is important that clients who are members of retirement funds and who have been, or are going through a divorce seek financial advice to build up sufficient retirement capital to replace what has been, or will be lost as a result of the clean break principle. Furthermore, it is of equal importance that non-member spouses, are assisted in the process of electing the most appropriate option in respect of their allocated pension interest to secure a better retirement for themselves.

[19] Marumoagae, *supra* note 8 at 13

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Hotline No 5/2013

Public Service Co-ordinating Bargaining Council Resolution 1 of 2017

Explanatory Memorandum Taxation Laws Amendment Bill 2012

Beneficiary nominations on policies – Advantages and Disadvantages

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Introduction

It seems that there is some uncertainty in some instances on the implications and advantages and disadvantages of nominating beneficiaries on insurance policies. When beneficiary nominations are discussed, it is important to take note of the legal structure and basis of beneficiary nominations and the rights of the policy owner and that of the nominated beneficiary. The article will also include a discussion on the advantages and disadvantages of nominating beneficiaries as well as the impact of nominating minors as beneficiaries on policies. Although beneficiaries can be nominated on various types of policies and it could be for the proceeds of the policy or for ownership of the policy, this article will only focus on the beneficiary for proceeds on life insurance policies. Lastly, two case studies pertaining to beneficiary nominations from the Office of the Ombudsman for Long-Term Insurance will be discussed.

The legal basis of a beneficiary nomination

When a policyholder (owner) nominates a beneficiary, he or she would, in most cases, nominate someone as a beneficiary for proceeds of the policy. In simple terms this means that on the death of the life assured the proceeds of the policy will be paid to the nominated beneficiary on acceptance of the benefits by the beneficiary. A beneficiary nomination is generally classified as a *stipulatio alteri* contract or a contract in favour of a third party. Where a policy forms part of a community of property marriage both spouses need to give consent to nominate a beneficiary on the policy. For this contract to be completed, the beneficiary must accept the nomination or the benefit itself.

It is not necessary for the consent of the nominated beneficiary for the contract to be valid but it is however important for the beneficiary to be in existence at the time that the benefit becomes payable. If the beneficiary is not in existence at that time, the nomination falls away and the benefit will pay into the estate of the policyholder, if he is also the life assured or to the policyholder itself if he is not the life assured.[1] The beneficiary nomination can be revoked at any time by the policyholder before the death of the policyholder or life assured and prior to acceptance of the nomination by the beneficiary. The consent of the beneficiary is not required to revoke the nomination nor does the insurer have to inform the beneficiary of the revocation.[2]

Parties to a beneficiary nomination

This leads to the next important aspect, which is the different parties to the beneficiary nomination. Typically there would be three parties to the nomination, namely the policyholder (owner), the insurance company and the nominated beneficiary. The policyholder enters into an agreement with the insurance company that in the event of the life assured dying, the insurer will pay the policy benefit to the nominated beneficiary. In some instances the policyholder will

[1] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2017) at Chapter 10.8.2
[2] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2017) at Chapter 10.8.3.5

also be the life assured and in other instances the policyholder will be someone other than the life assured. If the life assured and the policyholder is the same person then the policy proceeds becomes due on the death of the life assured. By accepting the benefits under the policy, the proceeds will then become payable to the beneficiary.

If the beneficiary should pass away after the life assured's death and has failed to accept the benefits during his own lifetime, the beneficiary's executor can accept the benefit if it is done in good time and has not been previously revoked. If the beneficiary should pass away before the life assured and the insured had expressly reserved the right to change or cancel the beneficiary nomination at any time, the beneficiary does not have any rights to the benefits of the policy and therefore no benefit vests in the estate of the beneficiary.[3] Should the policyholder not be the life assured and the life assured pass away the policyholder still has the opportunity to claim the death benefit for themselves before transferring the benefit to the beneficiary. Should the policyholder claim the benefit for themselves then the beneficiary will not receive anything. However if the policyholder does not cancel the nomination and claim the benefit, the beneficiary will be free to accept the benefits under the beneficiary nomination.[4]

Cessions and beneficiary nominations

It is well known that contractual rights, including rights under policies can be ceded freely. It is important to distinguish between security cessions and a change of ownership cession or the so-called out-and-out cessions. The situations is unclear whether a cession, security or out-and-out, cancels or revokes the beneficiary nomination automatically. The popular view is that the wording of the policy contract will determine whether a cession cancels the beneficiary nomination. If the policy contains a provision that any cession cancels the beneficiary nomination, the effect will be that the beneficiary nomination falls away and no benefit can be accepted by the beneficiary at the death of the life assured.

In the event of a security cession, the remainder of the policy proceeds after settlement of the debt will then have to be paid into the estate of the deceased or to the policyholder if he/she is not the life assured. In the event of an out-an-out cession, the cession will then cancel the beneficiary nomination and the new owner can then appoint a new beneficiary if he or she so wishes. Should the policy wording read that the cession does not cancel any beneficiary nomination, the cessionary is substituted for the policyholder and now holds the ceded rights to the policy. The beneficiary nomination remains in place and the beneficiary can claim the benefits at the death of the life assured if the nomination has not been revoked.[5] It is also held that the cessionary can revoke the beneficiary nomination because it forms part of the policyholder's rights that was ceded to the cessionary.[6]

[3] PPS Insurance Company v Mkhabela (1959/2011) [2011] ZACSA 191
[4] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2017) at Chapter 10.8
[5] M Botha, L Rossini, W Geach, B Goodall and L Du Preez, South African Financial Planning Handbook (2017) at Chapter 10.8.3.4
[6] Nienaber , "Some problems involving security cessions of life insurance policies" 2004 SA Merc LJ 83 at 100

Advantages of nominating a beneficiary on a life policy

- The death benefit can be paid out to the beneficiary without having to wait for the estate to be wound up and as soon as the claim has been recognized and there is no challenges from other beneficiaries;[7]

- The proceeds of the policy does not fall in the estate and therefore no executor's fees is payable on the benefit unless the beneficiary nomination has been revoked and the proceeds pays to estate of the life assured;[8]

- The policyholder can act freely with the policy during his life or the life of the life assured. The policyholder has the right to cancel or change the beneficiary nomination at any time until the benefits becomes payable on the death of the life assured;

- By nominating beneficiaries on the policy the policyholder can make sure that the people he/she wants to benefit from the policy does so and that it is not used to settle/pay debts in the estate;

- In terms of current case law the proceeds of a life policy will not form part of an insolvent deceased estate unless the beneficiary renounces the benefit;[9]

- By appointing trusts and/or guardians as beneficiaries on behalf of minor children the policyholder can avoid benefits having to be paid into the Guardians Fund.

Disadvantages of nominating a beneficiary on a life policy

- The benefits payable to the beneficiary does not enjoy the protection of a testamentary provision that excludes the benefits from a marriage in community of property or those subject to the accrual system;[10]

- In the event of a marriage or a divorce or changes to wills, policyholders sometimes neglect to change beneficiary nominations which could lead to benefits being paid to beneficiaries who were not supposed to receive the benefits. Beneficiary nominations are not automatically changed when someone gets married or divorced;[11]

- When a policyholder dies and the policy proceeds are payable to a beneficiary who lives in another country it is then important to note that the payment of the proceeds is not automatically exempt from exchange control regulations. Distributions and bequests from the estate of a deceased may be freely transferred to a non-resident on production of the liquidation and distribution account. Beneficiary nomination proceeds does not qualify as a bequest from the estate and therefore does not automatically qualify for the exchange control exemptions. Conditions can then be imposed on the payment of benefits to non-residents, especially if the non-resident was previously a resident in South Africa and is no longer a resident when the payment becomes due. Conditions may then apply that the

[7] Weeg voor-en nadele op voordat 'n polis begunstig word – Article from Sanlam Trust – July 2012
[8] Weeg voor-en nadele op voordat 'n polis begunstig word – Article from Sanlam Trust – July 2012
[9] Pieterse v Shrosbee and Other; Shrosbee NO v Love and Others [2004] 11 BPLR 6187 (SCA)
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[11] Weeg voor-en nadele op voordat 'n polis begunstig word – Article from Sanlam Trust – July 2012

person need to formally emigrate before they are regarded as non-residents for the purposes of this concession.[12]

- Beneficiary payments cannot be made to beneficiaries who lacks capacity to act on their own. In this event the proceeds will have to pay out to the *curator bonis* or the administrator as appointed in terms of the Mental Health Care Act[13] of the person who lacks capacity to act. This might be addressed by making use of a testamentary trust for the benefit of such a person.

- The policyholder can nominate a minor on a life policy but the proceeds of the policy will not be paid out to a minor beneficiary directly. The proceeds of the policy will usually pay out to the minor's legal guardian. This could obviously be problematic as the proceeds might end up in the hands of someone other than the person for whom it was intended. If the parents of the minor are divorced then the proceeds of the policy will be paid to the ex-spouse as legal guardian of the minor. This is assuming that the ex-spouse is the legal guardian. The money could then end up being used for something else which is exactly what the policyholder wanted to avoid.

  Payments to a guardian could also be problematic because a minor could have more than one guardian. The Children's Act[14] defines a guardian as *"a parent or other person who has guardianship of a child"*. Section 18(4) of the Children's Act determines that every person who qualify as a guardian in terms of the Act will be competent to act independently and without the consent of the other. The question then arises who will accept and hold the benefits on behalf of the minor as both legal guardians will be competent to accept and hold the benefits. If no guardian was appointed for the minor child, the proceeds of the policy will have to be paid into the Guardian's Fund until the minor reaches the age of majority, which is currently 18 years.[15]

- As already mentioned, in some instances the proceeds of policies where a minor is the beneficiary will have to be paid into the Guardian's Fund. The Guardian's Fund falls under the stewardship and administration of the Master of the High Court. Although the Guardian's Fund has to manage and invest the money for the minor's benefit, it could be very difficult and cumbersome for the minor's guardian to access the money. To claim maintenance from the fund, a prescribed form needs to be completed and this needs to be accompanied by supporting documents including quotations and accounts and a prescribed process needs to be followed to institute a claim against the fund. The interest on investments received in the fund is generally also lower than would be achievable with other investments.[16]

  Another problem that arises is that insurers have differing approaches to this situation. Insurers are sometimes reluctant to pay money directly to guardians or into the Guardian's Fund even if that is what legislation dictates. This might lead to uncertainty on what exactly will happen with regards to minor's benefits. Policyholders need to find out how their insurers will approach the situation to make sure that payment is made according to their wishes.

[12] Weeg voor-en nadele op voordat 'n polis begunstig word – Article from Sanlam Trust – July 2012
[13] Act 17 of 2002
[14] Act No. 38 of 2005, Chapter 1
[15] Lize de la Harpe – Nominating a minor as a beneficiary on a life insurance policy – March 2016
[16] Lize de la Harpe – Nominating a minor as a beneficiary on a life insurance policy – March 2016

Case Studies from the Office of the Ombudsman for Long-Term Insurance

Case Study 1

The policyholder nominated her minor daughter as beneficiary on a life policy. On her death the insurer insisted on paying the death benefit into a trust. The grandmother was appointed as the legal guardian of the daughter and she then complained to the Office of the Ombudsman because of the insurer's refusal to pay her. The Ombud informed the insurer that they had an obligation in terms of the law to pay the grandmother. The insurer informed the Ombud that they were willing to pay the benefit but would prefer to pay it into a trust to safeguard the money for the minor. The Ombud requested the guardian to consider this arrangement which she then accepted.[17]

Case study 2

The life insured was married in community of property to the complainant and had two policies with two different insurers. While married, she nominated her daughter as beneficiary on these policies by signing beneficiary nomination forms. The forms made provision for the signature of the insured's spouse if married in community of property. The husband did not sign any of the beneficiary nomination forms.

Following the death of the insured both the insurers then paid the daughter as per the beneficiary nomination. The husband then complained to the Office of the Ombud by contending that by not signing the beneficiary nomination he has lost his half share of the proceeds to which he was entitled to as a consequence of being married in community of property. He argued that his written consent was needed in terms of the Matrimonial Property Act.[18] The insurers rejected his claims based on the contention that the insured did not advise them that she was married in community of property. The Ombud agreed with the insurers in that the insured should have provided them with her marital status and that there was no obligation on the insurers to investigate how the insured was married. They could not have known that the provisions of the Matrimonial Property Act [19] was breached. The Ombud however suggested that the complainant must pursue the remedy against the estate as is provided for in legislation.[20]

Conclusion

From the above it is clear that nominating a beneficiary in a policy does not always mean that the proceeds will be paid out as the policyholder intended. The policyholder needs to make sure that the insurer will pay out to the intended parties, especially in the case where minor children have been nominated as beneficiaries. The impact of money being paid unintentionally into the Guardian's Fund must be carefully considered as well as the risks of money being paid directly to guardians. To safeguard the proceeds of life policies for minor beneficiaries, the use

[17] OMBUZZ, Office of the Ombud for Long-Term Insurance, Issue No. 32, November 2015
[18] Section 15(2)(c) of Act 88 of 1984
[19] Act 88 of 1984
[20] OMBUZZ, Office of the Ombud for Long-Term Insurance, Issue No. 32 November 2015

of testamentary trusts should be considered. It is also necessary for policyholders to take note of the impact of cessions of policies on the beneficiary nomination that has been noted on the policy before cession. A cession could lead to unintended consequences by cancelling a beneficiary nominations when the policyholder thought otherwise.

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Levying interest in sale agreements and the contractual implications thereof

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Introduction

It is common practice for parties in a sale agreement to include a clause that deals with interest payable on the outstanding capital. However, this may be something of the past due to a recent judgment in the Supreme Court of Appeal (hereinafter referred to as "the SCA").

In the unreported judgment of Vesagie No & Others v Erwee No & Another [1](hereinafter referred to as "the Vesagie-case") the SCA had to consider whether the National Credit Act, Act No 34 of 2005, (hereinafter referred to as "the NCA") was applicable to sale agreements, and if so, whether sale agreements where the seller was not registered as a credit provider in terms of the NCA are valid.

The Background of the Vesagie-case

During October 2008 the parties, namely the Paul Erwee Trust and the Ben Trust, entered into a sale of shares agreement (hereinafter referred to as "the agreement") in terms of which the Ben Trust purchased the Paul Erwee Trust's shareholding in various companies.

The purchase price for the shares was R 15 million, whereof R 5 million was payable 12 months after the conclusion of the agreement, the balance of R 10 million being payable 18 months after the conclusion of the agreement.

The purchase price clause provided that interest, at a rate of prime minus 1 was to be levied[2]. The Ben Trust only paid an amount of R 750 000 and thereafter no further payments were made. Due to the Ben Trust's failure to make further payments, the Paul Erwee Trust instituted legal action wherein the Trust claimed the balance of the purchase price, interests and costs.

The Ben Trust argued that the Paul Erwee Trust's claim should fail because the transactions fell within the ambit of section 8(4)(f) of the NCA which rendered the agreement null and void, due to the fact the Paul Erwee Trust was not registered as a credit provider.[3]

The issues before the SCA was reduced to a single legal question, namely *whether the agreement, on a proper interpretation thereof constitutes a credit transaction as provided for in terms of section 8(4)(f) of the NCA*.

[1] (734/2013) [2014] ZASCA 121
[2] Vesagie No & Others v Erwee No & Another (734/2013) [2014] ZASCA 121 at paragraph 2.2
[3] JR Hol, De Rebus November 2016: DR34

If the agreement was found to constitute a credit agreement as contemplated by the Act then the court would be obliged to declare the agreement null and void *ab initio*[4] since the Paul Erwee Trust was not registered as a credit provider in terms of section 40 of the NCA.

What constitutes a Credit Agreement in terms of the NCA

According to section 8(4)(f) of the NCA an agreement constitutes a credit transaction where payment of an amount owed by one person to another is deferred and any charge, fee or interest is payable to the credit provider in respect of the agreement or the amount that has been deferred.

In the Vesagie-case it was found that the agreement was an agreement as set out in terms of section (8)(4)(f), in that:

- ❑ the payment was deferred; [5] and
- ❑ interest was payable in respect of the agreement[6] or the amount that has been deferred. [7]

When must a person be registered as a Credit Provider?

According to section 40 of the NCA a person must be registered as a credit provider if:

- ❑ that person, alone or in conjunction with any associated person, is a credit provider in at least a 100 credit agreements, other than incidental credit agreements[8].[9]; or
- ❑ the total debt owed to that credit provider under all outstanding credit agreements, other than incidental credit agreements, exceeds the threshold prescribed in terms of section 42(1) of the NCA, as determined by the Minister from time to time.[10] The threshold at the time of the Vesagie-case was R 500 000, however the threshold has since been changed by the Minister to nil (R0).[11]

Sections 89(2) and 89(5) of the NCA provides that:

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[4] From inception
[5] Section 8(4)(f) of the National Credit Act of 2005
[6] Section 8(4)(f)(i) of the National Credit Act of 2005
[7] Section 8(4)(f)(ii) of the National Credit Act of 2005
[8] Incidental credit agreement in terms of section 1 of the National Credit Act of 2005 means:
An agreement, irrespective of its form, in terms of which an account was tendered for goods or services that have been provided to the consumer, or goods or services that are to be provided to a consumer over a period of time and either or both of the following conditions:
(a) a fee, charge or interest became payable when payment of an amount charged in terms of that account was not made on or before a determined period or date; or
(b) two prices were quoted for settlement of the account, the lower price being applicable if the account is paid on or before a determined date, and the higher price being applicable due to the account not having been paid by that date.
[9] Section 40(1)(a) of the National Credit Act of 2005
[10] Section 40(1)(b) of the National Credit Act of 2005
[11] General Notice 513 Government Gazette 39981 of 2016

- a credit agreement is unlawful if at the time the agreement was made, the credit provider was not registered to be a credit provider. [12]

- If a credit agreement is found to be unlawful, despite any provision of common law, any other legislation or any provision in the agreement to the contrary, a court must order that the agreement is void from the date of inception. [13]

In the Vesagie-*case* the SCA found that the agreement in question fell under the ambits of a credit transaction as envisaged in section 8(4)(f) of the NCA and the seller's failure to register as a credit provider, as is required in the NCA, rendered the agreement null and void *ab initio* in terms of section 89(5) of the NCA.

Exceptions

There are however certain exceptions where a credit provider is not required to register as a credit provider as contemplated in the NCA. Section 4 of the NCA provides that a credit provider/ supplier will not be required to register as a credit provider if:

- The transaction is not 'at arm's length'.[14] In Eden Court Holdings (Pty) Ltd v Khan[15], the Western Cape High Court dealt with a matter where an employee made a loan to an employee, which was interest free. The employer had the right to change the interest rate to prime less 5% in the event that the employee's employment was terminated prior to the loan being repaid. The question in issue before the court, was whether the loan agreement was subject to the NCA. The court held that the parties were not dealing with each other at an arms' length because it is a normal consequence of a loan agreement that the lender, taking into consideration the risk he assumes, will charge interest as compensation, and not satisfy himself only with a contingent arrangement for the payment of interest. The court came to the conclusion that the employer appeared not to have been focused on striving to get the utmost possible advantage out of the transaction for itself, and therefore the parties were not dealing at an arms' length.

- The consumer is a juristic person whose asset value or annual turnover, together with the combined asset value or annual turnover of all related juristic persons, at the time the agreement is made, *equals or exceeds the* threshold value determined by the Minister in terms of in section 7(1) of the NCA, [16] currently R 1 million. [17]

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[12] Section 89(2)(d) of the National Credit Act of 2005
[13] Section 89(5)(a) of the National Credit Act of 2005
[14] Arm's length in terms of section 4(2)(b) means:
(b) in any of the following arrangements, the parties are not dealing at arm's length:
(i) a shareholder loan or other credit agreement between juristic person, as consumer, and a person who has a controlling interest in that juristic person, as credit provider;
(ii) a loan to a shareholder or other credit agreement between a juristic person, as credit provider, and a person who has a controlling interest in that juristic person, as consumer;
(iii) a credit agreement between natural persons who are in a familial relationship and-
(aa) are co-dependent on each other; or
(bb) one is dependent upon the other; and
(iv) any other arrangement-
(aa) in which each party is not independent of the other and consequently does not necessarily strive to obtain the utmost possible advantage out of the transaction; or
(bb) that is of a type that has been held in law to be between parties who are not dealing at arm's length.
[15] (3918/12) [2012] ZAWCHC 383
[16] Section 4(1)(a)(i) of the National Credit Act of 2005
[17] General Notice 713 in Government Gazette 28893 of 2006

- ❑ It is a large credit agreement as defined in section 9(4) of the NCA and the consumer is a juristic person whose asset value or annual turnover, at the time the agreement is made, is below the threshold value,[18] (currently R 1 million).[19] A large agreement includes a mortgage agreement [20] or any other transaction, excluding a pawn transaction or a credit guarantee, on condition that the principal debt under the agreement falls at or above the higher of the thresholds established in terms of section 7(1)(b), [21] (currently R 250 000). [22]

Therefore, and provided that the above exceptions are present, the application of the NCA and the requirement to register as a credit provider will not be applicable, even though the agreement provides for deferred payments and the deferred payment attracts interest, a fee or a charge.[23]

Conclusion

The Vesagie-case therefore serves as a warning to parties who wish to enter into sale agreements where the purchase price is deferred and interest is charged on the outstanding capital amount. It also emphasizes the importance of the NCA when drafting sale agreements and the implications of the NCA thereon.

The amendment of the threshold to nil (R0) in terms of section 42(1) of the NCA broadens the application as it removes the threshold, previously R500 000, which is required to be owed to the credit provider before the provider is required to register as a credit provider.

It is therefore important that parties, who wish to enter into a sale agreement, take care when entering into a sale agreement. Even a small clause which levies interest can result in the agreement falling under the ambit of the NCA, which will require registration as a credit provider under the NCA. Failing to register as a credit provider, when the transaction falls within the ambit of the NCA, might result that the agreement is null and void.

[18] Section 4(1)(b) of the National Credit Act of 2005
[19] *Supra* at footnote 11
[20] Section 9(4)(a) of the National Credit Act of 2005
[21] Section 9(4)(b) of the National Credit Act of 2005
[22] Supra note 17
[23] JR Hol, De Rebus November 2016: DR34

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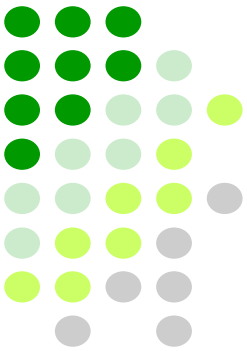

Estate Planning

The One Year Wonder

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Introduction

Mr X (60 years old) bequeaths his holiday home valued at R1 million (base cost R400, 000) and a commercial property valued at R10 million (base cost R6, 000,000) to the trustees of the ABC Family Trust subject to the lifelong usufruct in favour of his spouse, Mrs X (58 years old) and upon the death of his spouse, the usufruct will pass to Mr X's son for a period of one year. After the expiry of the year, the usufruct ceases and full ownership vests in the trust.

This arrangement or scheme is commonly known as the "one year wonder" and this article will examine the consequences of using such a scheme as well as compare it to the consequences of a direct bequest to the trust.

(1) When Mr X dies:

In order to understand the implications of the bequests, the concept of a usufruct and a bare dominium have to be understood.

The holder of a usufructuary interest (the usufructuary) enjoys the possession and control of the property and is entitled to its fruits, but may not dispose of it and has no vested right in it, since it vests in another person (the holder of the bare dominium). The holder of the bare dominium enjoys merely the naked ownership of the property (that is, without the right to use it or its fruits), and acquires the full ownership only on the termination of the usufruct.[1]

Estate Duty:

In the event that Mr X dies, the holiday home and the commercial property will be included as property[2] in Mr X's estate for estate duty purposes. The value of the property will be the fair market valuation[3]. A deduction will be allowed for so much of the value of any property included in the estate, which has not been allowed as a deduction, as accrues to the surviving spouse of the deceased[4].

The usufruct accruing to Mrs X will thus be deductible. The value of the usufruct is calculated by capitalising at 12%, the annual value of the right of enjoyment over the property subject to the usufructuary interest over the expectation of life of the person entitled to such interest, or if such right is held for a lesser period than the life of such person, over such lesser period[5].

[1] Stein ML, Estate Duty Principles and Planning, 3rd Edition
[2] Section 3(2) Estate Duty Act 45 of 1955
[3] Section 5(g) Estate Duty Act 45 of 1955
[4] Section 4(q) Estate Duty Act 45 of 1955
[5] Section 5(b) Estate Duty Act 45 of 1955

Calculation of the usufruct:

Annual value of commercial property	12% x R10, 000,000 = R1, 200,000
P.V. of R1 p.a. for Mrs X's life (age next birthday 59 years)	7,42321
R1, 200,000 x 7, 42321	R8, 907,852

Annual value of holiday home	12% x R1, 000,000 = R120, 000
P.V. of R1 p.a. for Mrs X's life (age next birthday 59 years)	7, 42321
R120, 000 x 7, 42321	R890, 785.20

Total: R8, 907,852 + R890, 785.20 = R9, 798,637.20

The Section 4q deduction in Mr X's estate in respect of the two properties will thus be R9, 798,637.20.

The value of the bare dominium will be the difference between the fair market valuation and the usufruct.

Calculation of the bare dominium:

	Commercial property	Holiday home
Market Value	R10, 000,000	R1, 000,000
Less Usufruct	R8, 907,852	R890, 785.20
= Bare dominium	R1, 092,148	R109, 214.80

Total: R1, 092,148 + R109, 214.80 = R1, 201,362.80

R1, 201,362.80 will thus be subject to estate duty. Estate duty is levied at 20%[6] on the net estate of the deceased above R3, 500,000.[7]

[6] First Schedule to Estate Duty Act 45 of 1955
[7] Section 4A of the Estate Duty Act 45 of 1955

Value Added Tax (VAT):

To determine whether there are VAT consequences for the estate, one firstly has to consider whether the deceased was:

- ❑ Registered as a VAT vendor; or
- ❑ The deceased was not registered as a VAT vendor but was required to be ; or
- ❑ The deceased was not registered as a VAT vendor but the estate is liable for the registration as a vendor[8].

In all three scenarios, VAT will be applicable. It is important to note that the VAT Act[9] includes an estate within the definition of a person.

VAT is levied at 14% of the value of the supply and the VAT system is based on input tax and output tax. Output tax is paid by a VAT vendor to the South African Revenue Services (SARS) on the supply of taxable goods or services rendered. If the vendor sells goods and charges R114 which includes VAT, then the vendor will have to pay output tax of R14 to SARS. Input tax is claimed from SARS by a VAT vendor where the vendor buys goods or a service from another VAT vendor in respect of which VAT was charged. The purchaser vendor will be able to claim a refund of R14 if the goods sold or the services rendered were acquired by the vendor for consumption, use or supply in the course of business of making taxable supplies.

If it is established that the deceased was a VAT vendor the estate will be liable to account for VAT on the distribution of goods and services that formed part of the deceased's enterprise, which in this instance will be the commercial property. Anything done as part of the commencement or termination of an enterprise is deemed to be done in the course or furtherance of that enterprise. For example, the sale of goods by the administrator in winding down the enterprise of a deceased person is conducted in the course or furtherance of the estate's enterprise.

Output tax is calculated by applying the relevant tax fraction (14/114) to the consideration charged, which, in most cases, will be nil where assets are bequeathed to a legatee or heir without a bequest price. Consequently, even though VAT is levied, the VAT due to SARS may be nil.

However, if:

- ❑ the supply is made for no consideration or for a consideration which is less than the open market value; and
- ❑ the supplier and recipient are connected persons in relation to each other; and

[8] SARS VAT Guide 404 for Deceased Estates
[9] Vat Act 89 of 1991

- ❑ if a consideration for the supply, equal to the open market value had been paid by the recipient, he would not have been entitled to make a deduction of the full amount of tax in respect of that supply,

then VAT must be accounted for on the open market value of the goods, notwithstanding the fact that no consideration was payable[10].

Usufruct:

In the case where the usufructuary and deceased were connected persons and the usufructuary will not be using the usufruct to make taxable supplies, the estate will have to account for output tax on the open market value of the usufruct.

The open market value already includes VAT[11], The tax fraction must therefore be applied to the open market value to calculate the VAT portion. Thus VAT of 14%, amounting to R1, 093,946.74 (14/114 x R8, 907,852) will be payable on the usufruct over the commercial property unless the transaction can be zero rated.

Requirements for zero rating:

(i) The seller and purchaser must be registered VAT vendors, and

(ii) The supply must consist of an enterprise or part of an enterprise which is capable of separate operation, and

(iii) The parties must agree in writing that the supply is a going concern, and

(iv) The seller and purchaser must, at the conclusion of the agreement, agree in writing that the enterprise will be an income-earning activity on the date of transfer thereof, and

(v) The assets necessary for carrying on the enterprise must be disposed of to the purchaser, and

(vi) The parties must agree in writing that the consideration for the supply includes VAT at the zero rate.

Thus the spouse will have to register as a VAT vendor and the spouse and the executor, in his representative capacity will have to agree in writing that the enterprise will be disposed of as a going concern and will be an income-earning activity on the date of transfer thereof.

Bare dominium:

Bare dominium means that the owner of the property does not have the use thereof as the right of use vests with the usufructuary as a personal servitude. The transfer of a *bare dominium* constitutes a supply which is subject to VAT at the standard rate, unless the property did not form

[10] Section 10(4) VAT Act
[11] Section 3(1)(b) of the VAT Act

part of the deceased's enterprise, in which case the supply of the property will not be subject to VAT.

The bare dominium holder will generally not be entitled to deduct input tax in respect of the acquisition of the bare dominium as the bare dominium can usually not be used to make taxable supplies. Output tax must be paid on the open market value of the bare dominium of the property distributed to the beneficiary if that person and the deceased were connected persons in relation to each other.

The open market value of the supply must be determined in accordance with a method approved by the Commissioner. The Land Bank value may not be used. The value of the bare dominium must be calculated by deducting the value of the usufruct from the open market value of full ownership of the asset.

The supply of the bare dominium cannot be zero-rated as the bare dominium owner cannot, on transfer, continue with the activities of the enterprise.

VAT on the bare dominium of the commercial property:

14/114 x R1, 092,148 = R134, 123.44 VAT payable to SARS.

Capital Gains Tax (CGT):

We firstly have to determine whether the usufruct and bare dominium are subject to capital gains tax.

Capital Gains Tax is dealt with in the 8th Schedule to the Income Tax Act and an asset is defined in paragraph 1:

"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;"

Both the usufruct and bare dominium would thus qualify as assets in terms of the definition above and be subject to capital gains tax.

Usufruct:

Para 40(1) (a) deals with persons who died before 1 March 2016:

"(40) Disposals to and from deceased estate

(1) A person who dies before 1 March 2016 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 subparagraph 67(2)(a);

(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-

(b) 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 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 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)"

Paragraph 67(1) and 67(2) (a):

"(67) Transfer of assets 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")

(c) 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 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;

(iv) Used that asset in the same manner that it was used by 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."

Section 9HA[12] deals with persons who died after 1 March 2016:

"9HA(2) A deceased person must, if his or her surviving spouse is a resident, be treated—

(a) as having disposed of an asset to that surviving spouse if that asset is acquired by that surviving spouse—

(i) by ab intestato or testamentary succession;

[12] Income Tax Act 58 of 1962 (inserted by the Taxation Laws Amendment Act 25 of 2015)

(ii) as a result of a redistribution agreement between the heirs and legatees of that person in the course of liquidation or distribution of the deceased estate of that person; or

(iii) in settlement of a claim arising under section 3 of the Matrimonial Property Act, 1984 (Act No. 88 of 1984); and

(b) as having disposed of that asset for an amount received or accrued equal to—

(i) the expenditure incurred by that person in respect of that asset that was allowed in terms of sections 11(a) or 22 as a deduction for purposes of determining that person's taxable income for the year of assessment ending on the date of that person's death; or

(ii) the base cost of that asset, as contemplated in paragraph 20 of the Eighth Schedule, as at the date of that person's death."

Both paragraph 40 and section 9HA (2) quoted above essentially states that any asset transferred to a surviving spouse of a deceased person, will not attract capital gains tax upon the death of the deceased, but the base cost rolls over to the surviving spouse, i.e. the surviving spouse takes over the base cost of the asset as at the date of the deceased's death[13].

The value of the usufruct is calculated by capitalising at 12%, the annual value of the right of enjoyment over the property subject to the usufructuary interest over the expectation of life of the person entitled to such interest, or if such right is held for a lesser period than the life of such person, over such lesser period[14] however where the Commissioner is satisfied that the asset subject to that limited interest could not reasonably be expected to produce an annual yield equal to 12% 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 be treated as being the annual value of the right of enjoyment of that asset.[15]

Bare dominium

The deceased will be liable for capital gains tax on the bare dominium of the property. The base cost will thus have to be apportioned between the usufruct and the bare dominium.[16]

Commercial Property:

Proceeds bare dominium	R1,092,148
Less Base Cost: R6,000,000 x R1,092,148/R10,000,000	R655,288.80
Capital Gain on bare dominium	R436,859.20

[13] Section 25(4) of the Income Tax Act 58 of 1962 (as amended by the Taxation Laws Amendment Act 25 of 2015)
[14] Paragraph 31(d) of the 8th Schedule to the Income Tax Act 58 of 1962
[15] Paragraph 31(2) of the 8th Schedule to the Income Tax Act 58 of 1962
[16] Paragraph 33 of the 8th Schedule to the Income Tax Act 58 of 1962

Holiday Home:

Proceeds bare dominium	R109,214.80
Less Base Cost: R400,000 x R109,214.80/R1,000,000	R43,685.92
Capital Gain on bare dominium	R65,528.88

The total Capital Gains Tax would thus be:

Total Capital Gain	R436, 859.20 + R65, 528.88 = R502, 388.08
Less annual exclusion	R300, 000.00
Net Capital Gain	R202, 388.08
@ 40% inclusion rate	R80, 955.23
@45% tax rate	R36,429.85

Transfer Duty:

Transfer duty is an indirect tax paid on the acquisition of fixed property in South Africa. Transfer duty is payable on the value of any property acquired by a person by way of a transaction (or in any other manner).[17]

Property as defined in the Transfer Duty Act includes a real right in land and would thus include the acquisition of a usufruct or the bare dominium over fixed property.

The value of the property is the greatest of:

- ❑ The consideration payable for the property[18]
- ❑ Where no consideration is payable, the declared value[19] (as declared by the purchaser)
- ❑ The fair value of the property as determined by the Commissioner.[20] The term "fair value" is defined in the Transfer Duty Act[21] and in respect of real rights in land it would be the fair market value of such land as at date of acquisition.

[17] Section 2 of the Transfer Duty Act 40 of 1949
[18] Section 5(1)(a) of the Transfer Duty Act 40 of 1949
[19] Section 5(1)(b) of the Transfer Duty Act 40 of 1949
[20] Section 5(6) of the Transfer Duty Act 40 of 1949
[21] Section 1 of the Transfer Duty Act 40 of 1949

The fair value of limited interests are determined through the use of the same tables used to calculate the value of a usufruct for estate duty purposes.[22]

Transfer duty is payable on a sliding scale based on the value of the property and the current Transfer Duty table effective from 1 March 2017 is as follows:

Value of Property	Rate
R0 – R900 000	0%
R900 001 – R1 250 000	3% of the value in excess of R900 000
R1 250 001 – R1 750 000	R10 500 plus 6% of the value in excess of R1 250 000
R 1 750 001 – R2 250 000	R40 500 plus 8% of the value in excess of R1 750 000
R2 250 001 – R10 000 000	R80 500 plus 11% of the value in excess of R2 250 000
R10 000 001 and above	R933 000 plus 13% of the value in excess of R10 000 000

In the event that a transaction is subject to VAT, it is exempt from transfer duty. The transfer of the commercial property (both usufruct and bare dominium) will thus be exempt from transfer duty, even where the transfer is zero-rated for VAT purposes.

The Transfer Duty Act further exempts any property that is acquired by way of an inheritance and even extends to any redistribution of the assets of the deceased[23]. The transfer of the holiday home (usufruct and bare dominium) will thus be exempt from transfer duty.

Summary:

There are thus potentially VAT and capital gains tax implications in respect of the bare dominium and no transfer duty consequences in respect of the usufruct or bare dominium. The appeal of this arrangement when Mr X dies, is to be found in the saving of estate duty as a result of the section 4q deduction in respect of the usufruct which accrues to the surviving spouse.

[22] SARS Transfer Duty Guide p16
[23] Section 9(1)(e) of the Transfer Duty Act

(2) When Mrs X dies:

Estate Duty:

When Mrs X dies her estate for estate duty purposes will include the value of the ceasing usufruct. The value of the ceasing usufruct shall be an amount determined by capitalising at 12% the annual value of the right of enjoyment of the property in which the deceased held any such fiduciary, usufructuary or other like interest, to the extent to which the person, who upon the cessation of the said interest of the deceased in consequence of the death of the deceased becomes entitled to any right of enjoyment of such property of whatever nature over the expectation of life of such person, or if such right is to be held for a lesser period than the life of such person, over the lesser period. The usufruct will thus be calculated over a 1 year period as the son will be receiving the usufruct for 1 year.

Calculation of usufruct for a 1 year period:

Annual value of commercial property	12% x R10, 000,000 = R1, 200,000
R1, 200, 000 x 0, 8929[24]	R1, 071,480

Annual value of holiday home	12% x R1, 000, 00 = R120, 000
R120, 000 x 0, 8929	R107, 148

Total: R1, 071,480 + R107, 148 = R1, 178, 628

R1, 178, 628 will thus be subject to estate duty.

VAT:

Usufruct over the commercial property:

The supplier and recipient are connected persons and the supply was for no consideration, but the provisions of Section 10(4) will not be invoked as the son would have been entitled to claim input tax had he paid the full consideration. Thus this supply will be one for no consideration, and thus no VAT will be payable.

[24] Table B: 1 year Haupt P, Notes on South African Income Tax Act, 2017

Capital Gains Tax:

When Mrs X dies, there is a disposal of the usufruct without any proceeds[25] which means that there is a loss for Mrs X. Mrs X can however only claim a capital loss on expiry of the usufruct, if she had used the asset for purposes of trade[26].

Commercial Property:

Proceeds usufruct	R0
Less Base Cost: R6,000,000 x R1,071, 480/R10,000,000	R642, 888
Taxable Capital Gain/Loss on usufruct	(R642, 888)

Holiday Home:

Proceeds usufruct	R0
Less Base Cost: R400,000 x R107,148/R1,000,000	R42,859.20
Taxable Capital Gain/Loss on usufruct	(R42,859.20)

Only the loss in respect of the usufruct over the commercial property may be claimed by Mrs X as it was used for trade purposes.

Transfer Duty:

There is no transfer of the bare dominium at this stage and thus no transfer duty consequences.

In the event that a transaction is subject to VAT, it is exempt from transfer duty. The transfer of the usufruct over the commercial property will thus be exempt from transfer duty, even where the transfer is zero-rated for VAT purposes.

The transfer of the usufruct over the holiday home will be subject to transfer duty as this transfer is not subject to VAT, however, there is no transfer duty payable where a usufruct comes to an end as a result of the death of the usufructuary.[27]

[25] Paragraph 11(1)(b) of the 8th Schedule to the Income Tax Act 58 of 1962
[26] Paragraph 15(c) of the 8TH Schedule to the Income Tax Act 58 of 1962
[27] SARS Transfer Duty Guide p36

Summary:

The usufruct valued over the 1 year period will be included in Mrs X's estate for estate duty purposes. There will not be any VAT, transfer duty or capital gains tax payable.

(3) When the son's 1 year usufruct ceases:

Estate Duty:

There will not be any estate duty implications as the son is still alive.

Donations Tax:

The definition of a donation is a "gratuitous disposal or gratuitous waiver or renunciation of a right".[28] The son thus cannot be said to have made a donation as he has not gratuitously disposed of or renounced his right to the usufruct and there will not be any donations tax payable.

VAT:

Usufruct over the commercial property:

The supplier and recipient are connected persons and the supply was for no consideration, but the provisions of Section 10(4) will not be invoked as the trust would have been entitled to claim input tax had it paid the full consideration. Thus this supply will be one for no consideration, and thus no VAT will be payable.

Capital Gains Tax

When the son's usufruct ceases, there will be a disposal of the usufruct without any proceeds as the ceasing usufruct has a market value of nil. The base cost would have been calculated upon the death of Mrs X, however, the consequent loss must be disregarded to the extent that the asset was not used for purposes of trade. The loss in respect of the usufruct over the commercial property may thus be claimed by the son.

When Mr X died, the trust received the bare dominium which was calculated as the difference between the market valuation and the value of the usufruct. The base cost was also apportioned between the usufruct and the bare dominium.

The trust now has the full ownership of the property when the usufruct ceases which means that the market value of the property in the hands of the trust increases quite substantially however

[28] Section 55 Income Tax Act

the base cost does not increase. The result is a bigger capital gain in the hands of the trust than there would have been had the trust inherited the property directly from Mr X.

Transfer Duty

There is no transfer duty payable where the trust acquires the full ownership as a result of the death of the usufructuary.[29]

Summary:

There will not be any estate duty, donations tax, VAT, transfer duty or CGT payable.

(4) What if son passes away before the 1 year commences?

Estate Duty:

If the son passes away before the 1 year, then the usufruct would have ceased in favour of the trust and be valued in the estate of Mrs X as follows:

"...Provided further that if upon the cessation of the interest held by the deceased it is not possible to ascertain until some future date the person or some or all of the persons who will become entitled to the right of enjoyment of the property, the value shall be determined by capitalising at 12% over a period of 50 years the annual value of the right of enjoyment of the property in which such interest was held... provided further that where upon the cessation of the interest of the deceased in any property, there accrues to the holder of the bare dominium therein, the full ownership in that property, the value of the advantage or benefit so accruing by reason of the cessation of the interest held by the deceased, shall not exceed the difference between the fair market value of that property as at such date of such cessation and the value of the bare dominium as at the date the when such bare dominium was first acquired under the disposition creating the said interest held by the deceased."[30]

This essentially means that had the usufruct ceased in favour of the trust, the ceasing usufruct would have been valued over 50 years subject to the maximum of the present fair market value of the property less the original value of the bare dominium.

Calculation of usufruct over a period of 50 years (subject to the maximum of the present fair market value of the property less the original value of the bare dominium):

[29] SARS Transfer Duty Guide p36
[30] Section 5(b) of the Estate Duty Act 45 of 1955

Annual value of commercial property	12% x R10, 000,000 = R1, 200,000
R1, 200,000 x 8,3045[31]	R9, 965,400

Annual value of holiday home	12% x R1, 000,000 = R120, 000
R120, 000 x 8, 3045	R996, 540

VAT:

Usufruct over the commercial property:

The definition of a connected person in the VAT Act includes any trust fund in respect of which any relative of a person is a beneficiary. The supplier and recipient are connected persons and the supply was for no consideration, but the provisions of Section 10(4) will not be invoked as the trust would have been entitled to claim input tax had it paid the full consideration. Thus this supply will be one for no consideration, and thus no VAT will be payable.

Capital Gains Tax:

When the son's usufruct ceases, there will be a disposal of the usufruct without any proceeds as the ceasing usufruct has a market value of nil. The base cost would have been calculated upon the death of Mrs X, however, the consequent loss must be disregarded to the extent that the asset was not used for purposes of trade. The loss in respect of the usufruct over the commercial property may thus be claimed by the son.

When Mr X died, the trust received the bare dominium which was calculated as the difference between the market valuation and the value of the usufruct. The base cost was also apportioned between the usufruct and the bare dominium.

The trust now has the full ownership of the property when the usufruct ceases which means that the market value of the property in the hands of the trust increases quite substantially however the base cost does not increase. The result is a bigger capital gain in the hands of the trust upon disposal of the property than there would have been had the trust inherited the property directly from Mr X.

[31] Table B: 50 years, Haupt P, Notes on South African Income Tax Act, 2017

Transfer Duty:

There is no transfer duty payable where the trust acquires the full ownership as a result of the death of the usufructuary.[32]

(5) If the trust sells the property

Estate Duty:

Estate Duty is imposed on the estates of deceased persons only and is thus not applicable.

VAT

Output VAT at 14% would be payable by the trust on the value of the commercial property sold unless the transaction can be zero rated.

For the transaction to be zero rated, the purchaser will thus have to be registered as a Vat vendor, and both parties will have to agree in writing that the enterprise will be disposed of as a going concern and will be an income-earning activity on the date of transfer thereof.

Capital Gains Tax

Assuming a 10% increase in the value of both properties, the calculation would be as follows:

	Commercial Property	Holiday Home
Market Value	R11, 000,000	R1, 100,000
Less Base Cost	R10, 000,000	R1,000, 000
Capital Gain	R1, 000,000	R100, 000
Total Gain		R1, 100,000
Less annual exclusion		N/A
@ 80% inclusion rate		R880,000
@ 45% tax rate		R396,000

[32] SARS Transfer Duty Guide p36

Transfer Duty

The transfer of the commercial property will be exempt from transfer duty, as it is subject to VAT.

Transfer duty would be payable by the purchaser on the acquisition[33] of the holiday home on the fair market value at date of acquisition provided that it is an arm's length transaction between unrelated persons. [34]

If the parties are related or the Commissioner is of the opinion that the consideration paid or payable is less than the fair market value, then the Commissioner may determine fair market value. In such an instance, the duty will be payable on the greater of:

- The consideration paid or payable for the property; or
- The fair value of the property as determined by the Commissioner.

What if Mr X had bequeathed the two properties directly to the trust?

Estate Duty:

Both properties would be included in the estate of Mr X for estate duty purposes. Mr X would be allowed a deduction if the properties were bequeathed to a trust for the benefit of Mrs X and provided that the trustees do not have the discretion to allocate any property or income to anyone other than the surviving spouse.[35]

VAT:

The provisions of Section 10(4) would be invoked in respect of the commercial property and VAT payable on the open market value unless the transaction can be zero-rated.

For the transaction to be zero-rated, the trust will have to register as a VAT vendor and the trustees and the executor, in his representative capacity will have to agree in writing that the enterprise will be disposed of as a going concern and will be an income-earning activity on the date of transfer thereof.

[33] Section 3(1) of the Transfer Duty Act
[34] SARS Transfer Duty Guide p6
[35] Section 4(q)(ii) of the Estate Duty Act

Capital Gains Tax:

The calculation would be as follows:

	Commercial Property	Holiday Home
Market Value	R10, 000,000	R1, 000,000
Less Base Cost	R6, 000,000	R400, 000
Capital Gain	R4, 000,000	R600, 000
Total Gain		R4, 600,000
Less annual exclusion		R300, 000
Net Capital Gain		R4, 300,000
@ inclusion rate of 40%		R1 720 000
@ 45% tax rate		R 774 000

Transfer Duty:

There is an exemption in respect of property that is acquired by way of an inheritance and even extends to any redistribution of the assets of the deceased. The transfer of both properties will thus be exempt from estate duty.

A comparison of the tax payable using the one year scheme vs a direct bequest to the trust:

	One Year Wonder	Direct Bequest to trust
Estate duty when Mr X dies (assuming Mr X is already utilising his R3.5 million abatement[36])	R1,201,362.80 @ 20% = R240,272.56	R0 if the spouse is the only beneficiary of the trust OR R11, 000,000 @ 20% =R2, 200,000
Estate duty when Mrs X dies (assuming Mrs X is already utilising her R3.5 million abatement)	R1, 178,628 @ 20% = R235, 725.60	N/A
Estate duty when the son's usufruct ceases	N/A	N/A
VAT when Mr X dies	R134,123.44	Zero-rated

[36] Section 4A of the Estate Duty Act

VAT when Mrs X dies	NIL	N/A
VAT when son's usufruct ceases	R0	N/A
CGT when Mr X dies	R36,429.85	R774 000
Taxable Capital Gain when Mrs X dies	(R642,888)	N/A
CGT when the son's usufruct ceases	No CGT	N/A
CGT if the trust later sells the property assuming a 10% growth in both properties	R4,140,369.10 Refer calculation (i) below	R396, 000 Refer calculation (ii) below
Transfer Duty when Mr X dies	Exempt	Exempt
Transfer duty when Mrs X dies	Exempt	N/A
Transfer Duty when son's usufruct ceases	Exempt	N/A

Calculation (i)

Market Value of both properties (R11,000, 000 + R1,100,000)	R12,100,000
Less Base costs (R655,288.80 + R43,685.92)	R698,974.72
Capital Gain	R11,401,025.28
@ 80% inclusion rate	R9,120,820.22
@ 45% tax rate	R4, 104,369.10

Calculation (ii)

Market Value of both properties (R11,000, 000 + R1,100,000)	R12,100,000
Less Base costs (R10,000,000 + R1, 000, 000)	R11, 000, 000

Capital Gain	R1, 100,000
@ 80% inclusion rate	R880, 000
@ 45% tax rate	R396,000

(6) General Anti avoidance provisions:

Section 80A of the Income Tax Act determines that an avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and-

(a) In the context of business:

- ❑ It was entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes other than obtaining a tax benefit; or
- ❑ It lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;

(b) In a context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for a bona fide purpose, other than obtaining a tax benefit; or

(c) In any context:

- ❑ It has created rights or obligations that would not normally be created between persons dealing at arm's length; or
- ❑ It would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this part).

Section 80B provides that the Commissioner may determine the tax consequences of any impermissible avoidance arrangement for any party by:

(a) Disregarding, combining, or re-characterising any steps in or parts of the impermissible avoidance arrangement;

(b) Disregarding any accommodating or tax indifferent party or treating any accommodating or tax indifferent part and any other part as one and the same person;

(c) Deeming persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;

(d) Reallocating any gross income, receipt or accrual of a capital nature or expenditure; or

(e) Treating the impermissible avoidance arrangement as if it had not been entered into or carried out, or in such other manner as in the circumstances of the case the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit.

The section further provides that the Commissioner must make compensating adjustments that he or she is satisfied are necessary and appropriate to ensure the consistent treatment of all parties to the impermissible avoidance arrangement.

The above anti-avoidance provisions are quite far-reaching and where the "one year wonder" arrangement has been entered into merely to obtain a tax benefit, SARS could thus invoke the provisions of this section.

Conclusion

It is very clear that the one year wonder is quite a complicated structure which relies on the death of the beneficiaries happening within a certain order, and should the beneficiaries not die in the order contemplated, then this arrangement may not end up achieving any tax saving and in fact may end up costing more than a direct bequest. And even in the event that a tax saving is achieved through the use of this scheme, one should be aware of the danger of falling foul of the anti-avoidance provisions in the Income Tax Act.

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The estate duty implications of contributions to retirement funds not allowed as a tax deduction or exemption

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Introduction

The maximum retirement age of 70 in respect of membership to retirement annuity funds was removed in 2008[1]. From 1 January 2009, no estate duty is payable in respect of lump sums received from pension, provident, preservation or retirement annuity funds[2], and annuities received from these funds were already exempt from estate duty before this.

As a consequence of these amendments, retirement funds became an attractive estate planning tool. National Treasury however viewed some of the transactions that were entered into as avoidance through excessive contributions to, in particular, retirement annuity funds[3].

The result was the introduction of Section 3(2)(bA) to the Estate Duty Act[4], which section will be discussed in more detail in this article.

The position from 1 January 2009 to 31 December 2015

As alluded to in the introduction, the fact that an investment in a pension, provident, preservation or retirement annuity fund attracts no estate duty on death, coupled with the fact that the maximum retirement age for retirement annuity funds was abolished, made, retirement annuity funds in particular, effective estate planning tools in certain instances, especially in the case of elderly persons, or persons diagnosed with terminal illnesses.

Example 1:

Mr A is diagnosed with a terminal illness and his medical practitioner estimates his reasonable life expectancy to be 6 months at most. Mr A invests R10 000 000 in a retirement annuity fund on 1 October 2014 and dies 3 months later. His non-retirement funding income for the year of assessment up to his date of death was R1 000 000. Mr A had never, prior to his death, received any lump sum from a retirement fund on withdrawal or retirement, nor had he been the recipient of severance benefit from an employer. At the time of his death the investment was worth R10 200 000. His dependants/beneficiaries opt to take the full benefit as a lump sum.

The effect of this is that the full amount of R10 200 000 is not subject to estate duty. From a tax point of view, the situation will look as follows:

R1 000 000 (non-retirement funding income) x 15%[5] = R150 000.

[1] The definition of a retirement annuity fund in section 1 of the Income Tax Act was amended via the Taxation Laws Amendment Act 3 of 2008.
[2] The Estate Duty Act was amended in this regard via the Revenue Laws Amendment Act 60 of 2008.
[3] Explanatory Memorandum on the Taxation Laws Amendment Bill 2015, p5.
[4] Act 45 of 1955. The Estate Duty Act was amended in this regard via Section 2 of the Taxation Laws Amendment Act 25 of 2015.
5 Section 11(n) of the Income Tax Act 58 of 1963, before it was repealed on 1 March 2016.

His taxable income for the year of assessment (for normal income tax purposes) is thus:

R1 000 00 – R150 000 = R850 000.

When the beneficiaries opt to take the lump sum the lump sum is deemed to have accrued to Mr A immediately prior to death[6], and it will thus be taxable in his hands.

Therefore:

R10 200 000 – R9 850 000[7] (R10 000 000 contributions minus R150 000 deduction allowed in terms of section 11(k))

= R350 000 (taxable portion of the lump sum).

As Mr A had not previously received any qualifying lump sums from retirement funds or severance benefits from an employer, the amount of R350 000 will be taxed as follows:

R350 000 taxed at 0%

= R0.

If the amount had been invested by Mr A in an investment other than a retirement fund at the same growth rate, this investment would, assuming that the R3 500 000 estate duty abatement is used in respect of other property or deemed property in his estate, have attracted additional estate duty in the amount of R2 040 000 (R10 200 000 x 20%) – the effect of possible capital gains tax is however ignored in this example.

The position from 1 January 2016

The effect of the tax and estate duty benefits through tax avoidance schemes as discussed above was the amendment of the Estate Duty Act by the promulgation of Section 3(2)(bA)[8], which provides as follows:

(2) "Property" means any right in or to property, movable or immovable, corporeal or incorporeal, and includes—

(bA) so much of the amount of any contribution made by the deceased in consequence of membership or past membership of any pension fund, provident fund, or retirement annuity fund, as was not allowed as a deduction in terms of section 11 (k) or (n) of the Income Tax Act, 1962 (Act No. 58 of 1962), or paragraph 2 of the Second Schedule to

[6] Paragraph 3 and 4(1)(e) of the Second Schedule to the Income Tax Act
[7] Paragraph 5(1)(a) of the Second Schedule to the Income Tax Act
[8] This Estate Duty Act was amended in this regard via Section 2 of the Taxation Laws Amendment Act 25 of 2015

that Act or, as was not exempt in terms *of section 10C of that Act in determining the taxable income as defined in section 1 of that Act, of the deceased;*

The purposes of the above section is thus to include contributions made to retirement funds not allowed as a deduction or exemption as at date of death, as property in the estate of the deceased person who made such contributions, thus potentially increasing the liability for estate duty in this regard.

It is however important to note that Section 3(2)(bA) is only applicable in respect of:

(a) The estate of a person who dies on or after 1 January 2016; and

(b) Contributions made to pension, provident or retirement annuity funds on or after 1 March 2015 that were not allowed as a deduction under section 11(k), or the Second Schedule of the Income Tax Act or exempted against compulsory annuity income in terms of Section 10C of the Income Tax Act.

There are however certain problematic aspects surrounding this amendment that will be discussed in more detail below.

The effect of lump sum benefits of pension, provident, preservation and retirement annuity funds taken by dependants or beneficiaries or paid to the estate on death of the member or former member of the fund

A possible interpretation of Section 3(2)(bA) is that where a lump sum is paid to the beneficiaries, dependants or estate of the deceased member (or former member) who made the contributions, the deduction allowed in terms of paragraph 2 of the Second Schedule[9] will in effect reduce or totally extinguish the value of this property in the estate of the deceased, because the contributions not allowed as a deduction or exemption on death will be deductible against the lump sum taken as contemplated in Section 3(2)(bA) of the Estate Duty Act. It is further argued that this interpretation is especially viable as the lump sum, in terms of the Income Tax Act is deemed to have accrued to the deceased (member or former member) immediately prior to this death[10].

It is however my view that such an interpretation is not correct for the following reasons:

(1) It is clear that his could never have been the intention of the legislature, as the inclusion of contributions disallowed as a deduction or exemption as property in terms of section 3(2)(bA) could then easily be avoided or reduced by the dependants or beneficiaries opting to take benefits in pension, provident and retirement annuity funds, or benefits provided via a living annuity as a lump sum in order to trigger the deduction provided for in the Second Schedule

[9] Read with paragraph 5 of the Second Schedule to the Income Tax Act
[10] Paragraph 3 and 4(1)(e) of the Second Schedule to the Income Tax Act

of the Income Tax Act. The scenario described in Example 1 above would thus, if this is interpretation is followed, remain unchanged:

Value of property in the estate: R9 725 000 (contributions not allowed as a deduction or exemption on death) minus R9 725 000 (deduction allowed against lump sum taken by beneficiary) = R0 included as property in the estate in terms of Section 3(2)(bA).

(2) The fact that the lump sum is deemed to accrue to the deceased for purposes of the Income Tax Act[11] thus enabling the deduction in respect of contributions not previously allowed as a deduction or exemption to be applied for income tax purposes against the lump sum[12], does not mean that this is also applicable to the Estate Duty Act. Section 3(1) read with Section 3(2)(bA)of the Estate Duty Act appears to imply that this is in fact not the case:

> *3. What constitutes an estate.—*
>
> *(1) For the purposes of this Act the estate of any person shall consist of **all property of that person as at the date of his death** and of all property which in accordance with this Act is deemed to be property of that person at that date.*
>
> *(2) "Property" means any right in or to property, movable or immovable, corporeal or incorporeal, and includes—*
>
> *(bA) so much of the amount of any contribution made by the deceased in consequence of membership or past membership of any pension fund, provident fund, or retirement annuity fund, as **was** not allowed as a deduction in terms of section 11 (k) or (n) of the Income Tax Act, 1962 (Act No. 58 of 1962), or paragraph 2 of the Second Schedule to that Act or, as **was** not exempt in terms of section 10C of that Act in determining the taxable income as defined in section 1 of that Act, of the deceased;*

It thus appears that the Estate Duty Act is concerned with the right to property of the deceased as at date of death, which will then include contributions not allowed as a deduction or exemption prior to death. The fact that, where a lump sum is taken by beneficiaries/dependants it will be deemed to accrue to the deceased for income tax purposes resulting in all relevant tax deductions becoming applicable, does not change the *de facto* position that there were disallowed contributions at date of death, and that the deduction will only be allowed after the date of death of the deceased.

Section 4q of the Estate Duty Act

Section 4q of the Estate Duty Act allows for a deduction from the value of property included in the estate, so much of the value of such property accruing to the surviving spouse of the deceased that have not been allowed as a deduction elsewhere. Section 4q provides as follows:

[11] Ibid
[12] Paragraph 2 read with paragraph 5 of the Second Schedule to the Income Tax Act.

4. Net value of an estate.—

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

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

Generally speaking, the provisions of Section 4q are clear – any property in the estate accruing to the spouse of the deceased will be deductible from the gross value of the estate. Section 3(2)(bA) is however unique in the sense that it is merely the contributions to a pension, provident or retirement fund not allowed as a deduction or an exemption, as discussed above, that is included as property in the estate of the deceased, and not the fund value of the investments in these funds (prior to retirement) or the investment in a compulsory annuity (post retirement).

The question is thus if the investment in a pension, provident or retirement annuity fund, or the investment in a living annuity accrues to the surviving spouse of the member of the fund or the holder of the annuity on death, would the section 4 q deduction be applicable. Technically speaking, one might argue that:

(i) it is the fund value (in case of a member of a fund that dies before retirement) or the investment value of a living annuity (in case of a holder of a living annuity that dies after retirement) that accrues to the spouse and **not** the contributions that were not deducted or exempted prior to death , and

(ii) because we are thus dealing with different concepts, the Section 4q deduction should not be allowed,

even if the fund or annuity proceeds are awarded to the surviving spouse. The argument in this regard is thus that because the investment in the fund or annuity awarded to the spouse is not property included in the estate, no deduction should be allowed in respect of the contributions made by the deceased that were not deducted or exempted for income tax purposes prior to death.

The effect of this interpretation can is illustrated in the following example:

Example 2:

Mr X makes a contribution to a retirement annuity fund in the amount of R10 000 000 on 1 March 2017 and dies on the same day. For purposes of this example it is assumed that no portion of this contribution is deductible or exempt prior to his death. The full fund benefit is awarded to his spouse. If the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is used elsewhere, this contribution not allowed as a deduction or exemption will attract additional estate duty of R2 000 000 (R10 000 000 x 20%).

His spouse elects to take the full fund value (assume that it is still R10 000 000) as a cash amount. She invests it in a money market account and dies 11 years later, and the value in the money market account is still R10 000 000. If the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is already utilised (i.e. if there is other property or deemed property in her estate exceeding R3 500 000 after deductions are applied), this money market investment will again attract additional estate duty of R2 000 000 (R10 000 000 x 20%).

The total estate duty payable in respect of this investment will thus be R4 000 000 (R2 000 000 in the estate of Mr X and R2 000 000 in the estate of his spouse).

If Mr X had invested the funds in a money market account and bequeathed this investment to his spouse, his estate would have been entitled to the section 4q deduction, and this investment would not in effect have attracted any estate duty on his death. On the death of his spouse, and assuming that the money market investment is still R10 000 000 on her death, the estate duty payable would be R2 000 000 (R10 000 000 x 20%) if the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is already utilised (i.e. if there is other property or deemed property in her estate exceeding R3 500 000 after deductions are applied).

The total estate duty payable in respect of this investment will thus be R2 000 000 (R0 in the estate of Mr X and R2 000 000 in the estate of his spouse).

A counter argument to this could perhaps be that the contributions made by the deceased that were not deducted or exempted for income tax purposes prior to death in actual fact form part of the investment in the fund or annuity, and that it will be equitable to allow for a deduction under section 4q equal to the value of the non-deductible and non-exempt contributions.

The interpretive conundrum becomes even more complex when only a portion of the investment in a pension, provident or retirement annuity or a compulsory annuity accrues to the surviving spouse of the member/former member on his/her death. This is illustrated in the following example:

Example 3

A member of a retirement annuity fund dies and the fund has a value of R1 000 000. An amount of R500 000 was not deductible in terms of section 11(k) or paragraph 2 of the Second Schedule or exempted under section 10C of the Income Tax Act. All retirement fund contributions not allowed as a deduction or exemption were made after 1 March 2015. The trustees of the fund allocate 60% (R600 000) of the benefits to the surviving spouse and the balance to other dependants of the deceased.

An amount of R500 000 will be included in the estate of the deceased as property. The value awarded to the spouse is R600 000.

If we assume that section 4q of the Estate Duty Act may be applied in these circumstances, it can be interpreted to provide that the full amount accruing to the spouse to the extent that it is included in the estate will be deductible under Section 4q. In terms of this interpretation an amount of R500 000 will be deductible under Section 4q.

A second possible interpretation could be that 60% of the amount included as property is effectively allocated to the surviving spouse and that only an amount of R300 000 (R500 000 x 60%) is deductible under Section 4q.

A third interpretation, as discussed above, is that the accrual of the interest (or part thereof) in the fund to the spouse is not property to the extent of "*contributions made by the deceased in consequence of membership or past membership of any pension fund, provident fund, or retirement annuity fund, as was not taken into account in terms of section 11(k) or (n) or section 10C of the Income Tax Act or paragraph 2 of the Second Schedule to that Act"* that accrues to the surviving spouse and that no deduction should be allowed in terms of Section 4q.

This issue can become even more problematic where the deceased was a member of more than one retirement fund. Where the trustees of two (or more) different funds exercise their discretion differently and there are contributions "*made by the deceased in consequence of membership or past membership of any pension fund, provident fund, or retirement annuity fund, as was not taken into account in terms of section 11(k) or (n) or section 10C of the Income Tax Act, or paragraph 2 of the Second Schedule to that Act"* that differ between the two funds, there may also be interpretational issues with regards to the application of Section 4q.

Example 4:

A member of a retirement annuity fund (fund value R1 000 000) and a pension preservation fund dies. In respect of the retirement annuity fund, an amount of R500 000 was not taken into account in terms of section 11(k) or section 10C of the Income Tax Act, or paragraph 2 of the Second Schedule to that Act. All retirement fund contributions not allowed as a deduction or exemption were made after 1 March 2015. The trustees of the pension preservation fund allocate 100% of the benefits to the surviving spouse and trustees of the retirement annuity fund allocate 100% of the benefits to other dependants of the deceased.

An amount of R500 000 in respect of the contributions made to the retirement annuity will be included in the estate of the deceased as property. It could possibly be argued that the deduction in terms of Section 4q will not be allowed as the contributions "made by the deceased in consequence of membership or past membership of any pension fund, provident fund, or retirement annuity fund, as was not taken into account in terms of section 11(k) or (n) or section

10C of the Income Tax Act, or paragraph 2 of the Second Schedule to that Act" do not relate to the pension preservation fund and will thus not accrue to the surviving spouse.

Where contributions are made to different funds in the same year of assessment it will be difficult, if not impossible, to establish to which fund the contribution not allowed as a deduction or exemption were made.

The above problem is exacerbated due to the fact that the deductions in terms of Paragraph 5 of the Second Schedule is allowed in respect of lump sums across different funds and not only in respect of a lump sum accruing from the fund that is being withdrawn or retired from.

A possible solution to the problems discussed above is if section 4q is amended to provide that, in relation to property included under section 3(2)(bA) the deduction will be based on the ratio of the value of the benefit the spouse receives in relation to the total benefit paid by all funds or long term insurers (in respect of member owned annuities) and apply that ratio to the value included as property under Sec 3(2)(bA) in order to calculate the value of the Sec 4q deduction. Where a conventional compulsory annuity is received by the surviving spouse, for example where a joint and survivorship annuity is being dealt with, it may necessitate an actuarial calculation based on the life expectancy of the surviving spouse to calculate the value of such annuity. The same would also be applicable to an annuity or pension provided in terms of a defined benefit fund. A possible downside of this is that a delay by the trustees of a fund to reach a final decision in the distribution of fund benefits (including fund owned compulsory annuities) may delay the winding up of the estate.

Example 5:

A member of a retirement annuity fund (fund value R1 000 000) and a pension fund (fund value R3 000 000) dies. At the date of death of the member, a total amount of R500 000 was not deductible or exempted in terms of section 11(k) or section 10C of the Income Tax Act, or paragraph 2 of the Second Schedule to that Act. All retirement fund contributions not allowed as a deduction or exemption were made after 1 March 2015. The trustees of the pension fund allocate 100% of the benefits to the surviving spouse and trustees of the retirement annuity fund allocate 100% of the benefits to other dependants of the deceased. If the above suggested method is followed, the section 4 q deduction would amount to:

R3 000 000 ÷ R4 000 000 (total retirement benefit) x R500 000 (property in the estate in terms of Section 3(2)(bA)) = R375 000.

Possible criticism of this method may be that if the spouse elects to take the benefit as a lump sum, the remaining amount of the lump sum (or assets purchased with this amount) will be included in the estate of the surviving spouse on death for estate duty purposes, but if the survivor opts to receive an annuity or where the surviving spouse has no option (e.g. with a joint and

survivorship annuity or an annuity/pension provided by a defined benefit scheme), the section 4q deduction will be granted, but the annuity will not be included in the estate of the survivor, thus resulting in a loss for the fiscus. Although it may be argued that where the spouse chooses, or is compelled to receive an annuity this loss may be offset by the fact that the spouse (and subsequent annuitants, where applicable) will not enjoy the exemption provided in section 10C[13], the counter argument is that, the value of the contributions not previously deductible or exempted may in any event be utilised against lump sums taken by other dependants or beneficiaries of the deceased member. This can be illustrate through the following example:

Example 6:

A member of a retirement annuity fund (fund value R1 000 000) and a pension fund (fund value R3 000 000) dies. At the date of death of the member, a total amount of R500 000 was not deductible or exempted in terms of section 11(k) or section 10C of the Income Tax Act, or paragraph 2 of the Second Schedule to that Act. All retirement fund contributions not allowed as a deduction or exemption were made after 1 March 2015. The trustees of the pension fund allocate 100% of the benefits to the surviving spouse and trustees of the retirement annuity fund allocate 100% of the benefits to other dependants of the deceased. The spouse opts for a living annuity to be provided to her with the full pension fund benefit (R3 000 000) and the other dependants op for the retirement annuity fund benefits (R1 000 000) to be paid as a lump sum.

When the spouse dies thereafter, the living annuity will not be included in her estate as property or deemed property for estate duty purposes, resulting in a loss for the fiscus in this regard. Although the spouse could argue that the section 4q deductions should be allowed as she would, from an income tax point of view, not have been entitled to an exemption against the living annuity income in terms of section 10C, a counter argument would be that even if the section 10C exemption was transferrable to subsequent annuitants, she would in this instance not have been entitled to the exemption in any event, as the R500 000 that had not been allowed as a deduction or exemption as at death of the member would have been used as a deduction against the lump sum (retirement annuity fund benefit of R1 000 000) taken by the other dependants.

A possible solution to the problem highlighted in Example 6 would be if Section 4q is amended to provide that a proportionate deduction is allowed as discussed above, but that the deduction is limited to a maximum amount equal to the lump sum taken by the surviving spouse. It is submitted that this would be the most equitable method to place property as contemplated in section 3(2)(bA) on equal terms with other property and deemed property as defined in the Estate Duty Act.

The following example demonstrates this suggested solution:

[13] Section 10C(2) provides that the exemption is only applicable to the person who made the contributions that were not previously allowed as a deduction or exemption.

Example 7:

A member of a retirement annuity fund (fund value R1 000 000) and a pension fund (fund value R3 000 000) dies. At the date of death of the member, a total amount of R500 000 was not deductible or exempted in terms of section 11(k) or section 10C of the Income Tax Act, or paragraph 2 of the Second Schedule to that Act. All retirement fund contributions not allowed as a deduction or exemption were made after 1 March 2015. The trustees of the pension fund allocate 100% of the benefits to the surviving spouse and trustees of the retirement annuity fund allocate 100% of the benefits to other dependants of the deceased. If the above suggested method is followed, the possible section 4 q deduction would amount to:

R3 000 000 ÷ R4 000 000 (total retirement benefit) = 0.75 (i.e. 75%) x R500 000 (property in the estate in terms of Section 3(2)(bA)) = R375 000.

If the spouse opts to take R375 000 or more as a lump sum the allowable section 4q deduction will be R375 000. If the spouse opts to taken an amount less than R375 000 as a lump sum, the section 4 q deduction will be limited to the amount taken as a lump sum, e.g. if the spouse takes R200 000 as a lump sum, the deduction is limited to R200 000, or if no lump sum is taken, no deduction will be allowed.

It is submitted that this is in line with the methodology that would have been followed with other property or deemed property. If for example the deceased was the holder of a life insurance policy with a death value of R500 000, and the surviving spouse is nominated for 75% of the proceeds whilst the other 25% is awarded to other beneficiaries, the section 4Q deduction would be: R500 000 x 75% = R375 000.

If we apply this methodology to the facts in Example 2, the solution will look as follows:

Example 8:

Mr X makes a contribution to a retirement annuity fund in the amount of R10 000 000 on 1 March 2017 and dies on the same day. For purposes of this example it is assumed that no portion of this contribution is deductible or exempt prior to his death. The full fund benefit is awarded to his spouse. His spouse elects to take the full fund value (assume that it is still R10 000 000) as a cash amount.

On the death of Mr X, no additional estate duty will be payable in respect of the benefit received, as the section 4q deduction will be equal to R10 000 000.

The spouse of Mr X invests the proceeds from the retirement annuity fund in a money market account and dies 11 years later, and the value in the money market account is still R10 000 000. If the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is already utilised (i.e. if there is other property or deemed property in her estate exceeding R3 500 000 after

deductions are applied), this money market investment will attract additional estate duty of R2 000 000 (R10 000 000 x 20%) in her estate.

The total estate duty payable in respect of this investment will thus be R2 000 000 (R0 in the estate of Mr X and R2 000 000 in the estate of his spouse).

If Mr X had invested the funds in a money market account and bequeathed this investment to his spouse, his estate would also have been entitled to the section 4q deduction, and this investment would not in effect have attracted any estate duty on his death. On the death of his spouse, and assuming that the money market investment is still R10 000 000 on her death, the estate duty payable would be R2 000 000 (R10 000 000 x 20%) if the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is already utilised (i.e. if there is other property or deemed property in her estate exceeding R3 500 000 after deductions are applied).

The total estate duty payable in respect of this investment will thus also be R2 000 000 (R0 in the estate of Mr X and R2 000 000 in the estate of his spouse).

If his spouse elected to take 50% fund value (assume that it is still R10 000 000) as a cash amount, and use the balance to purchase a living annuity, the section 4q deduction will be limited to R5 000 000. This will mean that the balance (R5 000 000) will in effect be dutiable from an estate duty point of view. If the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is already utilised (i.e. if there is other property or deemed property in her estate exceeding R3 500 000 after deductions are applied), this money market investment will again attract additional estate duty of R1 000 000 (R5 000 000 x 20%).

The spouse of Mr X invests the cash lump sum from the retirement annuity fund in a money market account and dies 11 years later, and the value in the money market account is still R5 000 000. If the R3 500 000 abatement awarded in terms of section 4A of the Estate Duty Act is already utilised (i.e. if there is other property or deemed property in her estate exceeding R3 500 000 after deductions are applied), this money market investment will attract additional estate duty of R1 000 000 (R5 000 000 x 20%) in her estate.

The total estate duty payable in respect of this investment will thus still be R2 000 000 (R1 000 000 in the estate of Mr X and R1 000 000 in the estate of his spouse).

It is the writer's view that if section 4 q is amended to operate as illustrated above, the avoidance of estate duty through big contributions made to pension, provident or retirement annuity funds will still be addressed effectively, whilst at the same time affording the same treatment to

property as contemplated in Section 3(2)(bA) as to other property and deemed property as defined in the Estate Duty Act[14].

The Person Liable for Estate Duty and the Right of Recovery by the Executor

Section 11 read with Section 13 of the Estate Duty Act essentially gives the executor the right to claim estate duty brought about by certain property and deemed property in the estate of the deceased from the person who enjoys the benefit for such property or deemed property. An example of this is where a person is the beneficiary, or the policyholder of a policy on the life of the deceased and the policy proceeds contribute to the liability for estate duty, the executor would be able to recover the proportionate estate duty brought about by such policy proceeds from the beneficiary or policyholder[15].

Section 11 and section 13 do however not make provision for the recovery by the executor of proportionate estate duty incurred by property as defined in section 3(2)(bA). A consequence of this would be that the estate is liable for the estate duty brought about by contributions to pension, provident and retirement annuity funds not allowed as a deduction on the death of the member (or former member). This could be problematic, especially where the heirs of the estate and the beneficiaries or dependants entitled to retirement benefits are not the same persons. The end result could be that the estate, and by implication the heirs, are liable for the estate duty incurred by the contributions not allowed as a deduction or exemption on death, whilst the beneficiaries or dependants essentially reap the benefits of the retirement investment. The effect if this is illustrated in the following example:

Example 9:

Mr X makes a contribution to a retirement annuity fund in the amount of R10 000 000 on 1 March 2017 and dies on the same day. For purposes of this example it is assumed that no portion of this contribution is deductible or exempt prior to his death. The full fund benefit is awarded to his children.

The net value of his estate (inclusive of the amount of R10 000 000 in respect of the contribution to the retirement annuity fund not allowed as a deduction or exemption), before the section 4A abatement is applied is R33 500 000. The sole heir of his estate (i.e. excluding the benefit in the retirement annuity fund) is his brother.

[14] In this regard it is submitted that the same amendments should also be affected to retirement benefits accruing to public benefit organisations, exempt institutions carrying on public benefit activities and the State or municipalities as provided for in Section 4(h) of the Estate Duty Act.
[15] Section 11(b)(i) read with section 13 of the Estate Duty Act.

The estate duty liability will thus be:

R33 500 000 – R3 500 000 (section 4A abatement)

= R30 000 000 x 20% = R6 000 000.

In this instance the estate will be liable for the estate duty, and will not have any recourse against the beneficiaries. It will thus have an effect on the eventual inheritance of the brother as the full R6 000 000 estate duty will be payable from the estate.

If the facts had been the same as above, except for the R10 000 000 benefit being a life insurance policy on the life of Mr X of which the children had been the beneficiaries, the executor would be able to recover the proportionate estate duty from the beneficiaries of the policy as follows:

R10 000 000 (policy proceeds) ÷ R33 500 000 (net value of the estate) x R6 000 000 (estate duty payable)

= R1 791 044.78

The balance of R4 208 955.22 (R6 000 000 – R1 791 044.78) would then be paid from property or deemed property in the estate (or by the heir of the estate, Mr X's brother).

It is further submitted that where the contributions to pension, provident or retirement annuity funds not allowed as a deduction or exemption is the only property, or constitutes the majority of the value in the estate, the South African Revenue Services may not be able to recover the estate duty payable. The following example illustrates the issue at hand.

Example 10:

Mr Y is diagnosed with a terminal illness. He sells all his assets and uses the proceeds to make a contribution to a retirement annuity fund in the amount of R23 500 000 on 1 March 2017 and dies on the same day. For purposes of this example it is assumed that no portion of this contribution is deductible or exempt prior to his death. The full fund benefit is awarded to his children.

The net value of his estate before the section 4A abatement is applied is thus R23 500 000. The estate duty liability will thus be:

R23 500 000 – R3 500 000 (section 4A abatement)

= R20 000 000 x 20% = R4 000 000.

In this instance the estate will be liable for the estate duty, and will not have any recourse against the beneficiaries of the retirement annuity fund. The problem is however that there are no assets in the estate, and the executor will thus not be able to pay the estate duty[16].

If the facts had been the same as above, except for the R23 500 000 benefit being a life insurance policy on the life of Mr X of which the children had been the beneficiaries, the executor would be able to recover the proportionate estate duty from the beneficiaries of the policy as follows:

R23 500 000 (policy proceeds) ÷ R23 500 000 (net value of the estate) x R4 000 000 (estate duty payable)

= R4 000 000

It is submitted that the problems highlighted in Examples 9 and 10 can be resolved if sections 11 and 13 of the Estate Duty Act are amended to provide that the beneficiary/dependant who received retirement benefits will be liable for the proportionate estate duty brought about by the value of the property contemplated in Section 3(2)(bA) in line with the share of the benefit received by such beneficiary. The effect of such an amendment could be illustrated in the following example:

Example 11:

Mr Z makes a contribution to a retirement annuity fund in the amount of R13 000 000 on 1 May 2015. He dies on 1 March 2017. At date of his death the value of the contributions not allowed as a deduction or exemption is R10 000 000. The net value of his estate (including the contributions to the fund that were not allowed as a deduction or exemption) before applying the section 4A abatement of R3 500 000 is R43 500 000. The full fund benefit (which is now R15 000 000) is awarded to his two children in equal shares.

The net value of his estate before the section 4A abatement is applied is R43 500 000. The estate duty liability will thus be:

R43 500 000 – R3 500 000 (section 4A abatement)

= R40 000 000 x 20% = R8 000 000.

[16] In this regard also see section 12 of the Estate Duty Act that provides that the liability of the executor in his representative capacity is for an amount not exceeding the available assets in the estate.

If the Estate Duty Act is amended to enable the executor to recover the proportionate estate duty in respect of the contributions to the retirement annuity fund not allowed as a deduction or exemption from the two children, the amount recoverable from each child would be as follows:

R10 000 000 (property in terms of section 3(2)(bA)) ÷ R43 500 000 (net value of the estate) x R8 000 000 (estate duty payable)

= R1 839 080.46

Each beneficiary (child) would thus be liable for:

R1 839 080.46 x 50% (50% of benefit awarded to child) = R919 540.23

The balance of R6 160 919.54 (R8 000 000 – R1 839 080.46) would then be paid from property or deemed property in the estate.

Conclusion

It is understandable that the Estate Duty Act was amended to prevent estate duty avoidance through the use of pension, provident and especially retirement annuity fund as estate planning vehicles.

It is however submitted that the amended legislation does not take cognisance of related aspects contained in the Estate Duty Act and that it should be adjusted accordingly to make provision for:

(i) The application of section 4(q) of the said Act in order to put property as defined in section 3(2)(bA) on an equal footing with other property or deemed property defined in this Act, where there is an accrual of retirement benefits to a surviving spouse, either via a pension, provident, preservation or retirement annuity fund, or via post retirement annuities. The same principles should apply where there is an accrual of these benefits to organisations as contemplated in section 4(h) of this Act.

(ii) The right of the executor to recover estate duty proportionate to the benefit received by dependants or beneficiaries in relation to the contribution of the property contemplated in section 3(2)(bA) to the total estate duty liability.

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Section 42 of the Income Tax Act – Estate Planning Considerations and Pitfalls

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Introduction

The Income Tax Act 58 of 1962 (hereinafter referred to as "the Act") contains certain provisions that provide for the tax-free transfer of assets between taxpayers. The tax on the asset is deferred until the disposal of the asset in the future.[1] One of the provisions providing tax relief is contained in section 42 of the Act. These transactions are known as asset-for-share transactions. Section 42 provides, in simple terms, for the tax to be deferred where a person disposes of an asset to a resident company in exchange for a qualifying interest in the equity shares in that company. The transaction, if done in accordance with section 42, will have no immediate income tax, capital gains tax, securities transfer tax or value added tax consequences.[2] For an individual with a capital gains tax and/or a problematic estate duty liability in their estate, section 42 appear, at first glance, to provide for the perfect solution. This article aims to critically examine section 42 in the context of financial planning taking specific care to highlight the dangers of misusing the provision.

Intention of the legislature

When an individual with a capital asset, such as fixed property, would want to transfer that asset to a company, for example, the transaction would most likely trigger capital gains tax in the hands of that individual which can have the effect of deterring the individual from entering into the transaction. The special rules and regulations contained in Part II of Chapter 3 of the Income Tax Act relating to tax deferment was set in place to encourage the incorporation of businesses by adjusting certain tax considerations that would have applied.[3] It is widely considered that asset-for-share transactions is a helpful tax planning tool in corporate restructure and setting up joint ventures.[4] Section 42 is a very complex piece of legislation which interlinks with other sections of the Act. The wording starts with two detailed definitions: "asset-for-share transaction" and "qualifying interest." In terms of subsection 1 an asset-for-share transaction is a transaction:

"(a)(i)in terms of which a person disposes of an asset, (other than an asset which constitutes a restraint of trade or personal goodwill), the market value of which is equal to or exceeds –

(aa) in the case of an asset held as a capital asset, the base cost of that asset on the date of that disposal; or

(bb) in the case of an asset held as trading stock, the amount taken into account in respect of that asset in terms of section 11(a) or 22(1) or (2),

to a company which is a resident, in exchange for the issue of an equity share in that company and that person—

(A) at the close of the day on which that asset is disposed of, holds a qualifying interest in that company or

[1] SAICA 2015: 1.
[2] Gad & Marcus 2008: 1.
[3] http://www.werksmans.com/legal-briefs-view/asset-share-transactions-beware-selling-shares-within-18-months-especially-context-share-buy-back/ 27/06/2017.
[4] SAICA 2009: 1-3.

(B) is a natural person who will be engaged on a full-time basis in the business of that company, or a controlled group company in relation to that company, of rendering a service; and

(ii) as a result of which that company acquires that asset from that person –

(aa) as trading stock, where that person holds it as trading stock;

(bb) as a capital asset, where that person holds it as a capital asset; or

(cc) as trading stock, where that person holds it as a capital asset and that company and that person do not form part of the same group of companies:..."[5]

From the definition it is clear that the nature of the asset to be transferred must be retained. If a person transfers a capital asset or trading stock the company must receive it as a capital asset or trading stock. It may be said that a loophole of sorts is created in subsection (cc) for companies acquiring the asset if the company is not part of the same group of companies to change the nature of the asset after receiving it. Section 42(5) prevents the misuse by establishing a clear anti-avoidance provision regarding the disposal of the share[6]. If a person disposes of his/her share within 18 months of receiving it and more than 50% of the market value of the share is trading stock or allowance assets (immediately before the disposal thereof), the disposal will be deemed to be that of trading stock and not capital in nature.[7]

In order for section 42 to apply, the transferor of the asset must hold a qualifying interest in the company after the transaction is concluded. An exception to the rule is if the person acquiring the shares is an individual who will be engaged on a full-time basis to render services for the company or any group of companies. A "qualifying interest" is defined in section 42 as:

"*(a) an equity share*[8] *held by that person in a company which is a listed company or will become a listed company within 12 months after the transaction as a result of which that person holds that share;*

(b) an equity share held by that person in a portfolio of a collective investment scheme in securities;

(c) equity shares held by that person in a company that constitute at least 10 per cent of the equity shares and that confer at least 10 per cent of the voting rights in that company; or

(d) an equity share held by that person in a company which forms part of the same group of companies as that person.

(e) any equity share held in a portfolio of a hedge fund collective investment scheme."

[5] The act continues on hedge funds, collective investment schemes and foreign companies.
[6] Subject to certain exclusions.
[7] SAICA 2016: 2.
[8] Equity share is defined in section 1 of the Income Tax Act as follows: Ordinary shares are equity shares, while on-participating preference shares are not. Non-participating equity shares are only entitled to a fixed amount in the case of a distribution and does not hold a qualifying stake in the company.

If assets are transferred to a company it is important that the shares must be issued to the transferor on the same day in order to comply with legislation and to ensure the "qualifying interest" requirement is met. Furthermore, if a person already holds a qualifying interest in a company he or she need not dispose of assets in exchange for a qualifying interest. That person can merely make the exchange for other equity shares, for example.[9]

Section 42(2)(b)(aa) provides that where a person disposes of a capital asset to a company, the company and that person will be deemed to be the same person in respect of the cost of the asset, the time of acquisition by the person and any valuation done by the person.[10]

In terms of section 42(3)(c) where a contract is disposed of by a person in a section 42 transaction to a company as part of the disposal of a business as a going concern, any previously carried over debtors allowance[11] and allowance in respect of future expenditure and contracts[12] may be transferred to the company.[13]

Can asset-for-share transactions be successfully utilised in estate planning scenarios? A basic example is that of a farmer with various farms in his name amounting to R20 million. In his will he bequeaths the farming properties to his son. The farmer is an elderly man with limited liquidity in his estate. Upon his death his estate would be liable for R12 million capital gains tax[14] and R5 million estate duty. Because there is limited or insufficient cash in the farmer's estate the son will have to sell the farm to pay what is due in the estate. Transferring the farming properties to a company where the son will have 90% shares and the farmer 10% as a qualifying interest without paying any income tax, capital gains tax (the company acquires the asset at the same base cost that the farmer had it) or value added tax could be a solution that ensures business continuity and a solution to estate duty and other tax liabilities if the liquidity in the estate reflects a shortfall. Since it is clear that such transactions was not the initial intention of the legislator caution must be had.

Possible pitfalls

Although there are many advantages when section 42 is utilised in the correct manner, its interplay with other sections of the Income Tax Act may result in unintended negative consequences.

[9] Haupt 2017: 523.
[10] Haupt 2017: 524
[11] Section 24 of the Income Tax Act.
[12] Section 24C of the Income Tax Act.
[13] Haupt 2017: 527.
[14] Assuming the base cost of the farming properties is R8,000,000 and no exclusions are applicable.

Section 42(8) states that qualifying debt that was transferred to the company as part of the asset-for-share transaction will be the amount accrued to the person who transferred the assets should he dispose of his shares.

For example, Mr. X borrowed R1 million to purchase a farm. The value of the farm grows to R1,5 million. Mr. X then disposes of the farm to Company A and obtains shares in the company. The value of the shares acquired will be, in simple terms, R500,000 (the net asset value). Section 42 states that the base cost at which Mr. X obtained the shares in Company A is deemed to be equivalent to the base cost at which Mr. X held the asset before the transfer (R1 million). However, the application of section 48(2) entail that Mr. X will be deemed to have additional proceeds equal to the debt that was assumed by the company (R1 million). Generally, if Mr. X were to dispose of his share at market value which is R500,000 and his base cost is R1 million he will trigger a capital loss of R500,000. Section 42(8) will result in a capital gain for Mr. X since the calculation must be applied as follows: R500,000 (market value) plus R1 million (deemed proceeds) minus R1 million (base cost) equals R500,000 capital gain.[15]

The reason for the negative effect created in section 42(8) is that many other provisions in the Act does not contain roll-over provisions in relation to deemed additional proceeds. If there is no further roll-over relief the future disposal may result in a capital gain liability.

Another provision that can put the person who transferred the asset in a worse position is section 42(5) which states:

"Where a person –

(a) acquired any equity share in a company in terms of an asset-for-share transaction; and

(b) disposes of any such equity share (other than by way of an intra-group transaction contemplated in section 45, an unbundling transaction contemplated in section 46 or a liquidation distribution contemplated in section 47, an involuntary disposal as contemplated in paragraph 65 of the Eighth Schedule or the death of that person) within a period of 18 months after the date of acquisition contemplated in paragraph (a) and immediately prior to that disposal more than 50 per cent of the market value of all the assets disposed of by that person to that company in terms of any transaction in respect of which the provisions of this Part apply, is attributable to allowance assets or trading stock or both,

that person must, to the extent that any amount received by or accrued to that person in respect of the disposal of that share is less than or equal to the market value of that share at the beginning of such period of 18 months, include that amount in that person's income."

[15] SAICA Integritax 2015: 2 -3.

If a person transfers allowance assets to a company which meet the 50 per cent criteria and the transaction is done as an asset-for-share transaction and within 18 months that person sells his shares or part of his shares to the company, the proceeds received will be taxed as income. Transactions where those shares have subsequently been sold by way of a share buy-back transaction will therefor lead to potential income tax liability.[16] This restriction does not apply to the disposal of shares by means of an intra-group transaction[17], an unbundling transaction[18], a liquidation distribution[19], an involuntary disposal[20] or the death of a person. Therefore, referring to the example above, if the transferor should die a month after the conclusion of the asset-for-share transaction and his shares be bequeathed in his will to his son who is the only other shareholder this provision will not apply.

An example of this:

Mr. Y disposed of trading stock at a cost of R1 million to Company B in terms of an asset-for-share transaction in exchange for 35% of the ordinary shares of the company. The shares are worth R1,5 million. Twelve months later, Mr. Y sells his shares, which he held as a capital asset, for R2 million.

His taxable income will be calculated as follows:

Proceeds on the sale of the shares deemed to be income	R1,5 million[21]
Less Deemed cost of shares	R1 million
	= R500,000
Capital gains tax calculation:	
Proceeds from disposal of shares	R2 million
Amount already taxed above	R1,5 million
	= R500,000
Annual exclusion	(R 40,000)
40%	= R460,000 x 40%
Taxable Capital Gain:	= R184,000
Total taxable income	= R500,000 + 184,000
	= R684,000

[16] http://www.werksmans.com/legal-briefs-view/asset-share-transactions-beware-selling-shares-within-18-months-especially-context-share-buy-back/ accessed on 27/06/2017.
[17] Secton 45 of the Income Tax Act.
[18] Section 46 of the Income Tax Act.
[19] Section 46 of the Act.
[20] Paragraph 65 of the Eighth Schedule to the Income Tax Act.
[21] market value at the beginning of the 18 month period

Conclusion

Asset-for-share transactions provide for extensive tax relief in certain specific circumstances. Section 42 is a complex piece of legislation and asset-for-share transactions should not be seen as a quick fix in an estate planning context. The legislature's purpose with the legislation was to assist in corporate restructures and joint ventures and not as a personal financial planning tool. It has however successfully been utilised in estate planning without any negative after effects as of yet. It is not be regarded as a perfect solution for all. Caution must be had when giving advice on the matter and it would be best to refer the client to a specialist in the field who will be able to assess each client's needs and circumstances individually on merit. The accounting officer of the client will play an important role when asset-for-share transactions are entered into. It is an intricate transaction that should be done with the assistance of a skilled accountant or auditor. Only after consideration of all the relevant facts and the legislative measures should an asset-for-share transaction be implemented.

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A practical view on the importance of reviewing security cessions when revisiting a client's estate plan

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Introduction

It often happens in practice that clients are required by financial institutions to provide security for debts by way of security cessions on life policies.

The client's knowledge of the implications of ceding policies to financial institutions, often does not go hand in hand with the above. More often than not, financial planners do not play a role in deciding which policy should be ceded or it can be that the financial institution merely requires a client to take out a new policy to stand as security for the debt in question. The client, and in some instances, the planner does not get the opportunity to discuss the practical implications of the security cession.

The essence of the matter is that the various life assurance companies, as well as the various financial institutions have different views on the rights of beneficiaries. It is thus of utmost importance that financial planners familiarise themselves with the way in which the various institutions deal with security cessions to be in a position to correctly advise clients when faced with similar queries.

This article will explore a scenario with which financial planners may be faced when dealing with clients who have ceded policies to financial institutions as security for a debt. The article will confirm the importance of a correctly structured estate plan in order to ensure that the correct advice is given to clients.

Facts

Client A bought a property. He applied for a mortgage bond with XYZ Bank to the value of R 3 000 000. The bank required security for the bond and the client mentioned that he has an existing life policy with Company ABC to the value of R 3 000 000 which he could cede to the bank. The bank agreed to this and the policy was ceded. The client's spouse was the beneficiary on the policy. The client's will stipulated that the residue of his estate was bequeathed to his three children.

Possible Scenarios

When Client A passed away, the outstanding amount on the bond was R 2 400 000. The bank notifies the insurer that Client A has passed away and institutes the claim for the payment of the life policy.

The question that arises is the manner in which the above scenario will be dealt with, firstly by the insurer, and secondly, by the bank.

It should be noted that the various insurers and banks have different views regarding the manner in which the above claim is handled.

The first possibility could be that the insurer pays over the full policy proceeds to the bank, as some insurers are of the view that a security cession suspends the nomination of a beneficiary while the cession is in effect. The second being that the insurer could enquire from the bank as to what the exact outstanding amount is in respect of the bond and only pay over that amount, whereafter the remaining portion is paid to the nominated beneficiary.

In the first possibility above, the view of the bank will also be of utmost importance. In the event that the bank's view is also that the beneficiary nomination is suspended by the cession, the remainder of the proceeds will be paid into the estate of the client. Some banks do however pay the remainder to the nominated beneficiaries as stated in the policy contract.

Assuming that the insurer pays the full amount to the bank and the bank pays the remaining portion of the proceeds into the client's estate, the portion paid into the estate will devolve in terms of the client's will. As the residue of his estate is bequeathed to his three children, they will eventually inherit the remaining portion. This option also brings the levying of executor's fees on the portion paid into the estate into play, which would not be the case if the remainder is paid to the nominated beneficiary.

As a result of the client not comprehending the impact of the cession on his beneficiary nomination, the remaining funds from the policy could end up being inherited by the wrong people.

This scenario can also be extended to consider what the impact would be if the bond is completely settled by the client before his death, but the security cession has never been cancelled. More often than not, the insurer would require proof of the existence of the debt before paying out the policy proceeds to the cession holder, but it may happen that the insurer pays the policy proceeds to the cession holder as the cession might be noted on their system without bearing any knowledge of the fact that the debt was fully repaid. In this instance the cession holder might pay the full proceeds to the estate of the deceased, depending on the wording of the policy and/or cession document.

Facts

Client B bought a business property and obtained a bond from ABC Bank. The bond amount was R 10 000 000. Client B took out a policy to the value of R 5 000 000 which was ceded to the bank as security. Client B was of the view that, by the time he died he would have surely have been able to repay most of the bond. In his will client B leaves the property to his children and the residue of his estate to his spouse.

Scenario

Upon the death of client B and without taking any of the other assets in his estate into account, there will definitely be problems.

The fact that the policy is not enough to repay the outstanding amount, will not result in the bank writing off the remainder of the outstanding amount on the bond. They will undoubtedly still require payment. There might also not be sufficient liquidity in the estate and the executor might be forced to sell the property. Assuming that this is the case, the executor will then have to repay the outstanding amount and the remaining proceeds from the sale of the property will be inherited by the client's spouse as it would form part of the residue, where it was intended that the property should be inherited by his children.

Conclusion

On numerous occasions the above scenarios have been encountered in various shapes and sizes, albeit that there is still a cession noted on a policy where the debt has been repaid or where the ceded policy is less than the outstanding amount on a debt and this should provide planners with some discomfort as the associated implications are immense.

If the policy proceeds do not end up where the client intended for it to, it will surely lead to countless headaches and in some instances even costly litigation, as has been the case in various matters that came before our courts and the ombudsman in the past.

Financial planners should thus ensure that when dealing with clients who have ceded policies to financial institutions, they inform clients of the relevant consequences taking into account that each scenario will have its own facts and/or consequences.

Furthermore it is also recommended that, when the planners do their reviews of the clients' estate plans, they also review the need for security cessions on the policies of their clients and ensure that the correct values are ceded.

Lastly, the importance of a correctly drafted will must not be overlooked. Their clients' wills must be reviewed in order to fit in with the client's estate plan to ensure that the client's wishes can be executed in a practical and effective manner.

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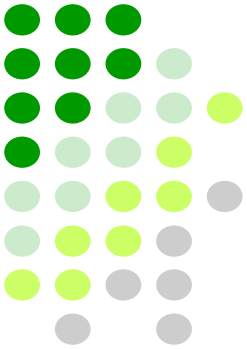

Retirement Planning

Retirement benefits: Mode of Payment

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Introduction

One of the options with regard to retirement funds when dealing with minor beneficiaries or dependants is to have retirement fund benefits paid into a testamentary trust. The question is whether a testamentary trust is the only and/or preferred option as protection vehicle of one's retirement benefit(s) for minor dependants or beneficiaries.

Retirement fund benefits

Section 37C (1) of the Pension Funds Act[1] (hereinafter referred to as "the Act") provides that —

"Notwithstanding anything to the contrary contained in any law or in the rules of a registered fund, any benefit (other than a benefit payable as a pension to the spouse or child of the member in terms of the rules of a registered fund, which must be dealt with in terms of such rules) payable by such a fund upon the death of a member, shall, subject to a pledge in accordance with section 19 (5) (b) (i) and subject to the provisions of sections 37A (3) and 37D, not form part of the assets in the estate of such a member, but shall be dealt with in the following manner:

(a) If the fund within twelve months of the death of the member becomes aware of or traces a dependant or dependants of the member, the benefit shall be paid to such dependant or, as may be deemed equitable by the fund, to one of such dependants or in proportions to some of or all such dependants."

Part of the duties imposed on a fund's board of trustees[2] by section 37C of the Act therefore relate to identifying a fund member's legal and factual dependants. Once the dependants/beneficiaries and the distribution of the benefit are determined, the board will decide on the "ideal method" of distributing this retirement benefit to the fund member's identified dependants/beneficiaries.

With effect from 1 November 2008, section 37C(2)of the Act reads:

"*a) For the purposes of this section, a payment by a registered fund for the benefit of a dependant or nominee contemplated in this section shall be deemed to be a payment to such dependant or nominee, 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 recognised 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;

[1] No 24 of 1956
[2] Hereinafter referred to as the board

(ii) a person recognised in law or appointed by a Court as the person responsible_for managing the affairs or meeting the daily care needs of a dependant or nominee; or

(iii) *a registered beneficiary fund.*"

Dennis[3] explains the intention of the legislature in enacting section 37C to be two-fold: the protection of dependants of a deceased fund member from destitution and the minimisation of the Government's expenditure with regards its social assistance programmes.

With regards section 37C(2)(a)(i) it is common for parents to stipulate in their will that a testamentary trust be set up for their minor children in the event of their death. Such trusts, as explained by David Hurford[4], are not cheap to administer. Will an existing inter vivos (living trust) not fulfil the same role and perhaps at a lesser charge?

As for section 37C(2)(a)(ii), payment of a retirement benefit to a minor dependant can be by way of payment to the guardian in instalments or payment of a lump sum to the guardian.

Many parents may question why payment needs to be made to the guardian and not directly into the bank account of the child(ren), often explaining in detail why they deem the father/mother "unfit" to look after their child(ren). The reality is that the Pension Funds Adjudicator has held in several determinations that a retirement benefit should only be paid to a minor directly in exceptional circumstances only.

In the matter of Dhlamini v Smith and Another[5], the Adjudicator held that: *"The payment of a minor's benefit to his/her legal guardian should be done in the ordinary course of events, and in my view, it should be displaced by the other two exceptional options only if there are cogent reasons for depriving the guardian of the natural consequences of guardianship, in this instance, the duty to take charge of the financial affairs of the minor, coupled with the right to decide how the funds due to a minor should be utilised in the best interests of the minor. Where the board has decided to depart from the ordinary rule, it will have to show the existence of good grounds giving rise to an apprehension that the guardian will fail to fulfil his/her duties towards the minor."*

Mafe v Barloworld (SA) Retirement Fund[6] is evidence again that retirement benefits are to be paid to the minor's parent. It is only if the personal circumstances of the parent is such that

[3] Dennis, M.M (2013) Section 37C of the Pension Funds Act, 24 of 1956: A social security measure to escape destitution at 68.
[4] http://www.iol.co.za/personal-finance/beneficiary-fund-can-secure-your-kids-future-2033424 [Accessed 25 June2017]
[5] [2003] 7 BPLR 4894 (PFA) at 21.
[6] PFA/ FS/13033/07/CN at 36.

payment to the parent would not be in the minor's best interest, should payment be made to a beneficiary fund.

In *Ramanyelo v Mineworkers Provident Fund*[7], the Adjudicator held that the following factors need to be considered by a board in its decision on whether or not to make payment of a retirement benefit to a minor's guardian:

- ❑ the amount of the benefit;
- ❑ the qualifications (or lack thereof) of the guardian to administer the monies;
- ❑ the ability of the guardian to administer the monies; and finally
- ❑ the benefit should be utilised in such a manner that it can provide for the minor until he attains the age of majority.

With regards section 37C(a)(iii), Jeffrey[8] explains that a "*beneficiary fund is a fund established for the purposes of accepting lump sum death benefits awarded in terms of Section 37C of the Pension Funds Act to a beneficiary (dependant or nominee) on the death of a member, which are not paid directly to that beneficiary (or his/her recognized care giver or guardian in the case of a minor), or to a trust nominated by the member, or to the member's estate or to the guardian's fund*."[9]

Section 10(1)(gE) of the Income Tax Act[10] exempts amounts paid by beneficiary funds, as defined in the Pension Funds Act[11]. Beneficiary funds are taxed similar to any pension fund in South Africa. And as Hurford[12] explains, because benefits are taxed first before being paid to the beneficiary fund any income or capital paid by the beneficiary fund is tax-free. Also, while no tax is paid when a child turns 18, and the fund is terminated (with any remaining funds payable to the child), nothing prevents an 18-year old from leaving the funds in the beneficiary fund and so continue to benefit from the tax advantages provided.

So while section 37C of the Act governs the disposition of retirement benefits, the board is empowered to consider various factors and conditions in effecting an equitable distribution of a retirement benefit. One such factor for the board to consider in effecting such an equitable distribution that should not be neglected is the retirement beneficiary nomination form stating, in part, who should receive the members' retirement fund interest and in what proportion[13].

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[7] [2005] 1 BPLR 67 (PFA) at 16.
[8] Jeffrey, M.M (2013) The Laws regulating Beneficiary Funds in South Africa: A Critical Analysis at 17.
[9] Beneficiary funds were introduced by the Financial Services General Laws Amendment Act, 22 of 2008 following the Fidentia scandal. These funds are also governed by the Pension Funds Act.
[10] Act 58 of 1962
[11] Haupt, P. Notes on South African Income Tax 2016 at 87.
[12] http://www.iol.co.za/personal-finance/beneficiary-fund-can-secure-your-kids-future-2033424 [Accessed 25 June 2017]
[13] Tsele v Bidvest South Africa Retirement Fund and another [2016] 1 BPLR 146 (PFA)

Conclusion

The focal point is always the best interest of the client and while the decision of any action lies with the client, it is understood that a client can only make an informed-decision if he/she has been provided with all the requisite information (with alternatives) to make such informed-decision. While section 37C of the Act governs the disposition of retirement benefits it is still advisable for fund members to request the assistance of their financial planners prior to completing their retirement beneficiary form.

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Taxation of retirement benefits relating to offshore service

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Introduction

The Taxation Laws Amendment Act[1] 2016, has brought about changes to the taxation of retirement benefits that accrue to South African residents in respect of services rendered outside of South Africa.

In this regard, a distinction needs to be drawn between the taxation of the benefits received by a South African resident from a foreign pension (i.e. a retirement fund that is not registered in South Africa), the benefits received by a non- resident from a South African registered retirement fund, and the benefits received by a South African resident from a South African registered retirement fund where the benefit relates to services rendered outside of South Africa.

The taxation of foreign pensions under the social security system of another country that accrue to a South African resident

Section 10(1)(gC)(i) of the Income Tax Act[2] deals with the taxation of foreign pensions received by South African residents. It provides that no income tax is payable on any amount received by or accrued to a South African resident under the social security system of any other country.

The taxation of retirement benefits received by South African resident where the benefit relates to services rendered outside of South Africa

Section 10(1)(gC)(ii)[3] read with Section 9(2)(i)[4] deals with the taxation of the benefits received by a South African resident in relation to services rendered outside of South Africa while contributing to a South African registered fund.

Prior to 1 March 2017, South African residents could apply for an exemption in respect of retirement benefits received by or accrued to them from 'a source outside of the Republic'.

Binding General Ruling 25[5] provided that the term 'source outside of the Republic' for purposes of Section 10(1)(gC)(ii), refers to the originating cause that gives rise to the retirement benefit – i.e. where the services have been rendered.

Accordingly, a formula was applied to the relevant benefit to determine the portion of the retirement benefit that will be exempt from income tax where there were services rendered partly in and partly out of South Africa:

[1] Act 15 of 2016
[2] Act 58 of 1962
[3] Act 58 of 1962
[4] Act 58 of 1962
[5] Binding General Ruling (Income Tax): No 25, 2014

$$\frac{\text{No of years foreign services rendered}}{\text{Total years services rendered}} \times \text{total benefit received}$$

The pro-rata portion of the benefit received was exempt from income tax.

Effectively, a South African resident who was working abroad but still contributing to his/her South African registered retirement fund while doing so, would have received a portion of his/her retirement benefit tax free.

Section 10(1)(gC)(ii)[6] was amended with effect from 1 March 2017 and Binding General Ruling 25 of 2014[7] has been withdrawn and replaced with Binding General Ruling 25 (Issue 2) dated 16 March 2017. The amendment applies to existing and future pensioners.

Section 10(1)(gC)(ii)[8] now provides that the exemption is only applicable to retirement benefits that are received by or accrue to a resident from a source outside the Republic as consideration for past employment outside the republic other than to benefits from a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity as defined in section 1(1)[9] .

With effect from 1 March 2017, the exemption is thus only applicable to foreign retirement funds and not funds registered in South Africa. South African residents who contributed to a foreign retirement fund while working abroad will enjoy the exemption under Section 10(1)(gC)(ii), but those that contributed to a South African Registered Fund while working abroad no longer qualify for an exemption in relation to their offshore service.

The amendment does, however, extend the benefit to amounts that are transferred to a South African registered fund from a foreign fund. This is unlikely to be of much application since a South African registered fund can only accept transfers from another approved fund – i.e. a fund registered with the South African Registrar of Pension Funds.

The taxation of retirement benefits received by a non-resident

In terms of Section 9(2)(i) of the Income Tax Act,[10] the pro-rata portion of any lump sum and annuity payments received by a non-resident from a South African registered pension or

[6] Act 15 of 2016
[7] Binding General Ruling (Income Tax): No 25, 2014
[8] Act 15 of 2016
[9] Income Tax Act 58 of 1962
[10] Act 58 of 1962

provident or pension preservation or provident preservation fund that relates to services rendered outside of South Africa, will be deemed to be from a source outside of South Africa and be exempt from income tax.

Effectively, a non-resident who contributed to a South African registered retirement fund (other than a retirement annuity) while working abroad, will qualify for a tax exemption in respect of the retirement benefit that accrues to such member that relates the services rendered outside of South Africa.

In order to determine the amount of the benefit that will be exempt from income tax, the following formula will be applied:

$$\frac{\text{No of years foreign services rendered}}{\text{Total years services rendered}} \times \text{total benefit received}$$

Note that this does not apply to benefits received by a non-resident from a South African registered retirement annuity fund since services rendered are in no way linked to a retirement annuity.

Conclusion

Section 10(1)(gC)(i)[11] which provides for an income tax exemption in respect of foreign pensions received under the social security system of another country by South African residents remains unchanged. Persons receiving such pensions will continue to receive them free of income tax.

Non-residents who receive a retirement benefit from a South African registered retirement fund (other than a retirement annuity fund) where the benefit relates to contributions made while employed outside of South Africa, will also continue to receive the tax concession in respect of the services rendered outside of South Africa.[12]

The only income tax concessions that a South African resident will be entitled to in respect of retirement benefits received by or accrued to that person relating to services rendered out of South Africa, will be in respect of amounts received or accrued from a foreign retirement fund or amounts that were transferred to a local fund from a foreign retirement fund.

[11] Income Tax Act 58 of 1962
[12] Section 9(2)(i) of the Income Tax Act 58 of 1962

The amendments to Section 10(1)(gC)(ii) and Section 9(2)(ii) of the Income Tax Act[13] have far reaching consequences for members of South African registered retirement funds who are South African residents and have contributed to their retirement funds while working abroad.

For clients who have not yet retired, the expected tax concession has been lost and will in all likelihood have a significant impact on the relevant member's retirement plan which will now require revision.

It is too late for those tax payers who are already drawing a pension - they will no longer be receiving a portion of their pension tax free, but will be taxed on the full pension income. Their retirement planning was based on the legitimate expectation of receiving a portion of their pension tax free - the negative effect on their remaining retirement capital is obvious as is the fact that their increased taxable income may result in their total taxable income being taxed in a higher tax bracket. This will have a further negative impact on their financial planning.

[13] Act 58 of 1962

Options at withdrawal from retirement funds

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Introduction

Saving for retirement could be one of the most important financial goals in a person's life. The number of social grants in our country has greatly increased over the past two decades, from approximately R4 million in 1994 to approximately R121 billion up to February 2017.[1] In 2014/2015, 41% of the government's budget for Social Grants, were utilised for the payment of Old Age Pension.[2] As on 31 May 2017, a total of 3,326,259 people were receiving the Old Age Grant from the state.[3] Many economists have questioned the sustainability of the model of social grants in South Africa. One of the causes of so many elderly people needing social grants to survive, is insufficient provision for retirement.

How can one make provision for retirement? There are numerous savings vehicles and one of the more common means of saving for retirement is in a retirement fund. Access to your retirement savings in a retirement fund before you retire (and even afterwards) is restricted and may only be taken in cash under certain circumstances, dependant on the vehicle you are invested in, and as allowed by law. The two main pieces of legislation applicable to retirement funds is the Pension Funds Act 24 of 1956 and the Income Tax Act 58 of 1962. There are a number of retirement funds in South Africa of which a person can be a member. This article focuses on certain options available when retirement savings in a retirement fund are accessed before retirement, specifically with regards to private sector pension funds, provident funds, retirement annuities and preservation funds.

Closely related to this topic is the tax consequences of multiple withdrawals from retirement funds. Therefore the article will also provide a brief overview of the principle of aggregation of retirement lump sum benefits, together with a few examples.

Retirement funds in South Africa

The three main retirement savings vehicles in South Africa are pension funds, provident funds and retirement annuity funds (hereinafter referred to as a RA). Preservation funds are also categorised under retirement funds.

A pension fund is a fund established for the benefit of employees with the purpose of providing annuities for employees upon retirement[4]. A provident fund has a similar definition, but the purpose of a provident fund is providing benefits to employees upon retirement[5]. Being a member of a pension or provident fund requires an employer-employee relationship. Membership (and contributions) must be compulsory for all employees who meet the relevant criteria. Most of these funds are categorised as defined contribution funds, meaning the amount

[1] Factsheet: Social grants in South Africa – separating myth from reality. Louise Ferreira. February 2017
[2] Breakdown of the Social Grant pie, Statistics South Africa, 2 June 2016
[3] Statistics South Africa Fact sheet: Issue 5 of 2017. 31 May 2017
[4] Definition of "pension fund" in the Income Tax Act 58 of 1962
[5] Definition of "provident fund" in the Income Tax Act 58 of 1962

of contributions made (plus investment growth less costs, etc.) determines the amount of benefits at retirement.

A retirement annuity is a fund (other than a pension or provident fund) established for the sole purpose of providing annuities for the members upon reaching their retirement age[6]. Membership of a RA does not require an employer-employee relationship.

A preservation fund is a "pension fund organisation"[7]. It is a retirement vehicle in its own right, but can rather be explained as a vehicle for preservation of retirement benefits that become available as a result of withdrawal from a retirement fund. Only transfers of benefits may take place into this type of fund. No member contributions are allowed.

Types of benefits

There are a number of benefits that can become available from retirement funds, during the course of the member's life. Termination of membership of a retirement fund prior to retirement normally arises due to resignation, retrenchment or dismissal from the service of the employer. Death of the member also gives rise to termination of membership prior to retirement. There is, however, a difference in the tax consequences if a cash amount is taken, depending on the reason for termination of membership of the fund (see more below).

❑ "Retirement" benefits

- This is the benefit that becomes available once the member retires from a retirement fund. This usually happens when the member retires from his/her employment, but not necessarily. Retirement benefits can also arise upon the death of the member; upon the commutation of an annuity or a portion of an annuity; and if the termination or loss of the member's employment is due to retrenchment/redundancy as defined in the Income Tax Act.[8] The definition of "normal retirement age" in the Income Tax Act also allows for retirement benefits to become available in the case of, what is commonly referred to as, permanent disability.[9]
- Retirement age can vary depending on the fund rules and there is no maximum retirement age prescribed by law. In terms of the Income Tax Act, the minimum retirement age as applicable to a RA is 55[10]. In the case of a RA, in order for the member to retire from the fund, he must have reached the age of 55, or have become permanently incapable of carrying on his/her occupation due to sickness, accident or injury or incapacity through infirmity of mind or body.[11]

[6] Definition of "retirement annuity fund" in the Income Tax Act 58 of 1962
[7] Definition of "pension fund organisation" read together with the definition of "pension preservation fund" and "provident preservation fund" in the Income Tax Act 58 of 1962
[8] Paragraph 2(1)(a) of the Second Schedule to the Income Tax Act 58 of 1962
[9] Definition of "normal retirement age" in the Income Tax Act 58 of 1962
[10] Definition of "normal retirement age" in the Income Tax Act 58 of 1962
[11] Definition of "normal retirement age" in the Income Tax Act 58 of 1962. Commonly referred to as "permanent disability"

- Retirement benefits in the case of a preservation fund become available when the member retires from the fund, as well as upon death or disability of the member[12]. Members of preservation funds do not have to retire from the preservation fund at the same time as retiring from/leaving their employment. There is also no maximum age of retirement from a preservation fund.
- In the case of defined contribution funds, the benefit on retirement is usually equal to the fund value. This is the total amount of your retirement savings (own plus employer contributions, where applicable) together with any growth on your investment less any costs.
- If a member retires from a pension fund, pension preservation fund or RA, a maximum of one third of the retirement benefit may be taken as a lump sum at retirement. The remaining two thirds must be used to purchase an annuity to provide the member with an income after retirement, unless the total fund value is less than R247,500 (or if two thirds of the total value is less than R165,000) in which case the total retirement benefit may be taken as a lump sum.
- In the case of a provident fund or provident preservation fund, currently the member may take the entire retirement benefit lump sum in cash upon retirement. The position may change in the near future, causing retirement benefits of members of provident funds to be treated the same way as pension funds, which is in line with National Treasury's efforts to harmonise the tax treatment of pension and provident funds, with the goal to promote preservation of retirement benefits.
- Retirement benefits taken in cash are not taxed in the same way that the member's normal income is taxed, but according to a special tax table, known as the "Retirement tax table", which is a measure implemented by the National Treasury to encourage retirement savings.

❑ "Withdrawal" benefits

- As mentioned, access to benefits from retirement funds are restricted by law. In certain circumstances, membership of a retirement fund can be terminated prior to retirement. Termination of membership prior to retirement normally arises due to resignation or dismissal from the service of the employer[13].
- When the member's employment is terminated, the member is as a rule generally no longer able to belong to the employer's pension or provident fund. Upon resignation from employment, the member's membership of the pension or provident fund is terminated. Upon resignation, the fund value the member has accumulated while being a member of the fund is known as the "withdrawal benefit".
- Prior to age 55, the member cannot withdraw from a RA. The only exceptions are, where contributions are discontinued prior to the retirement date,:
  - in the case of a member who was a resident of SA, upon emigration of the member or in the case of a member who is a non-resident, upon his/her departure from SA at the expiry of a visa obtained for purposes of visiting or working[14]; or
  - where the total retirement interest is less than R7 000[15],

[12] Definition of "pension preservation funds" and "provident preservation funds" read together with the definition of "normal retirement age" in the Income Tax Act 58 of 1962.
[13] Death/permanent disability and dismissal due to retrenchment/redundancy also constitutes termination of membership, but as stipulated above, results in a retirement and not a withdrawal benefit becoming available in which case the cash lump sum taken is taxed at the retirement tax table.
[14] Definition of "retirement annuity fund" in the Income Tax Act 58 of 1962
[15] Definition of "retirement annuity fund" in the Income Tax Act 58 of 1962

in which case the entire amount can be withdrawn as a lump sum prior to retirement from the fund[16].

A withdrawal can also be made in terms of a divorce award to a non-member spouse.

- Withdrawal benefits in the case of a preservation fund arise when the member chooses to make use of his/her "one pre-retirement withdrawal facility". The definition of "pension preservation fund" and "provident preservation fund" in the Income Tax Act allows the member to make one partial or full withdrawal from a preservation fund prior to retirement[17]. See "Preservation Funds" below.
- Withdrawal in terms of a divorce order
  - When a member of a pension fund gets divorced, often the order of divorce grants a portion of the pension interest of the member to the non-member spouse. Where a divorce order assigns part or all of the pension interest of a member of a retirement fund to the former spouse, the fund must endorse its records. The amount awarded under a divorce order constitutes a withdrawal against the fund. The applicable legislation is Section 7(8) of the Divorce Act[18] read together with Section 37D of the Pension Funds Act[19].
  - "Pension interest" relating to pension- provident and preservation funds means benefits to which the member would have been entitled if membership would have been terminated by way of resignation or in the case of a preservation fund, withdrawal, on the date of divorce;
  - "Pension interest" relating to retirement annuities means the total amount of contributions to the RA by the member up to date of divorce, plus simple interest at the official interest rate calculated annually.
- Withdrawal benefits taken in cash are also taxed according to a special tax table, known as the "withdrawal tax table."

Options at withdrawal

❑ Upon withdrawal, the member has a number of options available as to what to do with his/her accumulated benefit. The options available are subject to the rules of the fund. Generally, the benefit can be transferred to a preservation fund, RA or to the new employer's retirement fund. The member may also take the benefit in cash. The member may also take a part of the benefit in cash and transfer the remainder to a preservation fund, RA or to the new employer's fund, or to a combination of these, subject to the rules of the fund.

❑ Pension funds

- Withdraw from the fund and take the full amount in cash.
- Transfer the full amount to a pension preservation fund or retirement annuity fund or to the new employer's pension fund or to a combination of these funds (any approved fund).

[16] Paragraph (x) of the definition of "retirement annuity fund" in the Income Tax Act 58 of 1962
[17] Paragraph (c) of the respective definitions
[18] Act 70 of 1979
[19] Act 24 of 1956

- o There are restrictions applicable to the transfer applicable to a pension preservation fund as stipulated in RF1/2012, for example transfers or payments from a pension fund to a pension preservation fund may not be paid or transferred in such a way that it is split between more than one pension preservation fund.
- o Take part of the benefit in cash and transfer the remainder to a retirement annuity or pension preservation fund or partly to a retirement annuity and partly to a pension preservation fund. This option is only available if the rules of the transferring fund allows this.
- o Transfer the benefit to a provident fund or provident preservation fund. If the member makes this election, however, this transfer will be taxed as if the member took the full benefit in cash. The after-tax amount will be transferred to the provident/provident preservation fund.

❑ Provident funds

- o Take the full withdrawal benefit (fund value) as a lump sum in cash.
- o Transfer the full benefit to the new employer's pension/provident fund or provident/pension preservation fund or retirement annuity.
- o Transfer to a combination of the abovementioned funds is also possible, and there is (currently) no limitation or restriction regarding splitting of the benefit between funds. If a transfer is made to a pension or pension preservation fund or retirement annuity fund, the member will be bound by the rules applicable to that fund on retirement, specifically the member will no longer be able to take the full fund value in cash at retirement, a compulsory annuity will have to be purchased with at least two thirds of the fund value.
- o Taking part of the benefit in cash and transferring the remainder to an approved fund.

❑ Retirement Annuity funds

- o The non-member spouse to which a portion of the RA was awarded in terms of a divorce order may elect to take the benefit in cash or to transfer the benefit to an approved retirement annuity fund.
- o A member who discontinues contributions prior to the retirement date and of which the total retirement interest is less than R7 000[20] or in the case of a member who was a resident of SA, upon emigration of the member or in the case of a member who is a non-resident, upon his/her departure from SA at the expiry of a visa obtained for purposes of visiting or working, may take the full benefit in cash[21].

❑ Preservation funds

- o Once a benefit has been transferred to a preservation fund, the member has one opportunity to make a withdrawal from the preservation fund and take an amount in cash prior to retirement. Where the transfer into the fund stemmed from a private fund, the member may take part of the benefit, or the full benefit as a lump sum.

The one withdrawal facility applies in respect of each transfer made to the preservation fund. For example, Mr Member resigns from the pension fund of Employer A and transfers his full benefit of R1 000 000 from Pension Fund A to Pension Preservation Fund A. Three months later, Mr Member elects to withdraw R500 000 from Pension Preservation Fund A. The withdrawal lump sum will be taxed according to the withdrawal tax table and the aggregation principle will be applied.

[20] Paragraph (x) of the definition of "retirement annuity fund" in the Income Tax Act 58 of 1962
[21] Paragraph (x) of the definition of "retirement annuity fund" in the Income Tax Act 58 of 1962

No further pre-retirement withdrawals can be made by Mr Member from Pension Preservation Fund A in respect of the benefit transferred from Pension Fund A.

One year later, Mr Member resigns from his new employer, Employer B, and transfers his full benefit in the amount of R400 000 from Pension Fund B to Pension Preservation Fund A. Once again, Mr Member may later on make one withdrawal from Pension Preservation Fund A in respect of the transfer from Pension Fund B. Mr Member may either take the full amount transferred from Pension Fund B or a portion thereof, again taxed according to the withdrawal tax table and the aggregation principle will be applied.

- The member may take a portion of the withdrawal benefit from the occupational retirement fund in cash prior to transfer to the preservation fund, as long as the rules of the transferring fund allows this[22]. The member may then still make one withdrawal from the preservation fund.
- Divorce awards in favour of the non-member spouse will not be regarded as the member's one withdrawal from the preservation fund.

Tax consequences of options at withdrawal

- Any taxable cash lump sum, i.e. cash lump sum taken by the member upon withdrawal (as mentioned in more detail above under the heading "withdrawal benefits"), less certain allowable deductions, is taxed according to the withdrawal tax table.

  The withdrawal tax table is as follows:

Taxable income from lump sum benefits	**Rate of tax**
R0 – R25 000	0% of taxable income
R25 001 – R660 000	18% of taxable income above R25 000
R660 001 – R990 000	R114 300 plus 27% of taxable income above R660 000
R990 001 and above	R203 400 plus 36% of taxable income above R990 000

- If withdrawal from the fund was due to a divorce order and the non-member spouse elects to take the benefit or a portion thereof in cash, the non-member spouse will be taxed according to the withdrawal tax table[23]. If the non-member spouse elects to transfer the benefit to an approved fund (as set out below), such transfer will be tax-free.

- The following transfers between (approved) funds upon withdrawal is tax-free:
  - From pension fund to pension fund

[22] RF 1/2012.

[23] If the divorce order was granted prior to 13 September 2007, no tax will be payable, irrespective of the date of payment. If the divorce order was granted after 13 September 2007 and the benefit was due and payable on or after 1 March 2012, the non-member spouse will be taxed.

- From pension fund to RA
- From pension fund to pension preservation fund
- From provident fund to provident fund/pension fund/provident preservation fund/pension preservation fund and RA
- From RA to RA

❑ The following transfers are not tax free and will be taxed as if a cash lump sum was taken. The balance will be paid into the new (transferor) fund:

- From pension fund to provident fund
- From pension fund to provident preservation fund

To summarise, once it is established that the benefit constitutes a withdrawal benefit, and a cash lump sum is taken (whether it be a portion of the fund value or the full value), the cash lump sum will be taxed according to the withdrawal tax table. If no amount is taken in cash and the benefit is transferred in full to an approved fund (or only a portion of the fund value is so transferred), no tax will be payable on the amount as transferred.

Taxation and the principle of aggregation

Taxable lump sum withdrawal benefits which accrued as of 1 March 2009, retirement lump sum benefits which accrued as of 1 October 2007 and severance benefits that accrued as of 1 March 2011 will be aggregated with the current taxable lump sum taken on withdrawal/ retirement or a severance benefit being received, and be taxed according to the withdrawal tax table or the retirement tax table, depending on the current event that gives rise to the cash lump sum.

Thus, if the current event is a withdrawal, all the above mentioned amounts will be aggregated and taxed according to the withdrawal tax table. If the current event is a retirement, aggregation will still take place and the tax will be calculated according to the retirement tax table. If the member receives a severance benefit aggregation will once again apply and the retirement tax table will applicable.

Tax consequences of multiple withdrawals

It is important to note that taxable lump sums taken on withdrawal from retirement funds as of 1 March 2009, influence the tax payable on subsequent withdrawal benefits, retirement benefits taken in cash and severance benefits received or taken subsequently.

Taxable withdrawal lump sum benefits will be aggregated with prior withdrawal/retirement and severance benefits received as of the dates above, and taxed according to the withdrawal tax table.

Example: Mr. A resigned from employment with Company B and took his benefit in Pension Fund B in cash on 30 March 2010. The taxable lump sum was R100 000. This was the first time Mr. A received a lump sum from a retirement fund.

He then joined another Company C and became a member of Pension Fund C. On 1 February 2016 he resigned from employment from Company C. The taxable lump sum from Pension Fund C was R600 000.

Calculation of tax payable on the R600 000 lump sum:

Step 1 (current taxable lump sum)	R600 000
Step 2 (identify and add previous taxable lump sums[24])	R100 000
Step 3 (add steps 1 and 2)	R700 000
Step 4 (apply the withdrawal tax table to step 3 amount)	R125 100
Step 5 (apply the withdrawal tax table to step 2 amount)	(R 13 500)
Step 6 (subtract step 5 amount from step 4 amount)	R111 600

Thus, as illustrated, if aggregation principle is applied ,the tax payable on the R600 000 lump sum will be R 111 600 instead of just R103,500 (calculated by simply applying the withdrawal tax table to the R 600 000 lump sum) which would have been the case if Mr. B had not previously received the R 100 000 lump sum.

Retirement after withdrawal

All taxable cash lump sums taken at retirement as of 1 October 2007, withdrawal as of 1 March 2009 and any severance benefits received as of 1 March 2011 will influence the tax payable of retirement lump sums taken at retirement.

These prior lump sums will be aggregated with the cash lump sum taken at retirement, and taxed according to the retirement tax table, which could possibly (and will probably) result in a heavier tax load at retirement.

Example: Mr A (from the previous example) attained the age of 55 on 1 March 2017 and retired from his RA. He took one third of the fund value in cash. The one third taxable cash lump sum amounts to R1 000 000.

[24] Lump sums taken at retirement as of 1 October 2007, withdrawal as of 1 March 2009 and any severance benefits received as of 1 March 2011

Calculation of tax payable on the R1 000 000 lump sum:

Step 1 (current taxable lump sum)	R1 000 000
Step 2 (identify and add previous taxable lump sums[25])	R 700 000
Step 3 (add steps 1 and 2)	R1 700 000
Step 4 (apply the retirement tax table to step 3 amount)	R 364 500
Step 5 (apply the retirement tax table to step 2 amount)	(R 36 000)
Step 6 (subtract step 5 amount from step 4 amount)	R 328 500

The tax payable on the R1 000 000 retirement lump sum is R328 500 instead of only R117 000 (calculated by applying the retirement tax table to the R1 000 000 lump sum) which would have been payable had Mr. B received no cash withdrawal benefits in the past.

Conclusion

The various options at withdrawal from a retirement fund, specifically when a member resigns from employment, can often be confusing for the member. The measures implemented by the National Treasury,especially regarding taxation, encourages taxpayers to preserve their retirement benefits. Members should be aware of all available options as well as the consequences of each option to enable the member to make an informed decision. The choice the member makes could have long term implications and influences future options as well, as can be seen in the taxation aggregation principle that is applied at withdrawal and retirement and when receiving a severance benefit.

[25] Lump sums taken at retirement as of 1 October 2007, withdrawal as of 1 March 2009 and any severance benefits received as of 1 March 2011

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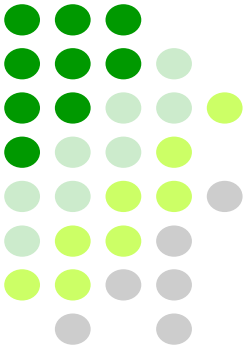

TAX

Options available to counteract the implications of Section 7C

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Introduction

National Treasury tightened the tax provisions applicable to trusts by introducing Section 7C into the Income Tax Act. The Taxation Laws Amendment Act of 2016 was promulgated on the 19th of January 2017, and was made effective on 1 March 2017. The Draft Taxation Laws Amendment Bill 2017[1] contains certain amendments to Section 7C, and the bill is still open for comment, at the time that this article was written. Section 7C was introduced to prevent the use of interest-free loans or lower-than-the-official-interest-rate-loans to trusts to avoid and/or reduce estate duty and donations tax.

Section 7C is applicable irrespective if the loan, advance or credit was made before, on or after the 1st of March 2017. Therefore it is applicable retrospectively to loans, even if it was made prior to 1 March 2017. The actual donation will however be deemed to take place on the last day of the tax year.

This article will attempt to summarise the options available to counteract the provisions of Section 7C. Options which were already frowned upon by Treasury will not be part of the article (where a company is introduced into the structure, to avoid Section 7C for instance). The Draft Taxation Laws Amendment Bill nonetheless addresses this through the widening of the definition of a connected person, therefore this loophole that existed before, is closed, in writers understanding.

Option 1: Levy the official rate of interest on the loan

The application of Section 7C can be prevented by the lender, if the lender levies the official rate of interest (7.75 % at the time of writing this article) on the loan per annum. Where the trust is earning taxable income one would need to consider whether it is worthwhile to levy the official rate of interest on the loan, since it may be deductible by the trust against the trust's taxable income[2]. Direction from the accountant/auditor will be advisable in this scenario, weighing up the charging of interest by the lender versus deducting the interest paid by the trust in the financials of the trust.

Where the lender is younger than 65 years

Phillip Haupt[3] highlights the fact that one should not loose sight of the interest exemption of R23 800[4], where the lender is younger than 65 years old. Interest of R23 800 could be earned by a lender who earns no other interest in a year of assessment, if he/she made a loan to a trust to the value of R307 097 (R23 800 divided by 7.75 %). This means that a loan of R307 097 by the lender (under the age of 65), where interest is levied at 7.75 % on the loan will not incur tax on the interest, as it is equal to the local interest exemption.

[1] GPJ van den Berg, *Interest free loans or low interest loans to Trusts and related companies*, Delport van den Berg Estate & Trust Services (21 July 2017)
[2] Section 11(a) Income Tax Act
[3] Haupt, Phillip, *Notes on South African Income Tax* (2017) at 825
[4] Section 10(1)(i), Income Tax Act, exemption for local interest earned

Where the lender is older than 65 years

Where the lender is older than 65 years of age, the current interest exemption is R34 500[5]. This means that a lender who earns no other interest in a year of assessment, can make a loan to a trust to the value of R445 161[6] (R34 500 divided by 7.75 %) without incurring any additional income tax liability, since the interest earned by the lender will be equal to the local interest exemption for persons 65 years or older.

Option 2: Use the donations tax exemption for both spouses[7]

In the instance where no interest is charged on the loan, then if the loan account owing to the lender is a maximum of R1 290 300, and the lender is not making any other donations in the year of assessment, no donations tax will be payable by the lender. If the lender is married, this means that R1 290 300 x 2 can be loaned between the two spouses to the trust, without the two spouses having a donations tax implication as individual tax payers.

R1 290 300 x 7.75 % = R99 998 (which is almost equal to the donations tax exemption for individuals).

Hence R0 donations tax will be payable by the lender, and the same would apply to his/her spouse, assuming that they are not making any other donations in the year of assessment.

Option 3: Use a combination of the interest and donations tax exemptions

Where the lender is not earning any other interest or making any other donation in the year of assessment, Phillip Haupt[8] suggests that the loan account could be:

Where the lender is younger than 65 years

A loan account of R 1 290 300 + R307 097= R1 597 397. If interest is charged at 1.489 %, then the calculation for income tax purposes will be:

R1 597 397 x 1.489 % = R23 785 interest payable (interest exemption is R23 800)

Thus the interest exemption will apply.

The calculation for donations tax purposes will be:

The difference between 7.75 % (the official interest rate currently) and 1.489 %= 6.261%.

Thus R1 597 397 x 6.261 % = R100 013 (R13 above the R100 000 donations tax exemption).

[5] Section 10(1)(i) Income Tax Act, exemption for local interest earning for persons 65 years or older
[6] C Muller, Presentation slides, Section 7 C of the Income Tax Act and Loan accounts, at 11
[7] Premiums & Problems Edition 115 (2017) at E 4, Donations Tax: Exemptions
[8] Haupt, Phillip, Notes on South African Income Tax (2017) at 825

Where the lender is older than 65 years

A loan account of R1 290 300 + R445 161 = R 1 735 461.[9] If interest is charged at 1.99%, then calculation for income tax purposes[10] will be:

R 1 735 461 x 1.99% = R34 535 interest payable (interest exemption is R34 500)

Thus the interest exemption will apply.

The calculation for donations tax purposes[11] will be:

The difference between 7.75 % (the current official interest rate) and 1.99 % = 5.76%.

Thus R1 735 461 x 5.76 % = R99 962 (Almost equal to the R100 000 donations tax exemption).

Option 4: Donate R1 290 300 of the loan account to the spouse

As noted in the example above, donations tax is only payable on a loan account in excess of R1 290 300 (assuming the donations tax exemption has not already been used by the lender during the tax year). The lender can donate R1 290 300 of the loan account to his/her spouse. There is no donations tax applicable between spouses.[12] This will then enable the spouse of the lender to also use his/her annual R100 000 donation exemption, if not already used for other purposes in the year of assessment.

It is important to note that the consequences of divorce and insolvency should be taken into account before the donation of a loan account to a spouse is considered by the lender.

Option 5: Trust can reduce or repay the loan account

Where the trust has enough liquid assets to repay or reduce the loan account to the lender, this can be considered. The loan account can even be paid by the trustees of the trust, by transferring assets to the lender as repayment. The trustees of the trust should consider the tax implications before decisions in this regard are taken:

(i) Where the trust needs to sell assets to get liquidity to repay/reduce the loan, capital gains tax implications should be considered, the same may apply where an asset is transferred as payment of the debt;

(ii) Where fixed property needs to be transferred as part of the plan to reduce/repay the loan account, transfer duty, transfer fees and conveyancing fees of the conveyancer should be considered;

(iii) Transfer of assets or cash(and where this is further invested) back to the lender will have the consequence that the lender's gross estate will increase where the assets grew in value for

[9] Muller Carl, Presentation Section 7 C of the Income Tax Act and Loan accounts, page 15
[10] Ibid page 15
[11] Ibid page 15
[12] Section 56(1)(b) Donations to a spouse are exempted from donations tax, Income Tax Act

instance, thereby causing the domino effect of increased costs in the lender's estate for example capital gains tax, estate duty, executor's fees etc. One should always look at the intention as to why the trust was created in the first place, and whether that is still what is accomplished, before taking a decision to reverse the initial transaction, where the trust has to repay the whole loan account. This could combat Section 7C yes, but cause other tax implications, which could even be worse. Therefore caution must be applied, when advising clients.

Conclusion

There is not one magic solution to combat the impact of Section 7C in any lender's estate. It is rather a case of looking at the specific circumstances of the specific client/lender, and advising the client/lender of all the options available. Financial planners should also always involve the client's accountant/auditor in the client's financial planning and tax affairs, and with the introduction of Section 7C it is no different and becomes even more important to do so. In this case, three heads might just be better than one.

Capital vs Revenue on the Disposal of Shares – Capstone 556 (Pty) Ltd v Commissioner: SARS

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Introduction

The categorisation of the proceeds on the disposal of shares as either capital or income has often been contentious. This can have a profound effect on a taxpayer's liability to SARS. The case of Capstone 556 (Pty) Ltd v Commissioner: SARS[1] is the most recent case where the High Court of the Western Cape had to decide on the distinction between capital and income where shares were disposed of.

Facts

In June 2002, Capstone 556 (Pty) Ltd ("the taxpayer") as a member of a consortium purchased a large percentage of shares in a listed company ("the company"). The shares were transferred and acquired by the taxpayer during December 2003. The company was in financial distress and the purchase of the shares was to assist with the recovery of the company. The rescue operation was expected to take between three to five years.[2]

However, a combination of improved economic conditions and the strategy employed the company led to the company improving its outlook sooner than expected. This resulted in the consortium disposing of its shares (at a profit) within five months of acquisition. The sale was pre-empted by one of the members of the consortium that happened to be a foreigner (and who had the authority to sell on behalf of the consortium). The fall in the rand price during this period prompted the foreign member to sell the shares.[3]

SARS argued that the shares were not acquired for investment purposes but for resale at a profit. This argument was supported by the fact that the shares were held for a relatively short period before being sold. The tax court agreed with SARS and found that the proceeds were revenue in nature. The matter was taken up on appeal to the High Court of the Western Cape.

[1] A49/14 [2014] ZAWCHC 123
[2] Doeling Lessing & Daleen Malan, Werksman Attorneys Legal Brief (2014)
[3] Doeling Lessing & Daleen Malan, Werksman Attorneys Legal Brief (2014)

Definition of Capital

The word "capital" is not defined in the Income Tax Act[4]. Maritz J in CIR v Visser stated[5]: *"Income is what capital produces, or is something in nature of interest or fruit as opposed to principal or tree. This economic distinction is a useful guide in matters of income tax but its application is very often a matter of great difficulty for what is principal or tree in the hands of one man may be interest or fruit in the hands of another."*

Receipts and accruals of a capital nature are generally excluded from the definition of gross income. However, certain receipts and accruals are specifically included in gross income regardless of their nature. One would include in gross income general inclusions in terms of the general definition of gross income as per section 1 of the Income Tax Act, specific inclusions in terms of paragraph (a) to (n) of the definition of gross income, deemed accruals (section 7 of the Income Tax Act), deemed interest (section 8E of the Income Tax Act) and accruals and interest deemed to be of a South African source.[6] The taxable capital gain (i.e. net capital gain after taking exemptions into account and applying the inclusion rate) on the disposal of a capital asset is included in the taxable income.

Sale of shares

The behaviour of the taxpayer in relation to the disposal of shares will determine whether the proceeds are income or capital. If the shares were acquired or held for resale (for profit) for a period of less than three years, one could conclude that the proceeds will be income in nature. If the shares were acquired or held for investment purposes to receive an income by way of dividends, one could view the proceeds on disposal as capital in nature.[7]

Judge Corbett in Elandsheuwel Farming v SBI[8] stated: "*Where the taxpayer sells property, the question whether the profits from the sale constitute gross income or receipts or accruals of a capital nature turns on the enquiry as to whether the sale amounted to the realisation of a capital asset or whether it was a sale of an asset in the course of carrying on a business or in pursuance*

[4] Income Tax Act No. 58 of 1962
[5] Commissioner for Inland Revenue v Visser [1937 TPD, 77 8 SATC 271]
[6] Income Tax Act No. 58 of 1962
[7] Madeleine Stiglingh assisted by Elzette Muller, Silke: South African Income Tax (2013)
[8] Elandsheuwel Farming (Edms) Bpk v SBI [39 SATC 163]

of a profit making scheme. The latter connotes the acquisition of an asset for the purpose of reselling it at a profit."

The taxpayer has to prove that the proceeds be viewed either as income or capital. [9] In the event of a dispute regarding the nature of the proceeds, the courts will look at each case on its own merits and reference will be made to all the facts, the external environment and most importantly the intention of the taxpayer.

Intention of taxpayer

The intention of the taxpayer, in holding the shares, is the critical determinant in classifying the proceeds on disposal as capital or income. If acquired for the purpose of resale, the proceeds will be income, however if the intention is to receive an income, the proceeds on the disposal will be capital in nature. In determining intention one will take into account the taxpayer's intention at acquisition, during the period that shares are held, and at disposal.[10]

Judge Corbett in Elandsheuwel Farming v SBI[11] stated further: "*The courts have recognised the possibility of an intervening change of intention. An asset acquired with the intention of reselling at a profit but thereafter the owner's intention may change and he may decide to hold it as an income producing capital asset or investment. This could be a strong indication that on disposal it was a capital realisation and the proceeds are capital in nature."*

Supreme Court of Western Cape Decision

The court confirmed the principle that the main factor in determining whether the proceeds on disposal are to be classified as revenue or capital is the taxpayer's intention. It was reiterated that one does not only look at the date of acquisition to determine the length that the shares were held for but the intention as well. The evidence provided supported the assertion that the rescue process would take between three and five years which led the court to conclude that the taxpayer's intention was to hold the shares for investment purposes.

The decision to sell resulted from an unforeseen opportunity that differed from the intention at acquisition. The court also took cognisance of the surrounding circumstances and facts. The

[9] Section 102 of Tax Administration Act No.28 of 2011
[10] Madeleine Stiglingh assisted by Elzette Muller, Silke: South African Income Tax (2013)
[11] Elandsheuwel Farming (Edms) Bpk v SBI [39 SATC 163]

taxpayer was a junior member of the consortium with no influence on the sale of the shares. It was a passive investment company that did not hold any meetings and reflected the shares as non-current assets as opposed to trading stock. This led the court to conclude that the intention of the taxpayer both at acquisition and disposal was to hold the shares as capital.[12]

Conclusion

The length that the shares are held for is important in determining whether the proceeds on disposal are income or capital in nature. The current tax legislation confirms that the holding of shares for more than three years is sufficient to conclude that the proceeds on disposal will be capital in nature. However, the intention of the taxpayer and surrounding circumstances must not be ignored if shares are disposed of within a shorter period of acquisition.

[12] Madeleine Stiglingh assisted by Elzette Muller, Silke: South African Income Tax (2013)

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Will frail care for an elderly person qualify for an Additional Medical Aid Tax Credit?

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Introduction

Frail care and its associated expenses are commonly regarded as part and parcel of growing old. For many these expenses form part of the 'sunk costs' that need to be catered for post-retirement.

The purpose of this article is to examine the costs associated with frail care and determine whether these costs qualify for an additional medical expenses tax credit. For the purposes of this article the focus will be on persons older than 65 years (hereinafter referred to as the retired tax payer).

What is a medical tax credit?

The 1st March 2012 saw a new dispensation being ushered in in respect of the tax treatment of contributions to a medical aid scheme.[1] A medical scheme contribution deduction in an individual's tax return was replaced in the Income Tax Act[2] with a medical scheme fees tax credit (hereinafter referred to as MTC), up to a Gazetted amount, adjusted each year by an inflationary amount. The amount one contributes to a medical aid scheme is no longer relevant. All taxpayers are now afforded the same medical tax credit. Other out of pocket expenses may be claimed as an addition medical expenses tax credit (hereinafter referred to as AMTC), certain requirements would need to be met.

Who qualifies for a medical tax credit?

The amendments to the ITA included a new section 6A, medical scheme fees tax credit, which applies to all taxpayers[3]. The current credits are[4]

- Taxpayer R303 per month
- Taxpayer and first dependant R606 per month
- Each additional dependant R204 per month

[1] Guide on the determination of medical tax credits (issue 8) at 2.
[2] 58 of 1962
[3] Applicable to persons under the age of 65 as well as those 65 years and older
[4] As at 1 March 2017

In addition, Section 6B (an addition medical expenses tax credit) makes further provisions to:

- Persons under 65 years
- Persons older than 65 years, and
- Persons with a disability

What does the retired tax payer have to comply with, to claim an additional medical expenses tax credit?

Section 6B of the Income Tax Act states the requirements for a qualifying medical expense. These include expenses related to:

"a nursing home or hospital or duly registered or enrolled nurse, midwife or nursing assistant (or any nursing agency in respect of the services of such a nurse, midwife or nursing assistant) in respect of the illness or confinement of the person or any dependant of the person."[5]

To qualify as medical expenditure, such expenses must have been paid during the year of assessment and must not have been recoverable from the medical aid and must exceed:

- 33.3% of the fees paid to a medical aid scheme or qualifying foreign fund as exceeds three times the amount of the MTC in terms of section 6A (2) (b) to which that person is entitled; plus
- 33.3% of qualifying medical expenses paid (out of pocket expenses) [6]

For the purposes hereof persons with a disability would have to further show that the qualifying expenses include a disability expenditure. In addition all medical expenses incurred in respect of the said disabilities in a registered nursing home will be afforded an additional medical tax credit.

Does frail care amount to a disability?

Disability is defined as

"*a moderate to severe limitation of a person's ability to function or perform daily activities as a result of physical, sensory, communication intellectual or mental impairment, if the limitation –*

(a) Has lasted or has a prognosis of lasting more than a year; and

[5] S6B of Income Tax Act 58 of 1962
[6] S6B Income Tax Act 58 of 1962

(b) Is diagnosed by a duly registered medical practitioner in accordance with criteria prescribed by the commissioner."[7]

Only a qualifying disability expenditure prescribed by a commissioner and which is necessarily incurred and paid for by the taxpayer in consequence of the disability qualifies for an AMTC under the subsection 6B. Additional requirements will be applicable. Of importance is that the expense must be necessarily incurred and in consequence of a disability suffered by the taxpayer or dependant of the taxpayer.

The terms necessarily incurred and in consequence of, is not defined in the Act and would therefore be afforded its ordinary meaning within the context of the Act. Therefore SARS notes in the Guide on the Determination of Medical Tax Credits that these phrases indicate that there must be a "direct link between the expenditure incurred and the disability and the item or service acquired must be necessary to alleviate or support such disability."[8]

Thus although an expense may be listed as a pre recognised expense by the commissioner, without a nexus with the disability, it will not be allowed.

SARS published a list of qualifying physical impairment or disability expenditure on 1st March 2012, which includes inter alia "*Personal Attendant Care*" expenses which relate to:

"Expenditure that is incurred and paid for the purposes of special care, for special services to assist, guide, care for a person with physical impairment or disability, regardless of the place where the service is rendered. (e.g. home, nursing home, retirement home, etc.)"[9]

In addition it includes salaries and agency fees and professional services rendered by a nursing home and excludes a spouse, parent or child being the caregiver and any live-in expenditure of the person with the disability. Therefore the cost of one spouse taking care of another spouse is excluded and the cost of the room in the house occupied by the person with a disability is excluded.

[7] S6B of Income Tax Act 58 of 1962
[8] SARS Guide of Determination of Medical Tax Credits (Issue 8)
[9] SARS Guide on Determination of Medical Tax Credits (Issue 8)

In respect of a person in frail care who is in the care of a qualified nursing sister, aide or a registered nursing home, such expenses will be allowed, provided the expense is in consequence of a disability of the taxpayer or a dependant of the taxpayer. The expense will qualify if incurred and paid by the taxpayer. Furthermore the costs of travel related expenses, where the person has to have training for the use of devices, cost of insurance for maintenance of devices and prosthesis in order to perform daily activities are also included.

Practically a disability would have to be established by complying with prescribed diagnostic criteria[10] for specific disabilities as listed by the commissioner on the SARS official document known as an ITR-DD for confirmation of disability. The ITR-DD is completed by a registered medical practitioner. Such medical practitioner must be registered with the Health Professionals Council of South Africa and specially trained to deal with such a disability. A general practitioner will not qualify. The ITR-DD is not submitted with the person's tax return but is retained together with proof of contributions to a medical aid scheme and the total amount of claims not refunded or paid by the scheme, in case of a SARS audit.[11]

Where the disability is of a temporary nature, the ITR-DD is valid for a year and if the disability is of a more permanent nature the ITR-DD is valid for a period of 5 years. With a temporary disability that persists beyond a year, the ITR-DD would have to be completed for each year of assessment. A disability will be regarded as temporary in nature if it lasts less than 5 years.

The registered medical practitioner in making his diagnosis will have to express an opinion regarding the disability, supported by appropriate diagnostic criteria and indicate:

- Whether the functional limitations with respect to performing activities of daily living is mild or moderate to severe (This will determine whether the definition of disability is complied with).
- Whether the disability has lasted or is likely to last for a continuous period of more than 12 months.[12]

[10] Paragraph 3.3.3(a) of Guide on Determination of Medical Tax Credits (Issue 8)
[11] Section 31 of the Tax Administration Act
[12] SARS Guide for determination of medical tax credits (Issue8) at 15.

The Additional Medical Expenses Tax Credit: Requirements for a Frail Care Claim

Given the parameters set out by SARS when handling a claim for additional medical tax credits it is clear that a person older than 65 years, living in a registered frail care facility who is incurring or has incurred expenditure that has a direct nexus with his/her challenges will be able to claim frail care expenses as an AMTC provided:

- ❑ Such expenses incurred in a registered nursing home.
- ❑ An ITR-DD form has been completed.
- ❑ All the qualifying expense records are kept for audit purposes.

Illustration of the impact of AMTC

Mrs M is 80 years old widow and lives in a frail care facility as she had a stroke and requires care which includes a care giver, physical therapy and a neurosurgeon. Currently she has limited mobility.

Mrs M has pension income of R30 000 per month and received no other form of income in the year. She contributes R3 000 per month to a registered medical scheme and:

- ❑ R15 000 per month for her stay at the frail care facility
- ❑ R 2 000 per month for Physiotherapy and Neurologist sessions
- ❑ R 1 000 per month for medication not covered by the medical aid
- ❑ Mrs M had no other exemptions or deductions in the tax year

Calculations:

Total contributions to medical aid (R3 000 x12)	R36 000
MTC (R303 x 12)	R 3 636
Calculation of tax liability	
Taxable income	R360 000
Normal tax on R360 000	R 81 583
Less primary rebate	(R13 635)
	R67 948

Less secondary rebate	(R7 479)
	R60 469
Less tertiary rebate	(R2 493)
	R57 976
Less MTC (S6A)	(R3 636)
	R54 340
Less AMTC (S6B) (see calculation below)	(R80 284)
Due to Mrs M	**R 25 944**

Calculation of AMTC for a person older than 65

Formula: 33.3% x {[A- (3xB)] + C}

A = fees paid to a medical aid scheme or qualifying foreign fund for the year of assessment
B = the MTC for the year of assessment
C = all qualifying medical expenses paid during the year of assessment including any disability expenses

A = R36 000 (R3 000 x 12)

B = R3 636 (R303 x 12)

C:

Duly registered nursing home	= R 180 000.00
Specialist care by duly registered medical practitioner	= R 24 000.00
Out of pocket expenses (direct link to her frailty)	= R 12 000.00
Total:	R 216 000.00

33.3% x {[A- (3xB)] + C}

33.3% x {[R36000-(3 x R3 636)] + R216 000}

33.3% x R241 092.00

R 80 284

Conclusion

The article has shown that provided certain criteria are met, the costs associated with frail care can be applied as an AMTC resulting in a form of tax relief.

Three reasons to avoid interest free loans

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Introduction

Just when we thought the mine field that is trust law could not get any more complicated, the introduction of Section 7C to the mix of anti- avoidance provisions applicable to trusts has further muddied the already murky waters.

The new Section 7C is an anti- avoidance provision which is intended at curbing the long established practise involving the use of using interest free loans in wealth transfer schemes. Section 7C extends the existing collection of anti- avoidance provisions contained in Section 7 of the Income Tax Act (hereinafter referred to as "the Act").

Closely related to Section 7C are Sections 7(8) and 31 of the Act which are also aimed, albeit indirectly, at policing dispositions to trusts. This article looks at the relationship between these three cousins and considers how they will interact in practice.

Section 7(8)

Section 7(8) provides that where a resident makes a donation, settlement or other disposition to a non- resident then the income which is received by or accrues to that non- resident as a result of the donation, settlement or other disposition, will be taxed in the donor's hands.

Example

Mr Mathe donates R10 million to the Mathe Family Trust, an offshore trust which is registered in the UK. The trust in turn invests the money in a portfolio of shares. During that tax year, the trust earns dividends with a Rand value of R200 000.

In terms of Section 7(8) this income will be taxed in Mr Mathe's hands since it is directly attributable to the initial donation and would have been income had the trust been a resident in South Africa.

Section 31

Section 31 is an anti-avoidance provision which is aimed at curbing transfer pricing and thin capitalisation[1]. It aims to ensure that that transactions between residents and non-residents who are connected persons are done on normal commercial terms (i.e. at arm's length). Transactions which are not concluded at arm's length are labelled as 'affected transactions' under Section 31.

An affected transaction is, *inter alia*, any transaction, operation, scheme, agreement or understanding (for simplicity hereinafter referred to only a transaction) which is entered into between a resident and a non- resident who are connected to each other and which contains terms and conditions which are different from those that would have existed if the parties had been independent persons dealing at arm's length. The transaction must result in a tax benefit being derived by any party to the transaction. A tax benefit is defined as any avoidance, postponement or reduction of any liability for tax.

It is apparent therefore that interest free and low interest loan agreements between offshore trusts and local residents fall within the ambit of this provision.

Under Section 31 taxpayers are obliged to determine whether the actual terms and conditions of any transaction meeting the definition of an 'affected transaction' differs from the terms and conditions that would have existed if the parties had been independent persons dealing at arm's length.

If there is a difference which results or will result in a tax benefit for one of the parties to the affected transaction, taxpayers are required to calculate their taxable income based on the arm's length terms and conditions of the affected transaction (i.e. the taxpayer will be taxed on the normal commercial rate and not the contractual rate). This is called the primary adjustment.

The misery does not end there for the taxpayer. If after completing the primary adjustment, there is a difference between the amount included in the taxpayer's taxable income (the arm's length rate) and the contractual rate, the difference will be deemed as a donation. Previously this amount was treated as a loan.

[1] Thin capitalisation refers to a situation in which a company is financed through a relatively high level of debt compared to equity. The effect of this is that SARS can contend that too much interest is being claimed as an income tax deduction.

Example

Mr Smyth loans an amount of R15 million to the Smyth Family Trust which is registered in the UK. In terms of the loan agreement, the loan is payable on demand and is interest free. Assuming that the Official Bank Rate (BOEBR) which would have applied in an arm's length transaction is 1.25%.

Is this an affected transaction*?*

It goes without saying that two independent people acting at arm's length would not have agreed on a 0% interest rate. There is no doubt that this is not a normal arm's length agreement.

Has a tax benefit *been derived?*

By opting to forego interest on the loan it can also be argued that Mr Smyth derived (or will derive) the following tax benefits as a result of the transaction:

- The avoidance of tax on the interest payments he would have received (resulting in the reduction of his tax liability).
- The avoidance of donations tax by using a simulated loan agreement.

The transaction is therefore an affected transaction. As a consequence Mr Smyth will be obliged to include the R187 500 (i.e. 1.25% X R15m) in his taxable income (primary adjustment).

The R187 500 which is included in his taxable income will also be deemed as a donation, subject to donations tax (R187 500 – 0) (secondary adjustment).

Section 7C

The new kid on the block, Section 7C, is specifically aimed at regulating transactions involving the use of interest free loans to trusts. This section applies where a loan is provided by a natural person directly or indirectly to a trust which is connected to that person.

Section 7C(3) provides that if a person, whether directly or indirectly makes an interest free loan (or a loan at a rate lower than the official rate of interest) to a trust (local or foreign) then the difference between the official rate and the interest actually charged will be treated as a donation payable by the taxpayer. The official rate of interest, if the loan is in South African Rands (ZAR) is the South African repurchase rate (repo rate) plus 100 basis points (6.75% + 1= 7.75% at the time of writing this article). For a loan denominated in a foreign currency, the official rate is the foreign equivalent of the South African repo rate plus 100 basis points. Therefore if the loan is in US Dollars (USD) the equivalent rate is the Federal Reserve Discount rate of 1%, which means that the official rate is 2%. The rates change from time to time.[2]

[2] Philip Haupt, Notes on South African Income Tax, H&H Publications, 2017

Example

Mr Smyth loans R15 million to the Smyth Family Trust. The loan is payable on demand and is interest free. According Section 7C the difference between the official rate of tax (7.75%) and the contractual rate (0%) will be treated as a donation. This means Mr Smyth will be liable for donations tax on R1 162 500 (i.e. 7.75% X R 15 million).

Section 7C contains a number of excluded transactions such as loans made to family trusts for the purpose of purchasing a primary residence. Also excluded are affected transactions as defined in Section 31.

So how do these three provisions interact with each other?

It is clear that while Section 31 will only apply to transactions which result in a tax benefit being obtained, Sections 7(8) and 7C will apply irrespective of whether a tax benefit has been obtained or not. Sections 7(8) and 7C apply to transactions between residents and non- residents and to transactions between residents. Section 31 however does not apply to transactions between residents. Section 7(8) is the only provision of the three that does not impose a donations tax liability.

As a rule of thumb it is suggested that the following can be inferred:

(1) Affected transactions falling under Section 31 will not be dealt with under Section 7C (Section 7C(5)(e) makes this clear).

(2) An interest free (or low interest) loan to a non- resident trust which is not considered as an affected transaction under Section 31 could however still be subject to Sections 7C and Section 7(8). The latter sections apply irrespective of whether a tax benefit has been derived or not.

(3) If Section 7(8) applies to a transaction then Section 31 will not apply. This is because Section 7(8) attributes the income of the trust to a donor. For Section 31 to apply a party to the transaction must have derived a tax benefit. It therefore cannot be said that a tax benefit has been derived if Section 7(8) has been invoked.

(4) Transactions falling under Section 31 will also not be considered under Section 7(8). This is because Section 31 includes the arm's length interest rate in the taxpayers taxable income. The transaction can therefore not be deemed to be a gratuitous disposition as contemplated in Section 7(8).

(5) Transactions falling under Section 7(8) however can also be subject to Section 7C. The application of Section 7(8) to a transaction does not preclude the application of Section 7C. A donor may therefore be required to pay tax on the income of a non- resident trust under Section 7(8) and also be liable to pay donations tax under section 7C.

Example

Mr Smyth donates R15 million to the Smyth Family Trust, a local trust. The loan is interest free and payable on demand. The trust invests the money and receives interest of R200 000 in the same tax year.

In this case Section 7(8) will apply to tax the R200 000 arising as a result of the gratuitous disposition (interest free loan). Section 31 will not apply in this case since the trust is a resident and also since it cannot be said that Mr Smyth has obtained any real tax benefit due to the application of Section 7(8).

Section 7C will however apply since an interest free loan has been used to transfer the funds. Therefore in addition to having the income of the trust attributed to him in terms Section 7(8), he will also have to pay donations tax on the deemed donation under Section 7C.

Conclusion

The use of interest free loans has always been a subject which deserved to be approached with a great measure of great circumspection. The amendments to Section 31 in 2015 and the introduction of Section 7C has further underlined, the disdain with which transactions involving interest free loans are viewed by the revenue. The retrospective application of Section 7C is also a cause for concern. It is suggested that in light of these developments, that estate plans which have been founded on interest free loans should be revisited and alternative structures be put in place.

Bibliography

Philip Haupt, Notes on South African Income Tax, 2017, H&H Publications

Income Tax Act, 58 of 1962