THE DAVIS TAX COMMITTEE

SECOND INTERIM REPORT ON

ESTATE DUTY

FOR THE MINISTER OF FINANCE

Intended use of this document:

The Davis Tax Committee is advisory in nature, and was established to make recommendations to the Minister of Finance. The Minister will take into account the report and recommendations and will make any appropriate announcements as part of the normal budget and legislative processes.

As with all tax policy proposals, these proposals will be subject to the normal consultative processes and Parliamentary oversight, once announced by the Minister.

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  - The maximum threshold for tax-deductible retirement fund contributions (R350 000) should be increased to take account of inflation.

- **The inter-spouse abatement**
  - The problems inherent in the section 4(q) abatement should not be ignored on pragmatic grounds alone (as suggested by the Katz Commission) as this result in the inconsistent treatment of married and single parent families.
  - The inter-spouse abatement should be withdrawn and replaced with a substantially enhanced primary abatement, thus ensuring the consistent equitable treatment of all taxpayers.

- **Primary abatement and rate**
  - The DTC recommends that the primary abatement should be substantially increased to R15 million for all taxpayers, irrespective of marital status.
  - SARS should further integrate its revenue and national compliance analyses, to support systemic compliance risk management within the estate duty system.
  - The estate duty rate be increased from 20 per cent to 25 per cent of the dutiable value of an estate exceeding R30 million.

- **Capital Gains Tax**
    - The DTC does not concur with the argument that the imposition of estate duty and CGT on death is tantamount to “double taxation”. CGT is widely regarded as an income tax on capital income and not a wealth tax. Estate duty and donations tax are wealth taxes.
    - The CGT rollover provisions of the Eighth Schedule to the Income Tax Act, 1962 (ITA) relating to inter-spouse bequests should be repealed and replaced with a generous exemption death exemption of R1 million.

- **Donations Tax**
    - If the inter-spouse abatements and allowances are to be removed for estate duty and capital gains tax (CGT) purposes it stands to reason that the inter-spouse exemption within the donations tax system should also be removed, save for providing an exemption for the reasonable maintenance of the taxpayer and family.
    - The taxation concept of an “enduring benefit” should be applied to determine a reasonable level of exemption for cash inter-spouse donations.
    - In order to prevent the diminution of estates in anticipation of death, the section 56 (1)(c) exemption *(donation mortis causa)* should be removed.
    - Transfer of assets in terms of a divorce order should be subject to the exemptions similar to a death benefit for estate duty and CGT. However the taxpayer’s death benefit abatements or subsequent divorce abatements would be reduced by the quantum of any allowances claimed during the taxpayer’s lifetime.

- **Bare dominium and usufruct arrangements**
    - SARS should establish comprehensive records of all bare dominium and trust arrangements. This process should include, but not be limited to, the requirement that all holders of part interests in property be required to submit tax returns irrespective of income levels.

Chapter 2: Trusts

- **Statistical analysis**
  - Statistics obtained from SARS are indicative of a very prevalent use of trusts in SA today. The disparity in the number of registered trusts, compared to the number of tax returns received, is cause for concern and warrants substantial further investigation of trusts by SARS.
  - The fact that 87,8 per cent (88 344 out of 100 590) of *prima facie* compliant trusts are apparently *inter vivos* trust arrangements reflects the need for a comprehensive analysis of each trust to ensure that the trust is compliant with the ITA and Estate Duty Act, 1955 (EDA).
  - The very fundamentals of the legislation should also be considered.

- **Estate duty and trusts**
  - NT should consider the possibility of extending the provisions of section 3(3)(d) of the EDA to include deeming provisions that identify "deemed control" of a trust through a loan account between a trust and a "connected person(s)", where the loan is not subject to interest or is subject to interest at below the official rate. In these circumstances, the loan provides the lender with *de facto* control over the trust.
  - All trust arrangements should be examined by SARS on registration of trust arrangements and upon transfer of assets into trusts. This should reduce aggressive tax planning and, at the same time, provide a level of assurance to taxpayers that their affairs are indeed in order.

- **Capital Transfer Tax**
  - Further investigation be conducted into the implementation of wealth taxes in SA. This will be addressed in a separate report of the DTC during 2016.

- **Income Tax: Vested trusts**
  - Donors and beneficiaries of all vested trust arrangements should be subject to stricter disclosure requirements and enforcement measures.

  - SARS should develop risk-profiling analysis to identify and examine trust arrangements.
  - Estate duty assessment procedures of SARS should concentrate on the examination of any trusts in which the deceased may have enjoyed a vested interest in order to ensure that all income and capital has been brought into account for both income tax and estate duty purposes.

- **Income Tax: Discretionary Trusts**
  - Only where a trust deed confers upon its beneficiaries an indisputable and irrevocable vested right to both the capital and income of a trust, should the income, both capital and revenue, be taxed in the hands of the beneficiary.
  - In all other cases:
    - Revenue income must be taxed in the trust in accordance with the definition of "gross income" contained in section 1 of the ITA.
    - Capital income, generated while assets are held in trust on anything other than a vested basis, must be taxed within the trust up to the time of vesting or disposal as defined in paragraph 11 of the Eighth Schedule to the ITA.

- **Trust tax rates and CGT inclusion rates**
  - The flat rate of tax applied to trusts should be retained at its current level and be subject to adjustment in line with changes in the maximum personal income tax rate.

- **Foreign Discretionary Trusts**
  - The comprehensive examination of foreign trust arrangements should not be confined to the application of the ITA when vesting or distribution occurs. SARS should also examine the substance of arrangements prior to vesting or distribution. Information sharing between tax authorities may well be the starting point for such investigations.
  - SARS should establish a separate investigations unit to thoroughly and comprehensively examine foreign trust arrangements. Where

disclosure deficiencies are detected, the penalty provisions of the Tax Administration Act, 2011 (TAA) should be rigidly applied.

- **Offshore retirement funds**
  - These arrangements should be further investigated by SARS.

CHAPTER 1: ESTATE DUTY

1. INTRODUCTION

1.1 OBSERVATIONS

The estate duty computation, in its briefest form, is as follows:

Free residue of estate

Less: Exempt bequests

Less: inter-spouse bequest

Less: Retirement Funds (excluded from estate)

Less: general abatement

= Dutiable value

Subject to estate duty at 20 per cent

South Africa abandoned a progressive rate of estate duty in 1988 in favour of a flat rate of 25 per cent in 1988.

CGT was implemented in South Africa, effective from 1 October 2001. In order to reduce the onerous consequences of both estate duty and CGT being levied on death, the estate duty rate was reduced to 20 per cent, effective 1 March 2001.

The primary estate duty abatement of R1,5 million was increased to R2,5 million, effective 1 March 2006 and then to R3,5 million, effective 1 March 2007.

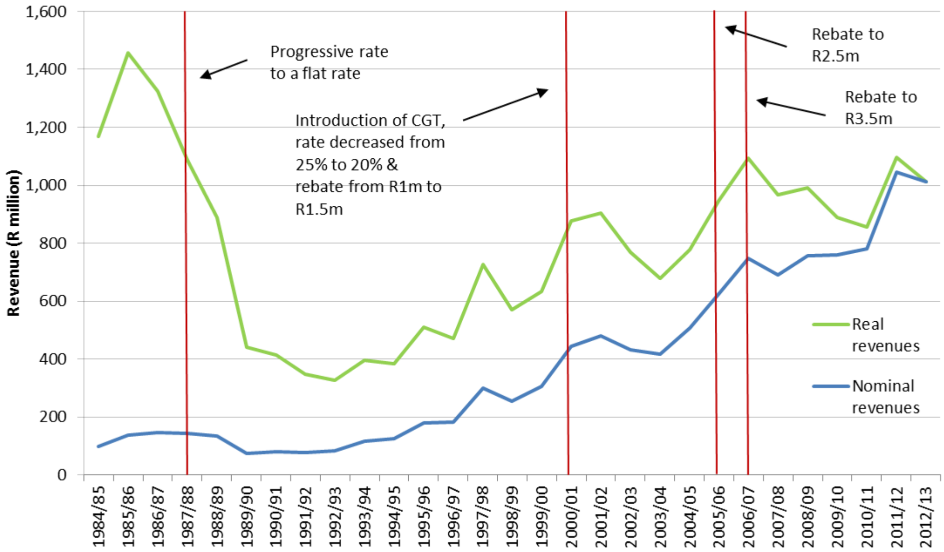
In addition, other abatements have been granted:

- The “portable spouse exemption”, effective from 1 March 2011
- The retirement fund exemption, effective 1 January 2008.

The CGT inclusion rate for personal income tax was initially established at 25 per cent on 1 October 2001. In order to compensate for the double tax exposure created when CGT is combined with estate duty or donations tax, the estate duty and donations tax rate was reduced to 20 per cent.

Figure 1 below reflects that estate duty collections have, in real terms, declined over the past 20 years.[1]

Figure 1 Estate duty collections 1985-2013



Source: National Treasury 2014

1.2 INTRODUCTION

The key question confronting the DTC is: "what is an equitable combined effective estate duty package?" This must be reconsidered as it is now 18 years since the Katz Commission report of 1997.

In order to achieve the above, it is necessary to examine the major components of the estate duty calculation individually.

2. RETIREMENT FUND EXEMPTION

2.1 OBSERVATIONS

Retirement fund death benefits are exempt from estate duty. This exemption was addressed in the first report where the DTC concluded that it should be retained,

[1] *Source: National Treasury*

subject to the implementation of measures to prevent the undue accumulation of wealth in retirement funds beyond the reasonable needs of the pensioner.

Recommendations made by the DTC contained in the first report have led to the amendment of section 3 of the EDA during 2015. In short, contributions to retirement funds in excess of the annual income tax allowances, made after 1 March 2015, will be excluded from the general retirement fund abatement in the estate duty computation.

The DTC considers that this simple amendment will put an end to the growing incidence of “deathbed retirement fund contributions”.

Furthermore the “capping” of tax deductions at the lower of 27,5 per cent of taxable income or R350 000 per annum, to be implemented with effect from 1 March 2016, will further contain the accumulation of wealth within retirement funds beyond retirement requirements.

2.2 RETIREMENT FUND ABATEMENT: RECOMMENDATIONS

Following the introduction of capping of the tax deductions on retirement fund contributions and the inclusion of non-tax-deductible contributions to retirement fund contributions in the estate duty computation, the retirement fund abatement should be retained.

It is important to note that the overall limitation of retirement fund deductible contributions has not been increased to keep pace with wage inflation since the initial proposals were published in 2012. This should be revisited by the National Treasury (NT).

3. THE INTER-SPOUSE ABATEMENT – SECTION 4(Q)

3.1 OBSERVATIONS

Inter-spouse bequests are currently completely exempt from estate duty. In the presence of such an unlimited exemption, the extent of the general abatement and, for that matter, estate duty in general, is of little consequence to married taxpayers. Estate duty is simply and effectively postponed until the death of the surviving spouse(s) by means of an inter-spouse bequest.

Section 4(q) was introduced in 1985 prior to the appointment of the Katz Commission. By virtue of its content, it raises questions of marital status.

The First Katz report addressed this issue within the context of gender discrimination:

> The Commission's view is that gender discrimination is probably unconstitutional and that discrimination on the basis of marital status is no longer appropriate….The Commission therefore accepts that some loss of personal tax yield is inevitable. It will however seek to limit it, and suggests ways of recouping it from other parts of the tax system.

As a result of the recommendations of the Katz Commission and rulings of the constitutional court the definition of "spouse" in section 1(1) of the Income Tax Act was amended in 2001 to include not only all forms of marriage and customary union but also any relationship, same-sex or heterosexual, which the Commissioner is satisfied is intended to be permanent.

In stark contrast, the Katz Commission recommended that bequests in favour of surviving spouses remain exempt from estate duty in spite of there being no intellectual justification for the retention of the exemption and it being potentially in breach of the provisions of the Constitution by privileging all forms of marital status above single persons. The Katz Commission recommendation was made entirely on "pragmatic grounds."

Similar exemptions enjoyed by married taxpayers are contained in the donations tax[2] and CGT legislation.[3]

The definition of "spouse" contained in section 1 of the Income Tax Act is, in effect, "the driver" of the section 4(q) estate duty inter-spouse abatement. This inevitably results in a widespread and liberal interpretation of what exactly constitutes a "permanent relationship", which is included therein. Simply put, the diversity of families in South Africa today makes it all but impossible to determine a one-size-fits-all definition. This leaves an unlimited abatement open to interpretation and may privilege certain forms of cohabitation over others. It also creates a tax incentive for

[2] *Section 56(1)(b) of the ITA*

[3] *Para 67 of the 8th schedule to the ITA*

bequests to be determined on the grounds of estate duty liability as opposed to what may be the taxpayer's preferred desire or intention.

Of of equal importance is a substantial number of families in South Africa today who remain excluded from any relief offered by section 4(q). These potentially include:

- Single parent families, divorced
- Single parent families, never married
- Families supported by grandparents
- Families supported by children
- Families supported by relatives or friends.

If the purpose of section 4(q) is to provide relief to families in the event of the premature death of a breadwinner, it is, at present, inadequately inclusive.

3.2 THE INTER-SPOUSE ABATEMENT: DTC RECOMMENDATION

The problems inherent in the section 4(q) abatement should not be ignored on pragmatic grounds alone (as suggested by the Katz Commission) as this result in the inconsistent treatment of married and single parent families.

The DTC recommends that the EDA should, as far as possible, reflect the same principles of "one taxpayer, one tax return" as contained in the ITA. Hence, the inter-spouse abatement should be withdrawn and replaced with a single all-encompassing and equitable primary abatement.

4. THE PRIMARY ABATEMENT AND ESTATE DUTY RATE

4.1 OBSERVATIONS

The primary estate duty abatement was increased to R2,5 million with effect from 1 March 2005 and to R3,5 million from 1 March 2007. Thus the primary estate duty abatement has not been increased for 9 years. This has allowed a substantial element of fiscal drag to enter the estate duty system whilst, at the same time, NT has been making concerted efforts to curb fiscal drag within the personal income tax tables.

The first report of the DTC recommended a substantial increase in the primary abatement.

In order to re-establish the primary abatement to exclude the effects of fiscal drag between 2007 and 2015 it is estimated that the abatement should have been increased to a minimum of R6 million by November 2015.

Following the publication of the first report, submissions received by the DTC have welcomed this recommendation. Some submissions have suggested that the abatement be increased to as much as R7,5 million.

The DTC notes that the submissions received are generally based on the existing primary abatement of R3,5 million, with the retention of the inter-spouse abatement being an acceptable starting point. However there has been little assessment as to whether or not a revised primary abatement (in the range of R6-R7,5 million) is an effective and equitable abatement.

It must be recognised that the beneficiaries of an estate are largely dependent on passive income. Interest rates have effectively halved since the general abatement was last increased, thus reducing interest income and/or accelerating the diminution of capital. Thus there is an urgent need for a generous increase of the general abatement.

Even if the general abatement was increased to R7,5 million, this would not represent a complete solution. It is not difficult to imagine that a taxpayer's modest primary residence and personal effects could easily exceed R3 million, leaving but R4,5 million remaining to cover savings, investments and life insurance benefits. This may be sufficient to provide for the modest maintenance of a retired widow(er) for 5-10 years but would be totally insufficient to cover the needs of a middleclass family following the death of a breadwinner.

The above scenario prompts the further observation that life insurance benefits (subject to estate duty) are treated inconsistently with retirement death benefits (exempt). Life insurance benefits are critical to the security of a family in the event of the death of a younger breadwinner taxpayer. In such an event the taxpayer would not yet have accumulated a substantial retirement fund portfolio that would benefit from the estate duty exemption.

Since the publication of the first report, the DTC has received more detailed statistics regarding the composition on the estate duty revenue stream. This has allowed the DTC to develop an alternative solution that seeks to address the shortfalls of both the inter-spouse exemption and the general abatement.

Table 1: Analysis of estate duty collections by number and value for the 2014/2015 fiscal year

2014/15 Estate value	Estates by Number	Estate Value	Estate Duty Collection	Cumulative Collection
<10000000	1 192	5 978 823 796	361 364 759	361 364 759
10000000-12500000	89	984 717 351	134 643 470	496 008 229
12500000-15000000	29	402 694 906	60 238 981	556 247 211
15000000-17500000	33	525 728 883	82 045 777	638 292 987
17500000-20000000	15	279 317 018	45 363 404	683 656 391
>20000000	87	3 920 232 869	723 146 574	1 406 802 965
Grand Total	**1 445**	**12 091 514 823**	**1 406 802 965**	

Table 1 clearly reflects that the majority of estates reported to SARS (1310 out of 1445 or 90 per cent) fall in the category below R15 million. However, their actual estate duty liability, R556 million, comprises 40 per cent of the total estate duty collection of R1,406 billion. It can thus be concluded that the loss of estate duty associated with dramatically increasing the primary abatement is no cause for alarm.

On the other hand, the R850 million of the total 2014/15 estate duty collection of R1,406 billion (60 per cent) derives from just 135 estates of value greater than R15 million.

It is important to note that the above analysis does not take into account estates where the dutiable value may exceed R15 million and that liability is postponed through the use of the inter-spouse bequest exemption.

4.2 PRIMARY ABATEMENT AND ESTATE DUTY RATE: DTC RECOMMENDATION

The DTC recommends that the primary abatement should be substantially increased to R15 million for all taxpayers, irrespective of marital status. At the same time, the inter-spouse exemption should be withdrawn. The estimated loss of estate duty collections would be R556 million. However, the expectation is that the revenue forfeited would be more than recovered by the removal of the inter-spouse bequest exemption.

This recommendation would have the added benefit of allowing SARS to concentrate its resources on the thorough examination of all dutiable estates with a value of greater than R15 million. Based on 2015 statistics this would reduce the number of dutiable estates from 1445 to a mere 135.

The ultimate net result of these amendments would be:

- Estate duty is applied solely to high net worth individuals, irrespective of marital status
- Estates with a net value of less than R15 million would be exempt from estate duty. To this must be added the value of the unlimited retirement fund exemption
- Estates with a net value of greater than R15 million would be subject to estate duty at a progressive rate (see below)
- It is emphasised that the value of remaining retirement fund benefits at date of death must be added to the above threshold.

The DTC suggests that this recommendation would address any concern of financial hardship associated with an estate duty regime whilst at the same time dealing with the inconsistencies associated with the inter-spouse abatement.

These proposals are based on providing estate duty exemption sufficient to cover:

- A home and personal effects to the value of R5 million

- Investments and cash to the value of R10 million which should be sufficient to provide a sustainable pre-tax income stream of R40 000 to R50 000 per month.

These proposals seek to exclude the middle class from estate duty liability, whilst at the same time targeting those who have large estates and who must, in the interests of the future of the country, be obliged to bear a larger burden without, in any material way, detracting from their lifestyle or family security.

The justification for this approach is evident from the discussion concerning inequality, which was contained in chapter one of the first report (which is also annexed to this report), that South Africa suffers from one of the most unequal patterns of income and capital inequality in the world. To recapitulate from that report: in 1948 at the dawn of apartheid, the top 1 per cent of income earners obtained 22 per cent of the national income; by 1975 this figure had declined to 10 per cent. By 20 years after the death of apartheid, it had climbed back to almost 20 per cent. This is politically and morally indefensible.

In order to contain a potential loss in estate duty collections, the DTC suggests that the estate duty rate be increased from 20 to 25 per cent of the dutiable value of an estate exceeding R30 million. Based on estate duty receipts for the 2015 fiscal year, this would increase estate duty receipts by approximately R150 million whilst affecting some 48 dutiable estates.

Estate duty will never be the panacea to solve SA's fiscal needs. However this is not to say that estate duty cannot make a useful contribution in creating sustainable revenue streams for SA and add to the legitimacy of the tax system where, at present, the middle class has been subject to an excessive tax burden.

There are various definitions and estimates of the number of high net worth individuals in South Africa today. If estimates are based on a taxable income more than R1,5 million per annum, the number can be clearly established at 78 543[4]. According to the Credit Suisse international wealth report 2014 the number of U$ millionaires (R15 million) in SA is of the order of 60 000. In contrast the "South Africa

[4] *Per National Treasury: Budget review 2015.*

2016 Wealth report" issued by New World Wealth estimated the number of U$ millionaires at 38500.

There is accordingly a strong indication to support the proposition that there are more than 50 000 taxpayers with estates valued in excess of R15 million. If a highly conservative death rate of 1 per cent per annum is applied to this population it would lead to an estimated number of estates of 500 per annum. Yet the number of estates exceeding R15 million assessed in 2015 is a mere 135.

This substantial discrepancy may be attributed to the following factors:

- Estates not reported to SARS or assets excluded from the estate duty computation
- The widespread utilisation of trusts
- The inter-spouse and retirement fund abatements
- Bare dominium and usufruct arrangements.

The additional information gathered by SARS during 2015 provides a strong indication that there is a substantial tax gap within the estate duty system.

The following recommendation contained in the IMF VAT tax gap report is of significance "SARS should further integrate its revenue and national compliance analyses, to support systemic compliance risk management. There is more scope for more detailed revenue analysis of revenues from individual industry sectors and taxpayer segments to support strategic risk analysis."

5. CAPITAL GAINS TAX

5.1 OBSERVATIONS

The DTC's terms of reference specifically direct the Committee to investigate the "double taxation on death" created by the imposition of both CGT and estate duty on death in South Africa. This has long been a contentious issue and was even raised by the Minister of Finance in the 2011/12 National Budget Speech.

In this regard, Professor J Roeleveld of the University of Cape Town has published a paper entitled "An argument for either excluding death as a CGT event or abolishing estate duty"[5] to which a number of submissions refer in support of the argument about 'double taxation'.

The conclusion of the paper is as follows:

> This paper has discussed the fact that in South Africa CGT and estate duty is levied at the same time in respect of the same asset. There is no justification or policy decision supporting the retention of the two taxes as is evident when reviewing previous reports on the tax structure of South Africa (the Margo Commission 1987 and the Katz Commission 1997), which did not recommend two capital transfer taxes but favoured the retention of one of them, estate duty.

Roeleveld's conclusion is largely based on the premise that both CGT and estate duty constitute "wealth taxes." The DTC does not concur with the above conclusion. CGT is widely regarded as an income tax on capital income and not a wealth tax. Estate duty and donations tax are wealth taxes. This distinction was clearly reported in the review of the CGT proposals conducted by the International Monetary Fund in December 2000 (prior to the implementation of CGT on 1 October 2001).

The CGT death exemption is currently R300 000. However, this may not be the crisp issue as the "roll over" relief granted by para 67 of the Eighth schedule (where CGT is postponed on the event of an inter-spouse bequest) cannot, at present, be quantified.

Statistics furnished by SARS reflect that the extent of CGT imposed on deceased estates is not substantial and are indicative that there is fiscal space to substantially increase the CGT exemption.

If the Committee's estate duty recommendations are implemented, the CGT rollover provisions of para 67 of the Eighth Schedule of the ITA should be repealed and replaced with a generous exemption death exemption of R1 million. This exemption, coupled with the primary residence exemption in para 45 of the Eighth schedule of the ITA of R2 million and the unlimited CGT exemption applicable to retirement fund benefits, motor vehicles, personal effects, certain boats and aircraft, should be sufficient to address concerns.

[5] *SAJAR*, Revised: June 2012, August 2012 Vol 26 No. 1, pp.143 to 16.

6. DONATIONS TAX

6.1 OBSERVATIONS: INTER-SPOUSE DONATIONS (SECTION 56 (1)(A) & (B)

In common with various provisions of the ITA, donations tax is not imposed in respect of transactions between spouses. The definition of “spouse” contained in section 1 of the Income Tax Act includes all forms of marriage and permanent relationships. This leaves the donations tax system open to manipulation and wide interpretation.

6.2 DONATIONS TAX: DTC RECOMMENDATION

If the inter-spouse abatements and allowances are to be removed for estate duty and CGT purposes, it stands to reason that the inter-spouse exemption within the donations tax system should also be removed, save for providing an exemption for the reasonable maintenance of the taxpayer and family. The quantum of such an exemption is inherently controversial.

By removing the inter-spouse exemption for CGT purposes, the inter-spouse disposal of most assets would become a CGT leviable event. However CGT exemptions would apply (personal effects, motor vehicles, certain boats and aircraft and, importantly, cash.) A pragmatic solution would simply be to carry these exemptions into the donations tax system by making inter-spouse donations subject to donations tax if they comprise CGT leviable transactions.

This would result in the apparently difficult conundrum of determining the quantum of a reasonable level of exemption for cash inter-spouse and family donations. This leaves the donations tax system (and inherently the estate duty system) vulnerable to abuse through the donation of cash between spouses and family. It may also lead to donations being made to avoid estate duty rather than out of genuine generosity.

6.3 INTER-SPOUSE ABATEMENT: DTC RECOMMENDATION

The unlimited inter-spouse exemption within the donations tax system should also be reconsidered as it represents a threat to the estate duty system if the inter-spouse estate duty exemption is to be withdrawn. However, the donations tax system must also recognise that inter-spouse transfers of cash and some assets are part of their everyday life in most families.

The DTC recommends that the inter-spouse donations tax exemption should not apply to the transfer of assets that constitute disposals in terms of the CGT regime contained in the Eighth schedule to the ITA. These provisions do not apply to cash, motor vehicles and personal assets.

The DTC recommends that a monetary limit be determined to curb excessive inter-spouse transfers of wealth through the donation of motor vehicles, jewellery and other collectables.

It is impossible to determine a monetary threshold to limit cash transfers between spouses. Thus, other means have to be developed.

The DTC refers to the taxation concept of an "enduring benefit"[6]. In general terms an enduring benefit exists where the benefit can be enjoyed for more than one year. The DTC recommends that inter-spouse donations of cash be limited to any amount that does not create an enduring benefit for the recipient spouse.

The use of the enduring benefit principle would allow for the inter-spouse donation of cash to remain donations tax exempt to the extent that it is expended in the maintenance of a family within one year of receipt. However, where inter-spouse donations of cash result in the accumulation of wealth by the recipient spouse, donations tax should be levied.

In the first report the DTC noted its concern regarding the practice of the donation of substantial amounts of cash in anticipation of death. Such donations are specifically exempt as a *"donatio mortis causa"* from donations tax in terms of section 56(1)(c).

The DTC reaffirms its suggestion that in order to prevent the diminution of estates in anticipation of death, the section 56 (1)(c) exemption be removed. Furthermore, the exemptions contained in sections 56(1)(a) and (b) should make specific provision for the exclusion of a *donatio mortis causa* from the inter-spouse exemption provisions.

[6] ***Palabora Mining*** *Co Ltd v SIR [1973] 35 SATC 158*

These proposals lead to the obvious criticism that they have the potential to aggravate the difficulties associated with divorce proceedings as, in the absence of relief, divorce settlements would potentially create both CGT and donations tax implications.

The DTC recommends that this problem be addressed by allowing the transfer of assets in terms of a divorce order to be subject to the exemptions similar to a death benefit for estate duty and CGT. However, the taxpayer's death benefit abatements or subsequent divorce abatements would be reduced by the quantum of any allowances claimed during the taxpayer's lifetime.

7. BARE DOMINIUM AND USUFRUCT ARRANGEMENTS

7.1 OBSERVATIONS

A wide range of bare dominium and usufruct arrangements are implemented in South Africa today.

In very general terms, usufructuary interests are widely employed as a means of deferring estate duty liability through the use of the section 4(*q*) inter-spouse abatement. Thus, if the proposals relating to inter-spouse exemptions and abatements contained in this report are implemented, many of the tax advantages associated with bare dominium and usufruct arrangements will be curtailed. However, taxpayers will remain at liberty to use these arrangements if they so wish.

On the death of the usufruct holder or the cessation of the usufruct or the sale of the underlying asset, income tax, donations tax, transfer duty and estate duty implications apply.

However, the DTC has been unable to confirm whether any enforcement measures are in place to ensure that these arrangements are revisited on termination of usufruct arrangements.

7.2 BARE DOMINIUM AND USUFRUCT ARRANGEMENTS: DTC RECOMMENDATIONS

The DTC recommends that SARS establish comprehensive records of all bare dominium and trust arrangements. This process should include, but not be limited to, the requirement that all holders of part interests in property be required to submit tax returns irrespective of income levels.

CHAPTER 2: TRUSTS

1. STATISTICAL ANALYSIS

1.1 OBSERVATIONS

SARS internal reports as at 31 October 2015 reflect that there are currently 333 465 active trusts registered with SARS. This number is in sharp contrast to the SARS Statistics 2015 publication which reflects the following statistical analysis of tax assessments and tax payments.

Table 2: Analysis of income tax assessments raised on trusts 2011-2014

Assessed Trusts: Taxable income and tax assessed by taxable income group, 2011 – 2014

Tax year	2011			2012			2013			2014		
Taxable income group	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)
A: < 0	68 400	-23 511	0	64 648	-25 321	4	60 296	-25 869	0	44 845	-20 810	–
B: = 0	147 073	-	3	130 942	-	2	118 911	-	1	79 611	-	4
C: 1 – 20 000	12 816	63	25	11 918	57	23	10 862	53	21	8 313	42	17
D: 20 001 – 30 000	1 436	35	14	1 396	34	14	1 296	32	13	994	25	10
E: 30 001 – 40 000	1 103	38	15	995	35	14	928	32	13	762	27	10
F: 40 001 – 50 000	891	40	16	847	38	15	811	36	14	522	24	9
G: 50 001 – 60 000	661	36	14	614	34	13	544	30	12	470	26	10
H: 60 001 – 70 000	519	34	13	530	34	14	497	32	13	366	24	9
I: 70 001 – 80 000	449	34	13	417	31	12	346	26	10	357	27	11
J: 80 001 – 90 000	363	31	12	297	25	10	328	28	11	288	25	10
K: 90 000 – 100 000	351	34	13	297	28	11	314	30	12	254	24	10
L: 100 001 – 110 000	280	29	11	314	33	13	302	32	13	234	25	10
M: 110 001 – 120 000	291	34	13	220	25	10	257	30	12	213	25	10
N: 120 001 – 130 000	226	28	11	235	29	12	226	28	11	200	25	10
O: 130 001 – 140 000	197	27	11	183	25	10	208	28	11	166	22	9
P: 140 001 – 150 000	204	30	12	182	26	10	166	24	9	165	24	10
Q: 150 001 – 200 000	743	129	51	774	134	53	722	126	49	578	100	39
R: 200 001 – 250 000	555	124	48	538	121	47	607	136	54	525	118	47
S: 250 001 – 300 000	413	114	45	386	105	42	421	115	46	357	98	39
T: 300 001 – 500 000	934	365	145	963	368	147	1 069	413	163	875	342	135
U: 500 001 – 750 000	538	327	131	605	369	147	697	425	169	588	359	144
V: 750 001 – 1 000 000	327	288	115	312	276	111	460	405	162	442	388	155
W: 1 000 001 – 2 000 000	466	655	266	525	729	296	553	783	319	504	713	287
X: 2 000 001 – 5 000 000	282	872	352	308	978	392	327	1 007	412	328	967	389
Y: 5 000 001 +	158	1 782	707	195	2 205	882	192	2 568	1 043	193	3 054	1 230
Total	**239 676**	**-18 364**	**2 057**	**218 641**	**-19 579**	**2 302**	**201 340**	**-19 449**	**2 594**	**142 150**	**-14 308**	**2 613**
<= 0	215 473	-23 511	3	195 590	-25 321	5	179 207	-25 869	1	124 456	-20 810	4
1 – 70 000	17 426	246	97	16 300	232	92	14 938	217	86	11 427	166	66
70 001 – 250 000	3 659	498	196	3 457	478	188	3 476	487	193	2 980	414	164
250 001 – 500 000	1 347	478	190	1 349	474	189	1 490	528	209	1 232	440	174
500 000 +	1 771	3 924	1 571	1 945	4 558	1 827	2 229	5 188	2 105	2 055	5 482	2 206
Total	**239 676**	**-18 364**	**2 057**	**218 641**	**-19 579**	**2 302**	**201 340**	**-19 449**	**2 594**	**142 150**	**-14 308**	**2 613**

There is a readily apparent and substantial discrepancy between the SARS register of trusts and the number of income tax returns received and assessed, which is of great concern. SARS has recently reacted to this by initiating a targeted project to investigate trusts.

Initial results of SARS investigations reflect:

- For the period 1 October 2014 to 30 September 2015, 146 178 trust tax returns were received by SARS. However, in many instances multiple tax returns were received from trusts covering various years of assessment
- The number of current tax returns received during the period 1 October 2014 to 30 September 2015 was 100 590. Thus, *prima facie*, only 33 per cent of active registered trusts appear to be tax compliant.

SARS readily admits that there is much work to be done in its investigations into trusts and, in particular, to explain the discrepancy.

Based on the 100 590 tax returns received, the following trends emerge.

Table 3 Analysis of trusts by category

Trust Type (Indicated On Latest Return)	Distinct Taxpayers (Trusts)	% Of Total
INTER_VIVOS	88 344	87.8%
TESTAMENTARY	9 750	9.7%
SPECIAL_A	1 592	1.6%
SPECIAL_B	508	0.5%
COLLECTIVE_INV_SCHEME	395	0.4%
Type Not Available	1	0.0%
Total	**100 590**	**100.0%**

Further investigations have revealed that 542 trusts receiving business income and 321 trusts receiving farming income are not VAT-registered despite income exceeding the VAT registration threshold. It may, however, be the case that some may be paying tax under a separate trading name or through a representative taxpayer arrangement.

A further 208 trusts pay salaries and wages, but cannot be matched with an employer tax number. The situation may, however, be that some may be paying employees tax under a separate trading name or through a representative taxpayer arrangement.

Table 4 Analysis of number of trust beneficiaries (inclusive of distributions and transactions)

Participant In Trust	Distinct Taxpayers (Trusts)	% Of Total	% Of Total (excluding Trusts without participants)
a. Nobody	50 097	49.80%	-
b. Only 1 person	22 670	22.54%	45%
c. Between 2 and 5	24 691	24.55%	49%
d. Between 6 and 10	2 602	2.59%	6%
e. Between 11 and 50	448	0.53%	
f. Between 51 and 100	14		
g. Between 101 and 1 000	23		
h. Between 1 001 and 10 0000	22		
i. Between 10 001 and 100 000	10		
j. More than 100 000	13		
Grand Total	**100 590**	**100.00%**	

1.2 STATISTICAL ANALYSIS: DTC RECOMMENDATIONS

At this early stage of the SARS investigations into trusts there is simply insufficient statistical data available for the DTC to do more than make the broadest of observations and recommendations.

The disparity in the number of registered trusts compared to the number of tax returns received is cause for alarm and warrants substantial further investigation of trusts by SARS. It may simply be the case that a large proportion of non-compliant trusts are dormant and have not been deregistered. But this cannot simply be assumed.

The fact that 87,8 per cent (88 344 out of 100 590) of *prima facie* compliant trusts are apparently *inter vivos* trust arrangements reflects the need for comprehensive analysis of each trust to ensure that the trust is compliant with the ITA and EDA. To further complicate matters, 49,8 per cent (50 097 out of 100 590) of *prima facie* compliant trusts have no specifically identifiable beneficiaries. The beneficiaries may have been identified by class or may not have been specified. In the latter event, the very formation of these trusts may be flawed.

At the very least, the above statistics are indicative that the use of trusts requires careful consideration. It would appear that in spite of all the modernisation and reconstruction of SARS over the past 15 years, enforcement measures to contain the use of trusts have received little attention. However, at this time, it is not possible to predict with any degree of certainty the extent of income tax or estate duty loss associated with the use of trusts.

Many submissions received by the DTC in response to the first report contain the valid point that there are a variety of sound commercial reasons to make use of trusts other than potential income tax and estate duty savings. However, this does not defend the argument that the tax savings associated with trusts may be insignificant, nor diminish the need for a long overdue review of trusts.

There can be no doubt that current legislation allows the taxpayer to reduce estate duty. Furthermore, the “conduit pipe/ flow-through principle” embodied in section 25B and paragraph 80 of the Eighth Schedule creates the potential situation in which income and capital gains are taxed at a lower rate in the hands of taxpayers other than in the trusts to which these accrued. At the very least, there should be strict enforcement measures in place to ensure that all income of trusts is ultimately subjected to tax at some point. However, the very fundamentals of the legislation should also be considered.

2. ESTATE DUTY AND TRUSTS

Few would contest the proposition that estate duty saving is one of the major incentives to form trusts. In short, from an estate duty point of view, SA taxpayers are almost at liberty to transfer their assets into trusts, thus postponing or reducing their estate duty liability.

There are only limited anti-avoidance measures within the estate duty system.

2.1 INTEREST-FREE LOANS TO TRUSTS: OBSERVATIONS

The cost of registering a trust is usually inconsequential to the main purpose of a trust.

Assets cannot simply be donated to a trust owing to donations tax implications under section 54 of the ITA. However, donations tax implications can be easily avoided by disposing of assets to the trust at market value on an interest-free loan account.

This has every possibility of creating the following immediate tax benefits:

- Donations tax exposure on the formation of the trust is eliminated since an interest-free loan account is recognised as a settlement or disposition and not a "donation" as defined under section 55(1) of ITA.
- The estate of the holder of the interest-free loan account is effectively frozen at the transfer value of the asset. In many instances the loan account dissipates over time through repayments or on-going annual donations (annual waivers of loan accounts). Even if the loan account balance does not diminish, the effective level of exposure to estate duty of the holder gradually dissipates over time through the effects of inflation.
- However, while the loan remains in place the holder of the loan is *de facto* in control of the trust, irrespective of the content of the trust deed or the actions of the trustees. In short, the holder is in a position to liquidate the trust at any time by simply calling for repayment of the loan. This power is sometimes referred to as the "trump card of control".

2.2 INTEREST-FREE LOAN ACCOUNTS: DTC RECOMMENDATION

It would appear that SARS does not examine trusts at the time that they are registered or when assets are transferred into trusts. This represents an opportunity for taxpayers to shed substantial value from their estates without the payment of donations tax or CGT. The DTC recommends that such transactions be comprehensively examined by competent SARS officials.

In the first interim report the DTC recommended that no attempt be made to implement some form of transfer pricing regulations regarding domestic trust arrangements. Submissions received by the DTC indicate support for this recommendation.

The DTC reaffirms its view that domestic transfer pricing legislation is not the answer in this instance.

The DTC does, however, recommend that NT should consider the possibility of extending the provisions of section 3(3)(d) of the EDA to include deeming provisions that identify “deemed control” of a trust, along the following lines:

- Where a loan account exists between a trust and a “connected person(s)” and
- The loan is not subject to interest, or is subject to interest at below the official rate of interest as prescribed by the ITA and
- The holder of the loan can demand repayment within a specified period,
- The holder of the loan will be deemed to be in effective control of the trust and section 3(3)(d) will be deemed to apply.

The effect would be as follows:

- The holder of the loan account would be subject to annual taxation on interest paid on the loan account (at least the official rate of interest) and
- The trust arrangement would be devoid of any estate duty advantage owing to the application of section 3(3)(d).

An amendment of this nature would have to be robustly reinforced by comprehensive disclosure requirements in both the income tax and estate duty returns of any party associated with a trust.

3. EXTENSION OF GENERAL ANTI-AVOIDANCE REGULATIONS (GAAR) TO THE EDA

3.1 OBSERVATIONS

In the first report the DTC stated that the pursuit of General Anti-Avoidance Regulations (GAAR) would not solve the problems within the estate duty system.

The DTC is of the opinion that section 80A of the Income Tax Act as well as judicial precedent do not currently act as an effective deterrent against the wide range of estate duty saving mechanisms that exist today.

The DTC also considers that the inclusion of GAAR provisions in the Estate Duty Act has little prospect of success.

Enforcement of the existing EDA could not be substantially improved through the employment and training of expert SARS estate duty assessors.

Submissions received by the DTC have suggested that if trusts are of concern from an estate duty point of view, which they undoubtedly are, it would be preferable to specifically address the issue with targeted anti-avoidance rules aimed at preventing the avoidance of estate duty.

3.2 EXTENSION OF GENERAL ANTI-AVOIDANCE REGULATIONS (GAAR) TO THE ESTATE DUTY ACT: DTC RECOMMENDATION

Before addressing the anti-avoidance rules applicable to estate duty and trusts, it is necessary for SARS to examine the true relationship that exists between donors, beneficiaries and trusts. This is not always readily reflected in the trust deeds and other documentation available to SARS. See for example, Zandberg v Van Zyl (1910 AD at 302). The court found:

> … the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature.
>
> And when a court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is, not what in form it purports to be.
>
> The maxim then applies *plus valet quod agitur quam quod simulate concipitur.*

Additionally, in CSARS v NWK (Pty) Ltd, 2011 (2) SA 67 (SCA) at para 55, the court found:

> In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms.
>
> Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to their transaction on the terms agreed.
>
> …if the purpose of a transaction is to only achieve an object that allows the evasion of tax… then it will be regarded as a simulation.

Such an examination is not as simple as it may seem. In the context of trusts, the examination of the true arrangement between the parties is a specialised and, in many cases, lengthy process that would require SARS to deploy massive resources. Conclusions reached by SARS may well be disputed, leading to lengthy litigation and further strain being placed on SARS. Considering that there are 333 465 trusts registered with SARS, this could be a massive undertaking.

This is not to say that there are no specific anti avoidance provisions in the EDA. For example, as noted, s3(3)(*d*) is a targeted anti-avoidance provision aimed at a situation in which the deceased was competent to dispose of property for his/her own benefit. In this regard a number of deeming provisions are contained in s3(5). This provision would apply, for example, when the founder of a trust retains the power to amend the trust deed or appoint the trustees. In other words, it may be invoked in cases in which the founder of the trust is unwilling to relinquish control of the assets of the trust, a common situation with a family trust when the trust has been put in place only for tax avoidance purposes rather than for a legitimate one.

The DTC has already recommended that section 3(3) be extended by way of anti-avoidance measures targeted at interest-free loan accounts between trusts and benefactors.

The examination of section 3(3)(*d*) should not be delayed until such time as income is received by or accrued to a trust. Again, the DTC recommends that all trust arrangements should be examined by SARS, on registration of trust arrangements, and upon transfer of assets into trusts. This should reduce aggressive tax planning and, at the same time, provide a level of assurance to taxpayers that their affairs are indeed in order.

4. CAPITAL TRANSFER TAX

4.1 OBSERVATIONS

In its first report the DTC referred to and concurred with the findings of the Katz Commission of Enquiry regarding Capital Transfer Tax.

> The following emerges from all the comparative research undertaken by the Commission:
>
> (a) Capital transfer taxes are prone to being extremely complex;
>
> (b) The complexities referred to above result in problems of administration and high costs of collection;
>
> (c) Anti-avoidance measures, in addition to having to comply with equitable principles, must be designed so as to result in taxation of transactions that should be subject to the relevant taxes but, on the other hand, must endeavour not to include within the tax net transactions that have legitimate commercial and other justifications;
>
> (d) Capital transfer taxes have a notoriously low yield, that is, revenue collected minus costs of collection; and
>
> (e) Regrettably, a worldwide phenomenon of capital transfer taxes is that they give rise to an unproductive estate planning industry.

The DTC recommended that, with some modification, the estate duty system could achieve many of the objectives outlined without resorting to the drastic measure of implementing Capital Transfer Tax.

Submissions received by the DTC have suggested that a potential solution to discourage aggressive estate duty avoidance may be to implement a periodic charge to estate duty in addition to a GAAR. As an example, the United Kingdom makes use of such a rule under which certain trusts are subject to a charge to the inheritance tax every 10 years, as are distributions from the trust.

4.2 CAPITAL TRANSFER TAX: DTC RECOMMENDATION

Following a resolution of the General National Council of the ANC it is noted that the Minister of Finance has now requested that a further investigation be conducted into the implementation of wealth taxes in SA. This will be addressed in a separate report of the DTC.

5. INCOME TAX ON TRUSTS

5.1 OBSERVATIONS

Currently trusts are taxed at a flat rate of tax of 41 per cent for income. Following announcements made in the 2016/17 National Budget Speech the CGT inclusion rate for trusts will be increased to 80 per cent, resulting in an effective rate of tax of 32,8 per cent on capital income. Thus the following significant arbitrages exist between trust tax rates and personal income tax rates: Trust tax rates exceed the personal tax rate when taxable income is below the current maximum marginal tax rate threshold of R701 301 per annum.

However, section 25B of the ITA allows the trustees of the trust to cause the trust income to vest in and be taxed in the hands of a beneficiary. This is known as the “conduit-pipe” principle. Paragraph 80 of the Eighth Schedule follows the same principle for capital gains, at least as far as resident beneficiaries are concerned.

Section 7 contains the “attribution back to donor” rules. Under these rules income is deemed to accrue to a trust donor to the extent that the trust’s income has been funded by a donation, settlement or other disposition and the income has not been vested in a beneficiary under section 25B. In some situations section 7 will override section 25B and deem income back to a donor even if it has been vested by the trustees in a beneficiary (for example, when income has been vested in a minor child).

The attribution rules in section 7 were originally intended as an anti-avoidance measure aimed at preventing a trust from being used as an income-splitting device. Prior to years of assessment, commencing on or after 1 March 1998, trusts were taxed on a sliding scale with the same maximum marginal rate as individuals, but without the rebates. It would therefore have been a simple matter to place income-generating investments in a number of trusts in order to take advantage of the trust’s sliding tax scale. The need for section 7 in those years will be appreciated if regard is had to the extremely high individual tax rates that prevailed at the time. For example, in 1972, the maximum marginal rate of tax for an individual was 66 per cent (inclusive of a surcharge), plus a loan levy of 12 per cent which increased the rate to 78 per cent.

From the 1999 to 2002 years of assessment, trusts were taxed at a dual rate of tax. For example, in the 1999 year of assessment, the first R100 000 of taxable income was taxed at 35 per cent and above that level at 45 per cent, the latter being equal to the maximum marginal rate of an individual. The dual rate prompted some taxpayers to form multiple investment trusts to take advantage of the 35 per cent rate, including the questionable practice of forming multiple "pour over" trusts. Thus Trust 1 would retain R100 000 and distribute the balance of its income to Trust 2 which in turn would distribute the excess above R100 000 to Trust 3 and so on. Even at this point, attribution to a donor made sense because it would have had the effect of taxing the donor at 45 per cent instead of 35 per cent.

For the 2003 and subsequent years of assessment, trusts have been taxed at a flat rate of tax which stands at 41 per cent for the 2016/17 year of assessment. As indicated earlier, following announcements made in the 2016/17 National Budget Speech trusts are subject to a CGT inclusion rate of 80 per cent, resulting in an effective CGT rate of 32,8 per cent (80 per cent × 41 per cent). When CGT was introduced in 2001, the "attribution back to donor" rules in paragraphs 68 to 73 of the Eighth Schedule merely followed the same rules as in section 7.

Because of the flat rate of tax of 41 per cent and effective flat rate for CGT purposes of 32,8 per cent, the attribution rules no longer serve their purpose as an anti-avoidance provision; the opposite is true. They now represent a concession to high net worth individuals. At best, income will be taxed at the same rate of 41 per cent but it could be taxed at anything from 0 per cent to 41 per cent, depending on the level of taxable income of the donor or beneficiary. Thus, the attribution rules can be, and now are, employed to avoid tax, consequently subverting the very purpose for which they were introduced. For CGT purposes, there is a definite benefit to a donor who is a natural person, with capital gains being taxed at between 0 per cent and 16,81 per cent instead of at 32,8 per cent.

A further aberration from the fiscus' standpoint is that attribution to a donor of income has no effect on the donor's estate for estate duty purposes, since the assets derived from the deemed income are in reality held by the trust. To make matters worse for the fiscus, a donor has the right to recover the tax on the deemed income from the assets of the trust under section 91(4). However, few donors would exercise that right since it would be better for them to pay the tax themselves, thus diminishing the value of their estates even further.

In summary, the attribution principle was established at a time when personal income tax rates were substantially higher than trust tax rates. This position has now been reversed, particularly in regard to capital tax rates where the highest rate of CGT for personal income tax (16,81 per cent) is now half the rate of trusts (32,8 per cent). Further benefits can be gained if trust income is taxed in the hands of the individual receiving income below the maximum marginal rate of 41 per cent attained at a taxable income level of R701 301 per annum.

In the light of these observations, the DTC recommended in the first report that many of the deficiencies of the current estate duty system be addressed by way of the following simple yet fundamental amendments to the existing legislation*:*

- The flat rate of tax for trusts should be maintained at its existing levels
- The deeming provisions of section 7 and 25B insofar as they apply to RSA resident trust arrangements should be repealed
- The deeming provisions of section 7 and 25B insofar as they apply to non-resident trust arrangements should be retained
- Trusts should be taxed as separate taxpayers
- The only relief to the rule should be the "special trust definition" contained in section 1 to the Income Tax Act which allows a trust to be taxed at personal income tax rates in limited special circumstances. The definition should be revisited by National Treasury so as to make provision for the inclusion of selected trusts used in Broad Based Black Economic Empowerment Structures
- No attempt should be made to implement transfer pricing adjustments in the event of financial assistance or interest-free loans being advanced to trusts.

Taxpayers must be allowed to make use of trusts when it makes sound sense to do so in the pursuit of a commercial justification or benefit, as opposed to an estate duty benefit. However, as is the case with present company tax rates today, the taxpayer must accept any potential adverse tax consequences.

The DTC acknowledged that the repeal of the attribution provisions will have diverse and far-reaching implications. Thus, it would be in the interests of equity that the repeal of the attribution provisions be announced in the 2016 National Budget Speech but only implemented with effect from 1 March 2017. An extensive consultative process will have to follow during the 2016 legislative cycle, so as to identify and address the many issues involved.

There would be numerous complexities associated with implementing a form of transfer pricing adjustment to deem a return on interest-free loans between SA registered trusts and SA taxpayers. The DTC concurs with the recommendations of the Katz Commission that this be avoided.[7]

The taxation of trusts has always been a contentious issue. Thus the DTC anticipated robust debate over the very prospect that the current taxation regime should be altered. Many submissions made to the DTC following this report challenge any prospect of altering the attribution/conduit principle. However, the submissions do not address the fundamental issue that the given principle was originally implemented as an anti-avoidance principle, but has evolved into a tax planning opportunity today.

6. INCOME TAX: VESTED TRUSTS

6.1 OBSERVATIONS

Many of the submissions received by the DTC express the valid point that a distinction must be made between “vested trusts” and “discretionary trusts”.

The primary argument made in submissions is that the benefits of vested trusts fall within the estate of the beneficiary, thereby negating any potential estate duty saving.

However, if the vested capital beneficiaries are grandchildren, “generation skipping” has been achieved. In addition substantial improvement of disclosure requirements in tax returns of the trust, donor and beneficiary is required.

[7] Third Report of the Katz Commission, 1997 at page 16.

The few statistics available reflect that, at the very least, a substantial component of income received by trusts is taxed in the hands of donors or beneficiaries in terms of the conduit/attribution principle.

Where the capital and income of a trust vests in, and is taxed in the hands of the beneficiary of a trust in terms of section 25B two less obvious taxation consequences result:

- If the income is retained in trust, any income generated on the vested amount subsequent to vesting is taxable in the hands of the beneficiary
- Any amount retained in trust after vesting falls within the estate of the beneficiary for purposes of the estate duty computation.

In short, a substantial risk of non-disclosure arises when income is taxed in the hands of a taxpayer who is different to the taxpayer receiving it or to whom it accrues. In spite of this risk, there is currently no system within SARS that actively monitors the vested interests of beneficiaries held but not distributed by trusts.

It is noted that the mismatch of income received by taxpayers in a representative capacity is of concern throughout the income tax system. This has recently led to the introduction of the new section 9HA and the amendment of sections 22(8)(b), 25,and paragraphs 40, 41 and 67 of the Eighth Schedule to the ITA, *inter alia* to deal with the reporting of income received during the administration of deceased estates.

6.2 INCOME TAX: VESTED TRUSTS: DTC RECOMMENDATION

As an immediate and urgent measure it is recommended that donors and beneficiaries of all vested trust arrangements be subject to stricter disclosure requirements and enforcement measures.

In particular, any trustee must be required to report on all distributions of income and capital made by a trust, in a manner similar to the IRP 5 certificate. Furthermore, SARS should review the disclosure requirements required in all tax returns.

SARS should develop a method of risk-profiling analysis to identify and examine trust arrangements.

Estate duty assessment procedures of SARS should concentrate on the examination of any trusts in which the deceased may have enjoyed a vested interest in order to ensure that all income and capital has been brought into account for both income tax and estate duty purposes.

However, the improvement of disclosure and compliance obligations of trusts is far from the only issue that requires urgent attention.

7. INCOME TAX: DISCRETIONARY TRUSTS

7.1 OBSERVATIONS

In their simplest form, discretionary trusts are taxed on revenue income at the flat rate of 41 per cent and capital income at the flat rate of 32,8 per cent. These rates are significantly higher than personal income tax rates on revenue income as they exclude the marginal tax brackets on income below R701 301 per annum and the lower capital gains tax inclusion rate of 40 per cent.

It is frequently argued that the higher trust tax rates applied during the existence of a trust compensate for any estate duty savings that may be achieved in the future.

However, this does not take into account the fact that the trustees of a discretionary trust can cause income to be taxed in the hands of the trust's beneficiaries through the distribution or vesting of income on a periodic basis.

At first blush it would appear that the periodic distribution or vesting of trust income poses no significant threat with regard to revenue income, as the flat trust tax rate and the maximum personal income tax rate are the same at 41 per cent.

However, since 2000, the personal income tax brackets have been substantially widened and today (in the 2016/17 year of assessment) the maximum personal income tax rate of 41 per cent is only attained at a taxable income level of R701 301. Thus, depending on the taxation profile of the trust beneficiaries, a substantial tax benefit may be achieved by causing the income of a trust to vest in the hands of the beneficiary, even if the income is retained within the trust.

The potential tax saving is even more substantial in the context of capital income.

Vesting of trust benefits takes various forms. This is demonstrated by the complex income tax treatment of capital gains. For CGT purposes it will depend on the nature of the vesting. If the beneficiary has a vested right to a particular asset, it is treated as the beneficiary's asset for CGT purposes even though it is held by the trust. Actions of the trustee are actions on behalf of the beneficiary. However, where the beneficiary merely has a right to the trust capital and not to a particular asset then the flow through of capital gains and losses is not automatic. The trust will have a base cost for its asset while the beneficiary will have a base cost for his or her vested right.

To complicate matters even further, many discretionary trusts exhibit both vesting and discretionary characteristics; i.e. discretionary for unvested assets and vested for vested assets.

This bifurcated system allows for the best of both worlds, that is, (i) the postponement or avoidance of estate duty (whilst the assets of the trust are held on a discretionary basis) and (ii) the CGT advantage achieved by applying the personal taxpayer's inclusion rate and lower marginal rate of tax if the proceeds are distributed or vested at the time when the asset is sold.

7.2 INCOME TAX: DISCRETIONARY TRUSTS: DTC RECOMMENDATION

The DTC recommends that where a trust deed confers upon its beneficiaries an indisputable and irrevocable vested right to both the capital and income of a trust, the income, both capital and revenue, should be taxed in the hands of the beneficiary.

In all other cases:

- Revenue income must be taxed in the trust in accordance with the definition of "gross income" contained in section 1 of the ITA.
- Capital income, generated while assets are held in trust on anything other than a vested basis, must be taxed within the trust up to the time of vesting or disposal as defined in paragraph 11 of the Eighth Schedule to the ITA.

8. INCOME TAX: TRUST TAX RATES AND CGT INCLUSION RATES

8.1 OBSERVATIONS

Submissions have been received by the DTC to the effect that if trusts are to be taxed in their own right, then they must be afforded the same “respect” as other taxpayers and, in particular, the trust tax rate should be similar to the corporate tax rate.

8.2 TRUST TAX RATES AND CGT INCLUSION RATES: DTC RECOMMENDATION

Provided that the above recommendations are implemented, it would appear to be equitable that trusts are afforded the same tax rates as companies. Corporate profits are subject to both corporate income tax and dividends tax.

However, to afford trusts the total corporate tax package would create an incentive for trusts to retain earnings and thereby achieve the corporate tax rate of 28 per cent. This is not an option.

The logical answer would be to reduce the flat rate of tax applied to trusts to the corporate tax rate if corporate income tax rates and dividends tax rates are combined (37 per cent). However, this situation would create a tax arbitrage of 4 per cent between the maximum personal income tax rate (41 per cent) and the trust rate. If trusts were given a flat rate of 37 per cent this would result in an unfair advantage for the high net worth individual if it is combined with the estate duty saving that would remain an inherent characteristic of a discretionary trust arrangement.

If the DTC proposals are implemented, trusts will remain a potential estate duty saving mechanism. For this reason the DTC recommends that the flat rate of tax applied to trusts be retained at its current level, but subject to adjustment in line with changes in the maximum personal income tax rate.

9. FOREIGN TRUSTS

9.1 OBSERVATIONS: LEGISLATIVE DEBATE

In the first report the DTC recommended that, owing to the difficulties of identifying the components of income distributed to a beneficiary, all distributions from foreign trusts be taxed as income. This recommendation, if implemented, would discourage offshore trust formation and can be justified on the grounds of the deferral of the tax that a beneficiary obtains through the use of an offshore trust.

This has, unsurprisingly, elicited many submissions to the DTC.

In short, the fundamental issues raised in submissions concern paragraph 80 of the Eighth Schedule and s25B of ITA are:

- What must be disregarded by the trust and/or taken into account by the resident beneficiary under paragraph 80(2)? Difficulties emerge in the determination of the *capital gain* in respect of the disposal of the asset by the trust?
- Do the words "any amount" in section 25B(1) and (2) refer only to "gross income" (as defined) or "income" (as defined), or do they – as their wording suggests – refer to all amounts, including amounts of a capital nature?
- Does the "conduit-pipe" principle apply equally in relation to receipts, as distinct from accruals?
- Do the provisions of section 25B as well as those of para 80 address the mismatch between accounting and taxable income?
- How does the ITA avoid the many Double Taxation Agreement conflicts which currently arise where SARS attempts to tax the capital gain of an SA trust accruing to a non-resident beneficiary (Since the other country has a right to tax the accrued gain in the hands of its resident, this potentially results in double taxation with no right to foreign tax credit relief as the tax is imposed in RSA on a different taxpayer?)

9.2 LEGISLATIVE DEBATE: DTC RECOMMENDATION

It is not the function of the DTC to formulate legislation on behalf of SARS and NT. Thus the DTC recommends that SARS and NT review the above legislation in the light of the alleged deficiencies noted.

10. FOREIGN DISCRETIONARY TRUSTS

10.1 OBSERVATIONS

The discussion in this report has been confined to foreign trust arrangements where the vesting or distribution of the trusts income or capital has indeed occurred. It has not addressed the pressing issue of the taxation consequences of discretionary foreign trust arrangements where distribution or vesting of the trusts income and capital to South African resident beneficiaries has yet to occur.

South Africa has a long history of taxpayers making extensive use of discretionary foreign trust arrangements specifically designed to conceal the true beneficial ownership of the underlying assets and income. Many of these arrangements date back to pre-1994.

In 2004, taxpayers were offered a generous income tax and exchange control amnesty for assets accumulated by them abroad in contravention of both the Income Tax Act and Exchange Control Regulations of the Reserve Bank.

42 672 South Africans participated in the amnesty programme. Assets in excess of R68,6 billion were identified and brought within the South African tax system. Exchange control levies totalled R2,9 billion.

Submissions received by the DTC in response to the first report called for yet another offshore disclosure programme. In subsequent discussions it was difficult to obtain specific detail. However, it would appear that the 2004 income tax and exchange control amnesty programme did not identify much of the South African wealth held within discretionary foreign trust arrangements. Thus, it would appear that many SA residents were advised that such arrangements would stand the test of time.

The ITA is virtually silent regarding discretionary foreign trust arrangements in which vesting or distribution of capital and income has not yet occurred.

South African-resident discretionary trusts are taxable at a flat rate of tax of 41 per cent. However, in the absence of any established link to an SA-resident taxpayer, it is simply not possible for SA to tax a foreign trust on income or capital gains from a non-SA source.

Thus, as the ITA stands today, it is possible for an SA resident taxpayer to accumulate income within an offshore foreign trust arrangement, thereby postponing income tax and estate duty exposure until vesting occurs.

The recommendation contained in the first report that all distributions of foreign trusts be taxed as income was intended to act as a deterrent against the use of discretionary foreign trust arrangements and compensate for the postponement of tax achieved through the use of discretionary foreign trusts.

This is not to say that foreign discretionary trust arrangements are not currently beyond attack from SARS under the ITA or the common law. In particular, (1) many foreign trust arrangements are managed from SA and as such are SA-resident taxpayers; (2) the true arrangement surrounding the foreign trust arrangement may well be that foreign administrators, acting as trustees, hold assets on behalf of the SA taxpayer and that the discretionary foreign trust is merely a façade to disguise the true arrangement between the foreign trust and its beneficiaries; (3) The taxpayer may have failed to apply the provisions of section 7(8) or paragraph 72 of the Eighth Schedule to deem the income or capital gains of the foreign trust back to the SA resident taxpayers who effected the donations, dispositions or settlements to the foreign trust.

In spite of the legislation, there will always be taxpayers who continue to fail to disclose the true nature of their foreign trust arrangements. In the course of time these arrangements may well be unravelled by SARS through the exchange of information between worldwide tax authorities.

In the first report, the DTC recommended that the criminal offence provisions of the Tax Administration Act 2011 be reviewed pursuant to the possible inclusion of separate criminal charges that could be brought against taxpayers who fail to disclose their direct or indirect interests in foreign trust arrangements, whether the interest is legal or is one which is based on the practice of the administration of the trust structure.

11. OFFSHORE RETIREMENT FUNDS

11.1 OBSERVATIONS

The DTC notes the emergence of new offshore investment products in South Africa that are promoted under the umbrella of an “offshore retirement fund”. The arrangements encompass the following general characteristics:

- Using the RSA taxpayer’s offshore investment allowance, funds are contributed to an offshore discretionary trust arrangement
- The contribution is not deductible in the determination of the SA taxpayer’s taxable income since the trust cannot be classified as an SA retirement fund
- The contribution is not classified as a loan or investment. This fact eliminates transfer pricing considerations and the establishment of base cost for CGT purposes
- The SA taxpayer is considered to have acquired a *spes* or hope of the receipt of a pension
- The contribution is argued to be exempt from donations tax since it is not based on a “gratuitous disposal” as contemplated in the definition of “donation” in section 55(1)
- On the death of the taxpayer, the accumulated investment is not included in the SA taxpayer’s estate duty computation as no vested right exists in respect of the trusts accumulated capital or income of the trust
- The offshore trust/retirement fund is not taxable in RSA since it is not resident in RSA.

This arrangement, in the view of the Committee, represents a concealment of the true arrangement between the SA taxpayer and the offshore trust/retirement fund. The true arrangement is that the taxpayer has a vested interest in both the capital and income of the offshore trust/retirement fund. As such, the income of the arrangement is taxable in the hands of the SA resident taxpayer and the capital should be included in the estate duty computation. Alternatively, if the true arrangement between the parties is indeed a donation, it should be subject to donations tax and the income deemed to be that of the SA taxpayer in terms of section 7(8).

11.2 OFFSHORE RETIREMENT FUNDS: DTC RECOMMENDATION

The DTC recommends that the above arrangements be further investigated by SARS.