Beware the bogeyman – Capital Gains Tax and loan accounts

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SUMMARY AND KEY TERMS

Estate planning is the arrangement and management of an estate owner's estate to the effect that the estate owner and his beneficiaries can enjoy maximum benefit from his worldly possessions during his lifetime and after his death. Unfortunately, for estate owners and their beneficiaries, a deceased estate has to pay an executor's fee, estate duty and capital gains tax on the demise of the estate owner, which means the amount the estate owner intended his heirs to receive, might be substantially decreased.

For decades trusts have been used for estate planning purposes. The decision of the estate owner to utilise a trust for estate planning purposes involves the disposal of growth assets from the estate owner's estate to the trust. This ensures that the value of a growth asset is pegged in the estate owner's estate and the asset continues to grow in the trust. The asset is disposed of by way of a loan account in favour of the estate owner and the parties agree that the outstanding amount is payable on demand. In his will, the estate owner then bequeaths the outstanding amount back to the trust.

However, Paragraph 12(5) of the Eighth Schedule to the *Income Tax Act* 58 of 1962 stated that capital gains tax will be levied in cases where a debt is reduced or discharged by a creditor for no consideration or for an amount which is less than the outstanding amount. In *ABC Family Trust* ITC 1793 the estate owner transfer assets to the trust on a loan account and in her will, bequeathed the exact outstanding amount back to the trust. It was argued on behalf of the trust that the bequest constituted a set-off and not a discharge of the debt. However, the court stated that the set-off took place because of the "operation of law" which is specifically included in the definition of a "disposal" for capital gains tax purposes. The court applied Paragraph 12(5) and found that the trust is liable to pay capital gains tax on the full outstanding amount.

In *XXX Trust* ITC 1835 the estate owner also transferred asset to a trust, but in her will she bequeathed the residue of her estate, and not the exact outstanding amount, to the trust. In this case the court placed emphasise on the intention of the estate owner and not on the possible application of Paragraph 12(5). The court found that it was not the intention of the estate owner to discharge or reduce the debt for no consideration. Subsequently, it was found that the trust is not liable for capital gains tax. Since these two cases Paragraph 12(5) has been deleted and Paragraph 12A inserted in the Eight Schedule to the *Income Tax Act* 58 of 1962.

The focus of this mini-dissertation is to determine which estate planning tools were available to estate owners to prevent a capital gains liability under Paragraph 12(5). The capital gains tax effect that Paragraph 12A might have on estate planning is also discussed.

Keywords:

Estate planning / estate planning tools / trust as estate planning tool / bequest of a loan account / Paragraph 12(5) of the Eighth Schedule to the *Income Tax Act* 58 of 1962 / Paragraph 12A of the Eighth Schedule to the *Income Tax Act* 58 of 1962 / discharge of debt / reduction of debt / *ABC Family Trust* ITC 1793 / *XXX Trust* ITC 1835

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LIST OF ABBREVIATIONS

CGT	Capital Gains Tax
CSARS	Commissioner for the South African Revenue Service
SA Merc LJ	South African Mercantile Law Journal
SARS	South African Revenue Service
Stell LR	Stellenbosch Law Review

1 Introduction and problem statement

1.1 Problem statement

The famous Benjamin Franklin[1] said "in this world nothing can be said to be certain, except death and taxes." Even after death a person's estate is still liable for taxes. Within the South African context this is especially true, where even after death a person's estate can still be held liable for a variety of taxes. In some situations it can occur that the deceased estate is liable for more than one type of tax, for instance estate duty[2] and capital gains tax,[3] which may substantially decrease the amount which the testator intended to bequeath to his heirs. In the 2010 Budget Review[4] it was stated that due to the fact that estate duty and CGT are both levied upon death the situation could be perceived as giving rise to double taxation. It was also stated that death taxes will be reviewed. However, estate duty is still applicable.

Although the possibility of minimising tax consequences should not be the sole reason, it is one of the reasons why some estate owners venture to the use of trusts for estate planning purposes. Meyerowitz[5] emphasises the fact that estate planning should not only take tax consequences into account when he provides the following definition for estate planning:

> ...it is the arrangement, management, securement, and disposition of a person's estate, so that he, his family and other beneficiaries can enjoy and continue to enjoy the maximum benefits from his worldly possessions during his lifetime and after his death.

To add value to the above-mentioned remark of estate planning and to effectively manage and arrange an estate owner's assets in the most favourable way possible, it is important to take cognisance of all the relevant legislation which will have an effect on the estate owner's estate before and after his demise.

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1 Smyth (ed) *The Writings of Benjamin Franklin* 69.
2 Estate duty is levied in terms of section 2 of the *Estate Duty Act* 45 of 1955. Hereafter referred to as the *Estate Duty Act*.
3 Capital gains tax (hereafter referred to as CGT) is levied in terms of the Eighth Schedule of the *Income Tax Act* 58 of 1962. Hereafter referred to as the *Income Tax Act*.
4 National Treasury 2010 http://www.treasury.gov.za/documents/national%20budget/2010/review/Budget%20Review.pdf.
5 Meyerowitz 1964 *The Taxpayer* 181.

In the 2000 Budget Speech[6] the former Minister of Finance, Trevor Manuel, announced that CGT will be introduced into the South African tax system. The aim of the introduction of CGT was to make income tax more equitable.[7] CGT was introduced into the *Income Tax Act* on 1 October 2001, which meant that all capital gains an individual received from a disposal of an asset from 1 October 2001 were subject to CGT.[8] According to Section 26A of the *Income Tax Act*, taxable capital gain (as determined by the Eighth Schedule to the *Income Tax Act*) will be included into a person's taxable income.[9] Section 26A provides the link between the Act and the Eighth Schedule.

According to Paragraph 40 of the Eighth Schedule:[10]

> (1) A deceased person must be treated as having disposed of his or her assets...
>
> (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 –
>
> (a) the estate of the deceased person, the estate must be treated as having acquired that asset at a cost equal to the market value of the asset as at date of death of that deceased person; or
>
> (b) an heir or legatee of the person, the heir or legatee must be treated as having acquired that asset at a cost equal to the market value of that asset at date of death of that deceased person, which cost must be treated as an amount of expenditure actually incurred for the purposes of paragraph 20(1)(a).
>
> (3) For the purpose of this Schedule, the disposal of an asset by the deceased estate of a natural person shall be treated in the same manner as if that asset had been disposed of by that natural person.

Furthermore, Paragraph 3 of the Eighth Schedule states:

> A person's capital gain for a year of assessment, in respect of the disposal of an asset –

6 Manuel 2000 http://www.info.gov.za/speeches/2000/000223202p1001.htm.

7 Manuel 2000 http://www.info.gov.za/speeches/2000/000223202p1001.htm. Prior to CGT taxpayers converted income, that would ordinarily be taxable, into tax-free capital gains. However, not every taxpayer had the luxury of extra income which could be converted into capital and on the sale of that asset into capital gains. In this sense CGT was introduced to provide more equity where everyone will be taxed on income and/or on capital gains.

8 Du Toit *South African Trust Law* 162.

9 Botha *et al Fundamentals of Financial Planning 2012* 315.

10 Any further reference to paragraphs will be the Paragraphs of the Eighth Schedule of the *Income Tax Act*, unless stated otherwise.

(a) during that year, is equal to the amount by which the proceeds received or accrued in respect of that disposal exceed the base cost of that asset.

It is clear from Paragraph 3 that before proceeding to determine whether CGT will be applicable, the meanings of "asset", "disposal", "proceeds" and "base cost" need to be established. This will be dealt with in further detail in Chapter four of this mini-dissertation.

For decades estate owners have used trusts as an estate planning tool and trusts are still regarded as a very useful tool for estate planning purposes.[11] In practice the property of an individual is disposed of to a trust with the result that the growth of the asset is pegged in the estate owner's estate while the value continues to grow in the trust.[12] The value of the property now grows to the benefit of the trust and to the benefit of the beneficiaries that will most likely be the heirs of the estate owner.[13] The main purpose of the utilisation of the trust in this manner is to minimise the executor's fee and the possibility of estate duty payable upon death of the estate owner. However, this should not be the sole purpose for the use of the trust as legislation may change and possibly have a negative effect on the estate owner.

The property is normally disposed of to the trust by way of an interest-free loan in favour of the estate owner, which is payable on demand. The loan is classified as a claim in favour of the estate and thus a property in the estate in terms of section 3 of the *Estate Duty Act*.[14] In order to minimise the loan account over a period of time, the holder of the loan account can donate R100 000.00 per year free of donations tax (in accordance with section 56(2)(b) of the *Income Tax Act*, and provided that he has not made any other taxable donations during the particular year), to the trust.

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11 Mazensky 2001 http://www.gt.co.za/files/busline_aug01.pdf. Also see Burger 2012 http://www.cover.co.za/financial-planning/trusts-and-estate-planning and Cameron 2003 http://www.roylaw.co.za/home/article/8161130/pageid/3104986.

12 Mazensky 2001 http://www.gt.co.za/files/busline_aug01.pdf.

13 Mazensky 2001 http://www.gt.co.za/files/busline_aug01.pdf.

14 Section 3 of the *Estate Duty Act* state:

(1) For the purpose 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 –

(a) any fiduciary, usufructuary or other like interest in property (including a right to any annuity charged upon property) held by the deceased immediately prior to his death;...

The trustees will then use the money received to pay a portion (R100 000.00) of the loan without attracting CGT.

Before CGT was introduced, the estate owner could bequeath the outstanding amount to the trust and there would have been no CGT liability. However, Paragraph 12(5) of the Eighth Schedule of the *Income Tax Act* dealt specifically with the situation where a debt was discharged or reduced by a creditor (the estate owner), in which case a capital gain arose equal to the amount of the debt discharged or the amount by which the debt had been reduced.

Within the context of the administration of deceased estates and the reduction of a debt as referred to in par 12(5) it has been addressed in two recent judgments, the *ABC Family Trust* ITC 1793 case and the *XXX Trust* ITC 1835 case. Due to their importance with reference to the application of Paragraph 12(5) of the Eighth Schedule of the *Income Tax Act*, these two decisions will be discussed in depth in this mini-dissertation.

Since these two cases, Paragraph 12(5) has been repealed by section 107 of the *Taxation Laws Amendment Act*[15] and replaced by Paragraph 12A. Paragraph 12A provides for more definitions and indicates, *inter alia*, that CGT will arise in the case where the debt owed by a person is reduced or cancelled in certain circumstances. Paragraph 12A is only effective from 1 January 2013 and the possible consequence from an estate planning perspective will be discussed in a later paragraph.

1.2 Research question

1.2.1 Main question

Based on the position as set out above, the following research question may be posed: From an estate planning perspective, which measures or estate planning structures were available to the estate owner that wanted to erase a loan account without attracting CGT?

15 *Taxation Laws Amendment Act* 22 of 2012. Hereafter referred to as the *Taxation Laws Amendment Act*.

1.2.2 Secondary questions

To assist with answering the main research question, the following secondary questions will be discussed:

- How did CGT develop?
- Why is there a distinction between proceeds of a capital- or income nature? Why is this distinction important?
- When is CGT levied?
- Why do estate owners use a trust as an estate planning tool? With regard to trusts and outstanding loan accounts, how was Paragraph 12(5) of the Eighth Schedule interpreted and applied by the courts?
- Which estate planning tools were available to limit the effect of Paragraph 12(5)?
- What does Paragraph 12A of the Eighth Schedule entail and what is the effect thereof on estate planning?

Each of these questions will be addressed in the following paragraphs.

2 The development of CGT in South Africa and the reasons for its introduction into the South African tax system

As previously mentioned,[16] the former Minister of Finance, Trevor Manual, announced in his 2000 Budget Speech that CGT will be introduced into the South African tax system. At that stage the idea of CGT was not a new phenomenon in South Africa. In its *Comprehensive Guide to Capital Gains Tax*, SARS states:[17]

> In 1969, the Franzsen Commission proposed a limited form of capital gains tax on immovable property and marketable securities, while the Margo Commission in 1986 recommended that capital gains should not be taxed. Most recently, the Katz Commission in its third report considered the merits and demerits of a capital gains tax in South Africa. It declined to make firm recommendations because of the complexity of its administration and the lack of capacity of the Inland Revenue at that time.[18]

16 At par 1.1.
17 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 3.
18 This was around 1995 when the Katz Commission Report was printed.

There are a number of reasons why CGT was introduced into the South African tax system. Firstly, in many of South Africa's trading partners CGT had been in operation for several years.[19] Even a couple of African countries[20] have also introduced CGT into their tax systems.[21] Secondly, a capital gain should have no different treatment from other forms of income. Every taxpayer should have the same tax burden, whether their income is derived from revenue or from capital gains. In the event that a capital gain is not taxed, it does not amount to equal treatment and there is no horizontal equity with regards to tax.[22] Thirdly, a taxpayer that is in a financial position to pay more taxes should in fact pay more taxes.[23] In a country such as South Africa where there is such a significant difference in the distribution of wealth, the levying of CGT will improve the vertical equity of the income tax system.[24] Fourthly, if capital gain is not taxed, the taxpayer has a motivation to modify income as capital in a bid to avoid being taxed on income.[25] Fifthly, introducing CGT makes more economic sense.[26] If capital gain is not taxed, the system promotes the investment of savings in assets which will provide return in the form of capital gains and not income producing assets.[27] Sixthly, it is proposed that with the introduction of CGT the range of taxation will be expanded, as more

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19 These countries include the United States of America, the United Kingdom, Canada and Australia.

20 For instance Botswana, Egypt and Nigeria. However, the application of CGT in these countries is regarded to be in a more limited form - McAllister *SARS Comprehensive Guide to Capital Gains Tax* 1.

21 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 1.

22 Patel *Capital gains taxation and its potential effects on taxpayers* 14-15 states that "A rand earned through the sale of a capital asset bestows the same economic power as does a rand gained through employment, and the dictates of equity suggest they should be taxed similarly... The horizontal taxation equity principle holds that people earning the same income, whether by capital gains or wages should be taxes at the same rate in a given year."

23 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 2.

24 See National Treasury Date Unknown http://www.treasury.gov.za/publications/other/katz/4.pdf where is it stated that "...the Commission stated its view that a major justification for a wealth tax is that it promotes vertical and horizontal equity. It is established that there is a huge disparity of income and assets between the various groups in South Africa. There is a significant concentration of wealth in the hands of relatively few people." See also Patel *Capital gains taxation and its potential effects on taxpayers* 16 where vertical equity is explained: "The vertical taxation equity principle holds that on the basis of rising incomes, those earning higher income can afford to pay a progressively higher tax burden."

25 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 2 explains: If money is invested offshore, the interest earned on the capital will be taxed as income tax. However, there is an alternative way to avoid the interest to be regarded as of an income nature. "...invest the money in a roll-up fund from which interest is not paid to the investor but retained by the fund. As a result the value of the shares in the fund increases by the amount of the retained interest. When the share are sold, it can be argued that the difference between the original cost of the shares and the selling price in a non-taxable capital gain."

26 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 2.

27 Patel *Capital gains taxation and its potential effects on taxpayers* 22.

taxpayers will be included in the scope, which will assist in lower tax rates in general.[28]

2.1 Conclusion

It seems there was mention of CGT in the 1960's already, but South Africa only formally adopted CGT in 2001. As mentioned above, one of the primary reasons for the implementation of CGT is to provide symmetry in the tax system. When new legislation is implemented in a country's legal system, there can only be speculation about what the exact outcome will be and as time goes by and cases come before the courts, the system will develop and be defined.

3 The distinction of proceeds of a capital- or income nature and the importance of the distinction

The question may be posed as to why a distinction has to be drawn between proceeds of a capital nature and proceeds of an income nature and why this distinction is important? The following paragraphs will aim at answering these questions.

3.1 The importance of the distinction of proceeds of a capital- or income nature

The distinction between proceeds of a capital- or income nature is important, since a lower tax rate applies to capital gains,[29] and income losses may be set off against both income and capital gains, whereas capital losses may only be set off against

28 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 3.

29 Williams *Capital Gains Tax* 21-22. SARS Date unknown http://www.sars.gov.za/TaxTypes/CGT/Pages/default.aspx where it is stated that "capital gains are taxed at a lower effective tax rate than ordinary income." According to the National Treasury 2013 http://www.treasury.gov.za/documents/national%20budget/2013/sars/Budget%202013%20Pocket%20Guide.pdf the income tax rate for the year ending 28 February 2014 for individuals, depending on your income bracket, and special trusts is 18%, 25%, 30%, 35%, 38% en 40%. The income tax rate for trusts and companies is 40% and 28% respectively. The effective CGT rate for individuals and special trusts is at a maximum of 13.3%, while the maximum effective rate for trusts and companies is 26.6% and 18.6% respectively.

capital gains. According to the South African Revenue Service (SARS),[30] the sections of the Act take precedence over the Eighth Schedule, therefore anything excluded from gross income on the basis that it is of a capital nature, will automatically be dealt with under the Eighth Schedule. Olivier[31] also states that "amounts that are not of a capital nature will be regarded as income" and on this basis it might be expected that if a receipt does not fall within the definition of "gross income" it will automatically be dealt with under the Eighth Schedule. Various tests are used by the courts to determine whether proceeds are of capital- or income nature. However, the distinction is not as unambiguous as one might have thought.

3.2 Capital- or income nature of proceeds

In quite a few sections of the *Income Tax Act* reference is made to the words "of capital nature".[32] The use of this phrase is significant for determining what is taxed on income account under the relevant sections of the Act and what is taxed on capital account under the Eighth Schedule.[33] However, the Act does not provide for a definition of "capital nature" and it has been left up to the courts to determine what "capital nature" entails.

In the process of determining whether proceeds are of income- or capital nature, the courts have come up with a number of tests. However, in *Estate AG Bourke v Commissioner for Inland Revenue*[34] Hoexter JA stated:

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30 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 8.

31 Olivier 2012 *De Jure* 172.

32 For example section 1 of the *Income Tax Act* refers to "capital nature" in the definition of "gross income". Section 9C provide for regulations in circumstances in which amount received or accrued from disposal of shares are deemed to be of *capital nature* (emphasis added).

33 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 8. See also Olivier 2012 *De Jure* 172: "Receipts and accruals of a capital nature do not form part of the gross income definition...and as such are not subject to income tax, but are subject to capital gains tax (CGT)." With reference to par 3 to 10 of the Eighth Schedule, Stiglingh (ed) *et al Silke 2013* 837 explains how CGT will be calculated. Firstly the taxpayer's total capital gains and –losses have to be determined by subtracting the base cost (including allowable expenditures referred to in par 20) from the proceeds. Thereafter the amount is reduced with the annual exclusion amount (par 5): currently R 30 000.00 p/a and in the year of the taxpayer's death R 300 000.00). The net capital gain is then taxed at 33.3% for individuals or special trusts and 66.6% for companies and ordinary trusts. This taxable capital gain will then be included into the taxpayer's income tax calculation (par 10).

34 *Estate AG Bourke v Commissioner for Inland Revenue* 1991 1 SA 661 A at 671.

> The question whether an accrual is to be categorised as capital or income falls to be decided on the facts of each particular case.

Furthermore, in *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust*[35] Smalberger JA stated:

> There are a variety of test for determining whether or not a particular receipt is one of a revenue or capital nature. They are laid down as guidelines only – there being no single infallible test for invariable application.

In *CSARS v Heron Heights CC*[36] the court considered the principles applicable when it has to determine whether an accrual is one of income or capital nature. The court stated that it was a question of law which had to be determined on the facts of the particular case.[37] The court stated that the following considerations come into play:[38]

> Capital may either be fixed or floating: the latter is consumed or disappears in the process of production, the former remains intact (albeit that it may have to be renewed); the question at issue is essentially whether the sale amounted to the realisation of a capital asset or whether it was the sale of an asset in pursuance of a profit-making scheme: the latter connotes the acquisition of an asset and holding it for the purpose of resale, at an opportune time, at a profit, which is then the result of the productive turnover of the capital represented by the asset (the taxpayer's stock-in-trade or floating capital) and therefore constitutes income, in contradistinction to which the former connoted the sale of an asset acquired with a view of holding it (either in a non-productive state, or in order to derive income from the productive use thereof); in determination of the question into which of these two classes a particular transaction falls, the intention of the taxpayer, both at the time of the acquisition of the asset and at the time of its sale (for the intention might have changed in the interim) is of great, sometimes decisive, importance (although it has not been laid down that a change in policy or intention by itself effects a change in the character of the assets); the mere *ipse dixit* of the taxpayer in this regards cannot, in the nature of things, be conclusive; it must be tested against all the other relevant considerations... All of these considerations are guidelines only, none is conclusive and the list is not exhaustive.

Oliver[39] is also of the opinion that the courts do not apply a single test only, but there are at least three different tests the courts apply.[40] The first test is the "profit-making

35 *Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA (39) A at 56 of Smalberger JA's majority judgement. Hereafter referred to as the *Pick 'n Pay Trust* case.
36 *CSARS v Heron Heights CC* 64 SATC 433 at par 4-10.
37 At par 6.
38 At par 7.
39 Olivier 2012 *De Jure* 172.

scheme" test (which includes a consideration of the intention of the taxpayer), the second test is the "fruit versus tree analogy" test, and the third test is the "fixed versus floating capital" test. Each of these tests will be examined individually in the following paragraphs.

3.2.1 Profit-making scheme test

In the *Pick 'n Pay Trust*[41] case the question before the court was whether the proceeds made by the trust were of capital- or income nature. The trust was created to allow employees to purchase shares in Pick 'n Pay (their employee). It is not the aim of the trust to purchase the shares and resell it at a profit in a profit-making scheme.[42] However, the trustees sold the shares to the employees at a certain rate and the trust indeed made a profit.[43] In his majority judgement,[44] Smalberger JA referred to *Overseas Trust Corporation Ltd v Commissioner of Inland Revenue*[45] in which it was stated:

> Although there is no single all-embracing test of universal application for determining whether a particular receipt is one of a revenue or capital nature, it is well established that if the receipt is 'a gain made by an operation of business in carrying out a scheme of profit-making', then it is revenue derived from capital productively employed and must be income.

The majority of the court stated that two questions had to be answered for determining whether the proceeds were of capital- or income nature, namely, did the trust, by way of the trustees, conduct a business *and* was it the intention of the trustees to conduct a business as part of a profit-making scheme.[46] With reference to

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40 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 10 state that there are a number of tests and guidelines which the courts have identified to distinguish between proceeds of a capital- and an income nature. However, the tests discussed in this mini-dissertation are the most recognised ones.

41 According to Olivier 2012 *De Jure* 173, the *Pick 'n Pay Trust* case is the "leading authority on the nature of an amount".

42 At 53 of Nicolas AJA's minority judgement of the *Pick 'n Pay Trust* case.

43 Olivier 2012 *De Jure* 173.

44 At 56-57 of Smalberger JA's judgement of the *Pick 'n Pay Trust* case.

45 *Overseas Trust Corporation Ltd v Commissioner of Inland Revenue* 1926 AD 441 at 453. See also *Commissioner for the SA Revenue Service v Wyner* 4 All SA 541 (SCA).

46 At 57 of Smalberger JA's judgement of the *Pick 'n Pay Trust* case.

the first question, the court stated that the trust was to operate as a *conduit*[47] for acquiring the share, and the trustees did not operate along accepted business lines – they bought the shares when they were obliged to do so and sold it when it was required.[48] Regarding the second question, the court stated:[49]

> The sole purpose of acquiring, holding and selling the shares was to place them in the hands of eligible employees. The forfeiture provision was not intended to yield a profit. Its purpose was to deter unwanted resignations.

The majority of the court found that the trustees were not conducting a business in trading shares and neither did they have the intention of doing so.[50] Even if it could have been said that the trustees were running a business, it was not run as a profit-making scheme.[51] Thus, the profits were of a capital nature and not of an income nature and no income tax could be levied on the amount.

With the profit-making scheme test it is clear that the intention of the taxpayer plays a very important role when determining whether proceeds are of a capital- or revenue nature.[52] In fact, Deist[53] states that the "primary test to determine the nature of the receipt is the taxpayer's intention in acquiring the asset." In *CIR v Stott*[54] Wessels JA states:

> The primary intention with which property is acquired is conclusive as to the nature of the receipt arising from the realisation of that property unless other factors intervene, which show that it was sold in pursuance of a scheme of profit-making.

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47 Garner (ed) *Black's Law Dictionary* 9th ed 1580 describes a *conduit* as a "pass-through". With regards to trust law the trust provides for a "pass-through" through which the trust's income or capital gain can be attributed to the beneficiaries and be taxed at a lower rate.

48 At 57 Smalberger JA's judgement of the *Pick 'n Pay Trust* case.

49 At 58 of Smalberger JA's judgement of the *Pick 'n Pay Trust* case.

50 At 57 of Smalberger JA's judgement of the *Pick 'n Pay Trust* case.

51 At 58 of Smalberger JA's judgement of the *Pick 'n Pay Trust* case.

52 Stiglingh (ed) *et al Silke 2013* 29 states that the "most important test used by the courts in deciding whether a receipt is income or capital in nature is the intention of the taxpayer". However, intention is subjective and only when the intended results have been achieved, then the intention might become clear. The results, on the other hand, will be determined objectively.

53 Deist *The Income Tax implications of options, forwards and future* 26. See also Haupt *Notes on South African Income Tax 2013* 44 where it is stated that the "dominant intention with which a taxpayer acquires an asset determines whether it is capital or revenue." Furthermore, see Williams 2010 *Without Prejudice* 50 wherein the intention of the taxpayer is also referred to as being the "dominant factor".

54 *CIR v Stott* (1928) 3 SATC 253 at 254.

If the taxpayer has the intention of acquiring and keeping the asset to generate income, then that is a capital asset and (where there is no change in intention) the disposal of such an asset will produce proceeds of a capital nature.[55] However, if the taxpayer acquires the asset with the purpose of making a gain when it is sold, it will be regarded as a profit-making scheme and the proceeds will be of an income nature. Thus, it is not the intention of the taxpayer to use the asset to generate income, but rather to realise the profit attached to the asset.[56] To determine the intention, all the surrounding circumstances will have to be considered subjectively.[57]

In some instances there might also be a change of intention of the taxpayer. Hawkey[58] is of the opinion that "crossing the Rubicon" is another test used by the courts to distinguish between "capital gains and taxable income on disposal of property." The phrase "crossing the Rubicon" was first used in *Natal Estates Ltd v SIR*[59] where the court stated:

> From the totality of the facts one has to enquire whether it can be said that the owner had crossed the Rubicon and gone over to a business, or embarked upon a scheme, of selling such land for profit, using the land as his stock-in-trade.

However, in *John Bell and Co (Pty) Ltd v SIR*[60] another requirement was added to the Rubicon "test". The court stated:[61]

> ...the mere change of intention to dispose of an asset hitherto held as capital does not *per se* subject the resultant profit to tax. Something more is required in order to metamorphose the character of the asset and to render its proceeds gross income. For example, the taxpayer must already be trading in the same or similar kinds of asset and he then and there starts some trade or business or embarks on some scheme for selling such assets for profit, and, in either case, the asset in question is used as his trade-in-stock.

As mentioned above, intention is determined subjectively and case law will not be the determining factor in this regard, but each case will have to be looked at

55 Haupt *Notes on South African Income Tax 2013* 44.
56 Haupt *Notes on South African Income Tax 2013* 45.
57 Williams 2010 *Without Prejudice* 50.
58 Hawkey July 2011 *De Rebus* 48.
59 *Natal Estates V SIR* 1975 4 SA 177 A at 202-203. Hereafter referred to as the *Natal Estates* case.
60 *John Bell and Co (Pty) Ltd v SIR* 1976 4 SA 177 A.
61 *John Bell and Co (Pty) Ltd v SIR* 1976 4 SA 177 A at 202-203.

separately.[62] It should also be borne in mind that just because the taxpayer obtained the highest possible price for the asset does not mean that the proceeds which are of a capital nature are now of an income nature.[63] The determining factor will be whether the taxpayer indeed crossed the Rubicon and now uses the asset as stock-in-trade which will make the proceeds of such an asset of an income nature when the asset is disposed of.

3.2.2 Fruit versus tree analogy

Olivier states:[64]

> Where an amount represents income from the disposal of the income-producing asset (i.e. the tree), the amount is of a capital nature. However, where an amount represents the fruit of the tree, such amount is not of a capital nature.

This principle was also explained in *CIR v Visser*:[65]

> 'Income' is what 'capital' produces, or something in the 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. Law books in the hands of lawyers are capital assets; in the hands of a bookseller they are a trading asset. A farm owned by a farmer is a capital asset; in the hands of a land jobber it becomes stock-in-trade.

In other words, when income is generated with the use of the capital asset, it will remain to be of an income nature. On the other hand, when the capital asset is sold and it produces proceeds, those proceeds will be of a capital nature. It might not always be clear when an amount constitutes the tree and when it constitutes the fruit,[66] every case will have to be determined on its own merits.

62 Olivier 2012 *De Jure* 177.
63 Olivier 2012 *De Jure* 177.
64 Olivier 2012 *De Jure* 173.
65 *CIR v Visser* (1937) 8 SATC 271 at 276.
66 Olivier 2012 *De Jure* 173.

3.2.3 Fixed versus floating capital

The courts have used the terms "floating" and "fixed" capital a few times to draw a distinction between income and capital, but it does not seem to be a very fruitful test.[67] However, Stiglingh[68] states that proceeds from the sale of floating capital are regarded as income. Fixed capital can be regarded as those assets acquired with the intention to provide such kind of benefit to the taxpayer, while floating capital are those assets acquired for sale or disposal.[69] In *CIR v George Forest Timber Co Ltd*,[70] the court said the following about "fixed" and "floating" capital:

> Capital, it should be remembered, may be either fixed or floating. I take the substantial difference to be that floating capital is consumed or disappears in the very process of production, while fixed capital does not; though it produces fresh wealth, it remains intact. The distinction is relative, for even fixed capital, such as machinery, gradually wears away and needs to be renewed. But as pointed out by Mason J, in *Stephen v Commissioner of Inland Revenue* (1919 WLD at 5) the two phrases have an ascertained meaning in accountancy as well as in economics. Ordinary merchandise in the hands of a trader would be floating capital. Its use involves its disappearance; and the money obtained for it is received as part of the ordinary revenue of the business. It could never have been intended that money received by a merchant in the course, and as the result of his trading, should not form part of his gross income.
>
> The proceeds of fixed capital stand in different position. The sale of such capital would, generally speaking, represent a mere realisation, which ought from its nature to be excluded, and which I think the section [the definition of 'gross income'] intended to exclude from the calculation of income.

To determine what the difference between fixed and floating capital is, there has to be a determination of the reason why it was acquired, and to determine a reason one has to look at the intention of the taxpayer.[71] Stiglingh[72] comes to the conclusion that this test is not a very successful one and the courts hardly ever apply it. Although there are a number of tests, Olivier[73] states that the "profit-making scheme" test is the one most often applied by the courts. However, Joubert[74] is of the opinion that

67 Stiglingh (ed) *et al Silke 2013* 34.
68 Stiglingh (ed) *et al Silke 2013* 33. See also Haupt *Notes on South African Income Tax 2013* 44.
69 Haupt *Notes on South African Income Tax 2013* 44.
70 *CIR v George Forest Timber Co Ltd* (1924) 1 SATC 20 at 23.
71 Haupt *Notes on South African Income Tax 2013* 44.
72 Stiglingh (ed) *et al Silke 2013* 34.
73 Olivier 2012 *De Jure* 174.
74 Joubert 2009 *Obiter* 381.

the “profit-making scheme” test is not the sole test the courts will use in determining whether proceeds are of an income- or capital nature.

3.3 Conclusion

From the discussion above it is clear that a distinction needs to be drawn between proceeds of a capital nature and proceeds of an income nature, because different provisions of the *Income Tax Act* apply to these different terms. The income tax rates will apply to proceeds of an income nature and CGT rates will apply to proceeds of a capital nature. Furthermore, capital losses may be set-off against capital gains, but income losses may not be set-off against income gains. Even before CGT came into operation it was important to distinguish between these two terms as taxpayer tried their best to have proceeds classified as being of a capital nature in a bid to prevent paying income tax.

There are a number of tests the courts have applied through the years, but the profit-making scheme test together with the intention of the taxpayer seems to be the most significant test to determine whether proceeds are of a capital- or an income nature.

The next step is to determine when exactly CGT will be levied in light of the provisions of Paragraph 3 of the Eighth Schedule.

4 When is CGT levied

As stated previously,[75] Paragraph 3 of the Eighth Schedule to the *Income Tax Act* determines when CGT will be levied. From this definition it is clear that there will be a taxable capital gain when an *asset* has been *disposed* of for *proceeds* exceeding the *base cost* of that asset.[76] These four requirements are regarded as the four “building blocks” of CGT.[77] An analysis of the four “building blocks” used in Paragraph 3 will provide more clarity as to when CGT will be leviable.

75 At par 1.1.
76 Also see Olivier 2007 *Meditari Accountancy Research* where it is stated that “all four building blocks must be present before a taxpayer has to account for CGT.”
77 Olivier 2007 *Meditari Accountancy Research* 37. See also Stiglingh (ed) *et al Silke 2013 837* where the requirements for CGT are also described as the four “building blocks” of CGT.

Paragraph 40 also determines that a deceased person must be treated as having disposed of his assets to his deceased estate just before his death. In this case CGT will also be levied. Furthermore, Paragraph 12 provides for the levying of CGT on disposal which might not seem like disposals, but are regarded as deemed disposals. These situations will also be examined in the following paragraphs.

4.1 Asset

An asset is the first building block in the CGT calculation. According to the definition,[78] "asset" includes property of a movable or immovable, corporeal or incorporeal nature, excluding currency, but including any coin made mainly from gold or platinum, and a right or interest of whatever nature to or in such property. A determination of what is included in the definition of "asset" is important because of the fact that CGT will, most likely,[79] not be triggered without the disposal of an *asset*. The definition of the term "asset" is very wide and includes all forms of property and all rights or interests in such property.[80] Olivier[81] states that the fact that rights and interests are included in the definition of an asset complicates CGT in South Africa, and the result is that both personal[82] and real[83] rights are regarded as assets for GCT purposes. Olivier[84] explains why this would lead to complications: the definition of "asset" does not differentiate between transferable and non-transferable property rights. CGT is only levied once there has been an actual or deemed disposal of an asset and the question may be posed as to whether the legislature only intended transferable rights to be included into the ambit of CGT.[85] This would imply that a

78 Par 1 of the Eighth Schedule of the *Income Tax Act*.

79 The exception was found in par 12(5) where a capital gain is triggered upon the reduction or discharge of a *liability* (the debt). The debt is regarded as a deemed asset.

80 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 33. See also Stiglingh (ed) *et al Silke 2013* 841 where it is stated that the "definition of "asset"...includes property of any nature, whether movable or immovable, corporeal or incorporeal...and a right or an interest of any nature in such property."

81 Olivier 2007 *Meditari Accountancy Research* 38.

82 Delport *South African Property Practice and the Law* 7 defines a personal right as a right which "merely gives the holder the right to claim from a particular person either that he delivers a thing, or performs or refrains from performing a certain act".

83 Delport *South African Property Practice and the Law* 7 defines a real right as a right which is "enforceable against the whole world, that is, against the owner of the property and all other persons that have legal claims to the property by virtue of a contract with the owner or because of the death or insolvency of the owner".

84 Olivier 2007 *Meditari Accountancy Research* 38.

85 Olivier 2007 *Meditari Accountancy Research* 38.

personal right, such as a claim for defamation, will not be included into the ambit of CGT as it is not legally transferrable.[86] However, Swart[87] explains that the transferability of an asset does not affect the existence thereof and is only relevant in the valuation of an asset.[88] Thus, real and personal rights are regarded as assets.

Still, the question may be asked what constitutes "property" as used in the definition of an asset. Although it was in the context of the *Estate Duty Act*, in *CIR v Estate C P Crewe*,[89] the following was said about "property":

> One would expect that when the estate of a person is described as consisting of property, what is meant by property is all rights vested in him which have a pecuniary or economic value. Such rights can conveniently be referred to as proprietary rights and are included *jura in rem*, real rights such as rights of ownership in both immovable and movable property, and also *jura in personam* such as debts and rights of action.

SARS also states that "property" refers to anything that can be disposed of and turned into money.[90] However, it is interesting to note that the definition excludes currency, but includes coins made mainly of gold or platinum. Olivier[91] states that the reason for the exclusion is, most likely, to prevent situations where there is a deduction of a capital loss due to the money being stolen.

A strange phenomenon is found in Paragraph 12(5) where CGT will be levied where a *debt* has been reduced or discharged. When a trust holds an outstanding loan account in favour of an estate owner it is clear that the outstanding loan will not be an asset in the hands of the trust, but rather a liability. This is in contrast to the rest of Paragraph 12. The legislature had to figure out how to approach this situation for CGT to be levied on transactions where a debt was discharged or reduced. As will be discussed further on, when the estate owner bequeaths the outstanding loan

86 Olivier 2007 *Meditari Accountancy Research* 38.
87 Swart 2005 *SA Merc LJ* 15.
88 For purposes of this mini-dissertation Swart's explanation will be sufficient. For a more in depth discussion on this topic, refer to Swart 2005 *SA Merc LJ* 15-16 and Cassidy 2004 *SA Merc LJ* 164-195.
89 *CIR v Estate C P Crewe & another* 1943 AD 656 at p 667.
90 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 34. See also Olivier 2007 *Meditari Accountancy Research* 37 where it is stated that "from the definition it is clear that the word "asset" is synonymous with the word "property" as interpreted in terms of the "property clause"...writers agree that the word should be interpreted "widely" to include everything that has a monetary value."
91 Olivier 2007 *Meditari Accountancy Research* 39.

account to the trust, the legislature deems the discharge or reduction to be a disposal and this creates a claim in favour of the trust which will then be an asset for CGT purposes.

Disposal is the second building block for CGT and will be discussed in the subsequent paragraph.

4.2 Disposal

Before CGT will be levied on a transaction, there has to be a *disposal* or a *deemed disposal* of an asset.[92] According to SARS:[93]

> The disposal of an asset triggers the liability of CGT and it is, therefore, a core rule that is fundamental to the application of CGT. It is for this reason that a wide meaning has been given to the term 'disposal'.

Paragraph 11 provides for a definition of a disposal and states that a disposal is "any event, act, forbearance[94] or operation of law which results in the creation, variation, transfer or extinction of an asset". Disposal includes the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset.[95] Furthermore, it includes the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset.[96] In certain instances a disposal may not be regarded as an outright disposal, but for CGT purposes it is a deemed disposal.

Paragraph 12 deals with events that are deemed disposals.[97] Paragraph 12(5),[98] specifically, dealt with situations where-as debt owed[99] by a person to a creditor had

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92 Stiglingh (ed) *et al Silke 2013* 841.

93 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 66. Also see Olivier 2007 *Meditari Accountancy Research* 42 – "In line with the legislature's desire to cast the tax net as widely as possible, the term "disposal" is widely defined in par 11..."

94 Forbearance may be defined as the act of refraining from enforcing a right, obligation, or debt (Garner (ed) *Black's Law Dictionary* 7th ed 656).

95 Par 11 of the Eighth Schedule to the *Income Tax Act*.

96 Par 11 provides for more acts which will be included into the definition of "disposal" and also which acts will be excluded. For the purpose of this mini-dissertation, the acts mentioned above will suffice.

97 Stiglingh (ed) *et al Silke 2013* 841.

98 Par 12 deals with more events regarded as deemed disposals, e.g., Par 12(2)(a)(i) where it is a deemed disposal when a person commences to be a resident; Par 12(2)(a)(ii) where it is a

been discharged or reduced without full consideration. When the debtor acquired the claim, it is a deemed disposal.[100] As stated in paragraph 4.1 above, in instances where an estate owner bequeaths his outstanding loan account to his trust, legislation deems the claim which the debtor has acquired to be an asset. When the trust receives the claim it cancels the debt it owed to the estate owner, by way of set-off. The definition of disposal includes the cancellation of an asset in the ambit of a disposal. Thus, the trustees are deemed to have disposed of the asset (his claim). Paragraph 12(5) and Paragraph 12A, which repealed Paragraph 12(5), will be dealt with in more detail below.

Another important factor to take into consideration with regard to the disposal of an asset is the time of disposal (which is, for the most part, dealt with in Paragraph 13). The time of the disposal is important for two reasons. Firstly, it may have an influence on the CGT rate, and secondly, it may influence the possibility of a capital loss being set off against a capital gain.[101] Paragraph 13(1) prescribes certain circumstances[102] in which a change of ownership will occur because of an "event,

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deemed disposal when a foreign company commences to be a controlled foreign company; etc. For purposes of this mini dissertation the focus will be on the discharge of a debt as a deemed disposal, but notice is taken of other events regarded as deemed disposals. For more information regarding deemed disposals, see the remainder of Par 12.

99 "Debt owed" as used in par 12(5) refers to amounts in respect of which there is an unconditional liability to pay - McAllister *SARS Comprehensive Guide to Capital Gains Tax* 88.

100 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 90.

101 Stiglingh (ed) *et al Silke 2013* 855.

102 Par 13. Time of disposal:

(1) The time of disposal of an asset by means of-

(a) a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by the operation of law is, in the case of-

(i) an agreement subject to a suspensive condition, the date on which the condition is satisfied;

(ii) any agreement which is not subject to a suspensive condition, the date on which the agreement is concluded;

(iiA) the distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset, the date on which the interest vests;

(iii) a donation of an asset, the date of compliance with all legal requirements for a valid donation;

(iv) the expropriation of an asset, the date on which the person receives the full compensation agrees to or finally determined by a competent tribunal or court;

(v) the conversion of an asset, the date on which the asset is converted;

(vi) the granting, renewal or extension of an option, the date on which the option is granted, renewed or extended;

(vii) the exercise of an option, the date on which the option is exercised;

act, forbearance, or by the operation of law" and when that specific event takes place, that will be the time of disposal. Thus, the time at which ownership changes will not be the determining factor, but the time at which the event happens, will indeed be. When the disposal does not fall within the ambit of these prescribed events, the time of disposal will be the time at which ownership of the asset changes.

After it has been determined that there is an asset and a disposal, the next building block for CGT is proceeds.

4.3 Proceeds

Botha[103] states that CGT is not tax on proceeds, but on the capital gain. Thus, when the proceeds and the base cost are determined, the difference between the two amounts will be the capital gain (if the proceeds are greater than the base cost). In the event that the base cost of an asset is greater that the proceeds, there will be a capital loss.[104] It is important that the capital gain and capital loss for a specific year of assessment be determined separately and not be used in the same calculation.[105] This is important to ensure that the CGT calculation for a specific year is correct.[106] According to Paragraph 35(1), the "proceeds from the disposal of an asset...are equal to the amount received by or accrued to...that person in respect of a disposal".

(viii) the termination of an option granted by a company to a person to acquire a share, participatory interest or debenture of that company, the date on which that option terminates; or

(ix) any other case, the date of change of ownership.

103 Botha *et al Fundamentals of Financial Planning* 2012 320.

104 Williams *Capital Gains Tax* 69.

105 Williams *Capital Gains Tax* 69.

106 When examining par 3-10 it becomes clear that a capital gain and a capital loss should be calculated differently. Par 3-10 has a number of different terms with regards to a taxable capital gain and assessed capital loss. Firstly, when there is a capital gain on the disposal of an asset it has to be determined separately for every disposal (par 3). The capital gain will be equal to the amount that the proceeds exceed the base cost of an asset. Secondly, where there is a capital loss on the disposal of an asset it also has to be determined separately for every disposal (par 4). A capital gain on a disposal of an asset will be equal to an amount that the base cost exceeds the proceeds of the disposal. Thirdly, there will be an aggregated capital gain when the total capital gain (of all the assets disposed of in a specific year) exceeds the total capital gain (also of all the assets disposed of in a specific year) and the annual exclusion in terms of par 5 in the case of natural persons and trusts (par 6). Fourthly, there will be an aggregated capital loss when the total capital loss exceeds the total capital gain for a specific year as well as the annual exclusion (par 7). Fifthly, there will be an assessed capital loss where an aggregate capital loss for that year is equal to the aggregate capital loss for that year plus an assessed capital loss for the previous year (par 9). Sixthly, net capital gain is the amount with which an aggregate capital gain for that year exceeds an assessed capital loss for the previous year (par 8).

The first word in Paragraph 35(1) that needs more consideration is the word "amount". The word "amount" is not defined in the Eighth Schedule, but due to the fact that the Eighth Schedule forms part of the *Income Tax Act*, Olivier[107] is of the opinion that cases where the interpretation of the word "amount" for income tax purposes were considered may also by applied to CGT cases. In *W H Lategan v CIR*[108] the word "amount" for its use in the definition of gross income was considered. The following was said:

> In my opinion, the word 'amount' must be given a wider meaning, and must include not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value.

This explanation was confirmed in, *inter alia*, *CIR v Butcher Bros. (Pty) Ltd*[109] and *CIR v Delfos*.[110]

The next phrases in Paragraph 35(1) that need more consideration are the phrases "received by" and "accrued to". Similarly, these phrases have also been considered by the courts for income tax purposes.[111] It is interesting to note that it has be stated that the general rule is that if there is no receipt or accrual then there can be no income tax liability.[112] However, the *Income tax Act* does subject a person to tax where an amount was not even "received by" nor "accrued to" a taxpayer. [113] In this regard section 7 of the *Income Tax Act* specifically deals with deemed accruals and receipts of income. In *Geldenhuys v CIR*[114] the court stated that "received by" means "received by the taxpayer on his own behalf for his own benefit". In *CIR v People's Store (Walvis Bay) (Pty) Ltd*[115] the issue before the court was whether the amount accrues to the taxpayer when it is due (in other words when the taxpayer becomes entitled to it), or only when it is due *and* payable.[116] The court found that "accrued to"

107 Olivier 2007 *Meditari Accountancy Research* 40.
108 *W H Lategan v CIR* 1926 CPD 203 at 208-209. Hereafter referred to as the *Lategan* case.
109 *CIR v Butcher Bros. (Pty) Ltd* 13 SATC 21 at 34.
110 *CIR v Delfos* 6 SATC 92 at 251.
111 Olivier 2007 *Meditari Accountancy Research* 40.
112 Jiyane *'Received by' and 'accrued to'* 5.
113 Jiyane *'Received by' and 'accrued to'* 5.
114 *Geldenhuys v CIR* 1947 3 SA 256 C at 266.
115 *CIR v People's Store (Walvis Bay) (Pty) Ltd* 1990 2 SA 353 (A). Hereafter referred to as the *People's Store* case.
116 Jiyane *'Received by' and 'accrued to'* 9.

means “to which he has become entitled”.[117] This would mean that in some instances, the proceeds will accrue to the taxpayer even though he is not yet in a position to enforce the payment.[118] The *People’s Store* judgement was widely criticised.[119] Jiyane[120] is of the opinion that the court was supposed to determine whether “accrued to” means that the taxpayer has a vested right of income, or whether it means that there is potential income in the future; alternatively, does “accrued to” include both issues? In *Ochberg v CIR*[121] the record was set straight when the court found that

> So soon as an unconditional sale has been concluded there vests in the seller the right to claim the purchase price in defined instalments at defined future dates; in other words the right to claim these instalments accrues to him.

Jiyane[122] concludes that “before an amount can accrue, the taxpayer’s right to claim payment must be conditional.”

The third phrase in Paragraph 35(1) that needs more consideration is “in respect of”. This phrase indicates that even though the receipt and accrual of the proceeds do not happen at the same time, if it is connected to the disposal, it will form part of the proceeds of that specific disposal.[123]

When an estate owner bequeaths an outstanding loan account to the trust, how will Paragraph 35 be applied? From the discussion above, it has been indicated that Paragraph 12(5) creates an asset and a disposal for CGT purposes. To fall within the definition of proceeds, there has to be a determination of the amount received or accrued to the debtor. When the debtor receives the claim, it is clear that that amount will be the amount the debtor has received. Thus, the proceeds will be equal to the amount with which the estate owner (the creditor) has relieved the debt with. This is also what Paragraph 12(5)(b)(ii) stipulates.

117 *CIR v People’s Store (Walvis Bay) (Pty) Ltd* 1990 2 SA 353 (A) at 362.
118 Olivier 2007 *Meditari Accountancy Research* 41.
119 Jiyane *‘Received by’ and ‘accrued to’* 10-11.
120 Jiyane *‘Received by’ and ‘accrued to’* 10.
121 *Ochberg v CIR* 1993 CPD 256 at 264.
122 Jiyane *‘Received by’ and ‘accrued to’* 11.
123 McAllister *SARS Comprehensive Guide to Capital Gains Tax 269.*

The next building block for CGT purposes is base cost.

4.4 Base cost

A capital gain is determined by subtracting the base cost from the proceeds of the disposal of the asset. Thus, the starting point is to determine what the base cost of an asset is.[124] The base cost of an asset is the sum of the actual expenditure incurred for the acquisition or creation of the asset, plus other expenditures which may include, *inter alia*, those incurred for the improvement or maintenance of the asset.[125] According to SARS:[126]

> The determination of qualifying expenditure under par 20 is relevant for determining the base cost of both pre- and post-valuation date assets.

Therefore, knowing which expenditures in terms of Paragraph 20 may be included into the base cost and which not, can have a detrimental effect on a taxpayer's CGT calculation.

As mentioned before, CGT came into effect on 1 October 2001 (and all the assets of individuals had to be valuated on this day which is now referred to as the valuation date). Nevertheless, this does not mean that CGT will only be applied to assets which were acquired after the valuation date, but; it will also be applied to assets acquired before the valuation date and which have not been disposed of before the valuation date. Thus, a distinction exists between the base cost of pre- and post valuation date assets. Post-valuation date base cost is much easier to determine, since the purchase price, including certain qualified expenditures, will make up the base cost of the asset. However, pre-valuation date base cost might be more difficult to determine, since not every individual valuated their assets on the valuation date. Williams[127] states that "even a market-value valuation by an expert is only an educated estimate." However, part IV of the Eighth Schedule provides the taxpayer with provisions for the calculation of the base cost of a pre-valuation date asset.

124 Williams *Capital Gains Tax* 61.
125 Other expenditures are stipulated in par 20(1), for example, transfer cost, stamp duty, transfer duty, etc.
126 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 122.
127 Williams *Capital Gains Tax 62.*

There are three different methods from which the taxpayer may choose to determine the base cost of his assets. In some instances the taxpayer might not be able to apply a certain method because of a lack of information. Each of these methods, namely, the market value of the asset at valuation date, the apportionment menthod and the 20% of proceeds rule, will be discussed in the following paragraphs.

4.4.1 Market value of the asset at valuation date

Paragraph 29 prescribes the provisions for determining the market value of an asset on valuation date. According to Paragraph 29(4) this option may only be used when:

- The asset was valued on or before 30 September 2004;
- The price of the asset was published by the Commissioner in the *Gazette*; or
- The asset was acquired from a spouse that determined a market value, and that market value will now be adopted by the transferee spouse.

When none of these prescriptions are available for determining the base cost of pre-valuation assets, one of the following methods may be used.

4.4.2 Time-apportionment method

According to Paragraph 30 the standard formula for using the time-apportionment method is: $Y = B + [((P – B) \times N)/(T + N)]$.[128] According to Williams:[129]

> ...time-apportionment assumes that the value of an asset acquired prior to 1 October 2001 and disposed of after that date increased at an even rate...from the date of acquisition to the date of disposal.

However, when using this formula, the taxpayer should have kept record of the acquisition cost and the qualified expenditure. If these costs cannot be determined, the taxpayer would have no choice but to use the market value method (if the

128 In this formula:
"Y" is the amount to be determined;
"B" is qualified expenditures before 1 October 2001;
"P" is the proceeds from the disposal;
"N" is the number of years from the date on which the asset was acquired until the day before 1 October 2001; and
"T" is the number of years from 1 October 2001 until the date the asset was disposed of.

129 Williams *Capital Gains Tax* 66.

taxpayer would be able to comply with the provisions of Paragraph 29) or the 20% of proceeds rule.[130]

4.4.3 20% of proceeds rule

According to this rule (as set out in Paragraph 26(1)), the base cost of an asset will be equal to 20% of the proceeds of the disposal of the asset, less the qualified expenditure incurred on or after the valuation date. Williams explains this rule as follows:[131]

> In other words, this method of determining the value of the asset as at 1 October 2001 assumes that 80% of the proceeds on disposal (less the expenditures...) constitutes a gain in value which occurred after 1 October 2001, and is thus subject to CGT.

In the event that the taxpayer acquired the asset shortly before the valuation date and disposed thereof after the valuation date, this method will most likely be the most advantageous.[132] However, in most cases this method will only be used by taxpayers that are unable to use one of the other two methods.[133]

It is clear that the base cost of an asset consists of actual expenditure incurred for the acquisition of the asset as well as expenditure incurred for the maintenance and improvement of the asset. In the event that the estate owner bequeaths his outstanding loan account to the trust and the trustees acquire a claim against the estate, it is clear that the trust had no expenditure to acquire the claim. Thus, the base cost of the claim will be nil, as determined in Paragraph 12(5)(b)(i) as well.

4.5 Disposals to and from deceased estate

Paragraphs 40(1) and 40(1A) states that a deceased person must be treated as having disposed of his or her assets to his or her estate right before his or her death at a cost equal to the market value of the asset as at date of death of the deceased.

130 Williams *Capital Gains Tax 67.*
131 Williams *Capital Gains Tax* 67.
132 Williams *Capital Gains Tax* 68.
133 Williams *Capital Gains Tax* 68.

A deceased estate is regarded as a person for purposes of the *Income Tax Act* and therefore CGT may also be levied on a deceased estate.[134] Paragraph 40(2) states that when a deceased estates disposes of an asset to an heir or legatee then the deceased estate must be treated as having disposed of the asset for proceeds equal to the base cost and the heir or legatee must be treated as having acquired the asset at a cost equal to the base cost. This means that the deceased estate will be liable for CGT when the assets are "disposed" of to the deceased estate, but the heirs and legatees will not have a second CGT liability when the deceased estate disposes of the assets to them.

The question may be posed as to how this situation will be dealt with when the estate owner bequeaths his outstanding loan which was owed to him by the trust, back to the trust. An outstanding loan in favour of the estate owner will be a claim in favour of his estate, which makes it an asset in his estate. Paragraph 40 clearly states that on his or her death, the estate owner should be treated as having disposed of all his or her assets to the estate for an amount equal to the market value of the asset as at date of death. It is important to note that if this calculation has been done and there is a CGT liability, the deceased estate will be liable to pay it to SARS. Paragraph 40 clearly states that when the asset is transferred to the heirs or legatees there will be no second CGT liability in their hands.

4.6 Deemed disposals

Paragraph 12 specifically deals with events treated as disposals and acquisitions even where there was no actual disposal or acquisition. The following events are deemed to be disposals:

- When a person commences to be a resident;[135]
- When a foreign company commences to be a controlled foreign company;[136]
- When a foreign company ceases to be a controlled foreign company as a result of becoming a resident;[137]

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134 Williams *Capital Gains Tax* 71.
135 Par 12(2)(a)(i).
136 Par 12(2)(a)(ii).
137 Par 12(2)(a)(iii).

- When an asset of a non-resident becomes part of that person's permanent establishment in South Africa by means other than acquisition;[138]
- In the event that an asset of a non-resident ceases to be part of that person's permanent establishment in South Africa by means other than a disposal;[139]
- When assets which were not used as trading stock, become trading stock;[140]
- In the event that personal-use assets ceases to be held as personal-use assets;[141]
- When an asset which was not used for personal-use becomes a personal-use asset;[142]
- In the event that a debt is reduced or discharged.[143]

A CGT liability arises when any of these events occur. For purposes of this mini-dissertation only the reduction of discharge of a debt will be examined in more detail.

4.7 CGT and waiver of debt

As stated in paragraph 1.1 above, according to Paragraph 12(5) of the Eight Schedule, CGT will be levied in a case where debt is forgiven (or discharged) or reduced by a creditor for no consideration or for an amount which is less than the amount which is outstanding. Paragraph 12(5) specifically reads as follows:

> (a) Subject to paragraph 67, this sub-paragraph applies where a debt owed by a person to a creditor has been reduced or discharged by that creditor-
> (i) for no consideration; or
> (ii) for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged...
>
> (b) where this sub-paragraph applies the person contemplated in item (a) (in other words the debtor) shall be treated as having-
> (i) acquired a claim to so much of the debt as was reduces or discharged for no consideration was paid, to so much of the reduction or discharge of the debt as exceeds the consideration, which claim has a base cost of nil; and

138 Par 12(2)(b)(i).
139 Par 12(2)(b)(ii).
140 Par 12(2)(c).
141 Par 12(2)(d).
142 Par 12(2)(e).
143 Par 12(5), which has since then been deleted by the *Taxation Laws Amendment Act*.

(ii) disposed of that claim for proceeds equal to that reduction or discharge.

The aim of Paragraph 12(5) is to ensure the debtor will be liable for CGT on the amount of which he was relieved of.[144] According to McAllister, the objective of Paragraph 12(5) is to:[145]

> Provide symmetry in the tax system by ensuring that there is a matching of capital gains and losses. In the absence of paragraph 12(5), creditors would be able to claim losses, while debtors would not be taxed on the corresponding gains.

In light of the position set out in paragraph 1.1, the debt the debtor (the trust) owes the creditor (estate owner) is a liability in the hands of the trust and not an asset as required by the definition in the Eighth Schedule, which would indicate that CGT could not be levied. However, to bring the waiver of a *debt* into the ambit of the Eighth Schedule, Paragraph 12(5)(b) creates the following:[146]

- *Asset*: The debtor is deemed to have acquired a claim to the debt reduced or discharged.
- *Base cost*: The base cost of the asset is deemed to be nil.
- *Proceeds*: The proceeds are determined as follows:
    - If the debtor paid nothing – the amount discharged or reduced.
    - If the debtor paid something – the difference between the amount paid and the amount discharged or reduced.
- *Disposal*: The claim acquired by the debtor is deemed to be disposed of.

It is clear that CGT will be levied on a number of occasions, even when there is not an actual disposal, but only a deemed disposal. For a number of years estate owners made use of the "scheme" of bequeathing the outstanding loan account back to the trust, which will then eliminate the loan account in the estate owner's estate. However, may this be regarded as a deemed disposal in light of Paragraph 12(5)? Paragraph 12(5)(a) states that the debt must have been reduced or discharged by *that* creditor. When the creditor bequeaths the debt to the trust in his will, can it be regarded as the "creditor" having reduced or discharged the debt? When the creditor drafted the will and when he was still alive, the debt was still owed to the creditor. Furthermore, the creditor cannot perform any further acts (in the form of reducing or

144 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 88.
145 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 88.
146 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 89-90.

discharging the debt) after his death. It might be said that when a debt is reduced or discharged in general, only the debtor "receives" something in the sense that he is relieved of his liability to repayment of the debt. However, when a creditor bequeaths the outstanding amount back to the trust there might be a *quid pro quo*.[147] The creditor gives the outstanding amount to the debtor and in return the debtor is no longer liable to repay the debt to the creditor. However, Paragraph 12(5) only makes mention of the debtor being treated as having acquired a claim. As Thersby[148] points out correctly:

> It has always been widely believed that, since there is no waiver of the debt in these circumstances, and therefore no deemed disposal, the trust will not be liable for CGT on the value of the debt that has been extinguished.

However, SARS did not share this belief and Paragraph 12(5) eventually came under the spot light in two tax court cases. The use of trusts as an estate planning tool and a discussion of these two cases will follow in the next paragraph.

4.8 Conclusion

CGT will be levied where a disposal of an asset for proceeds exceeding the base cost of that asset has taken place. The four building blocks of CGT, namely, asset, disposal, proceeds and base cost are not very straight-forward terms with regard to CGT. In some instances parties had to venture to the courts to obtain clarity on the meaning of these terms. Paragraph 12 also provides for circumstances where no actual disposal has to exist in which case CGT will also be levied. The most significant circumstance for purpose of this mini-dissertation is the reduction or discharge of a debt. Paragraph 12(5) specifically dealt with this situation and for purposes of this provision no asset might seem to have been disposed of for proceeds exceeding the base cost, but the legislature deems these four building blocks to be present.

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147 The writer's own conclusion in light of par 12(5) and the application thereof on bequeathing an outstanding loan back to a trust.

148 Thersby 2005 *Tax Breaks Newsletter* 2. See also Williams *PWC Synopsis* 6.

5 A trust as an estate planning tool and the courts' interpretation and application of Paragraph 12(5)

5.1 An overview of the use of trusts in estate planning

The reason why discretionary *inter vivos*[149] trusts are such popular estate planning tools, is that trust assets are considered to be disconnected to the assets of the founder, the beneficiaries and the trustees. The assets in the trust do not form part of the estate owner's estate and upon death the assets in the trust will not be subject to estate duty.[150] The assets, liabilities, rights and duties of the trust vest in the trustees in their official capacity and not in a beneficial capacity.[151]

A few other reasons why trusts are such popular estate planning tools is that when it is set up correctly,[152] it can provide a number of advantages to the estate owner and his family.[153] For instance, trusts are used for asset protection. The estate owner can use and enjoy the assets, but ownership of the assets is vested in the trust.[154] The advantage lies therein that, on the one hand, when the estate owner becomes insolvent, the creditors will not be able to attach the assets in the trust as it is not registered in the name of the estate owner and thus not his property.[155] On the other hand, an estate owner's heirs might be minors, unrehabilitated insolvents or not able to run their own affairs and when the assets are registered in a trust it provides them

149 Du Toit *South African Trust Law* 18 – An *inter vivos* trust is created by a *stipulatio alteri*. This is a contract on behalf of a third party. Thus it is a contract between the founder and the trustees to the benefit of the beneficiaries. Geach *Trusts Law and Practice* 18 – If the founder is alive when the trust is formed it is known as a trust *inter vivos*.

150 Honiball and Olivier *The Taxation of Trusts* 198.

151 Geach *Trusts Law and Practice* 19.

152 For a trust to be set up correctly, it has to comply with the essentials of a valid trust. Cameron *et al Honoré's South African Law of Trusts* 117 explain what the essentials for a valid trust are: "(a) the founder must intend to create one, (b) the founder's intention must be expressed in a mode appropriate to create an obligation, (c) the property subject to the trust must be defined with reasonable certainty, (d) the trust object, which may either be personal or impersonal, must be defined with reasonable certainty, and (e) the trust object must be lawful".

153 Visser *Cover* 78. Also see Senne 2013 http://www.polity.org.za/article/using-a-trust-as-an-estate-planning-tool-2013-07-30 and O'Halloran 2012 http://www.farmersweekly.co.za/article.aspx?id=32061&h=Why-trusts-are-still-a-great-idea.

154 Senne 2013 http://www.polity.org.za/article/using-a-trust-as-an-estate-planning-tool-2013-07-30.

155 Beachen 2013 http://www.ens.co.za/news/news_article.aspx?iID=1173&iType=4. Also see Waevind 2013 http://www.bdlive.co.za/personalfinance/2013/02/17/trusts-are-a-pricey-way-to-dodge-taxes and Senne 2013 http://www.polity.org.za/article/using-a-trust-as-an-estate-planning-tool-2013-07-30.

with financial protection.[156] Trusts also allow for estate "pegging" and saving on taxes.[157] When growth assets are transferred to the trust it ensures that the estate owner's estate does not grow with the value of the asset and therefore estate duty will also be reduced.[158] Another reason why trusts are popular estate planning tools is that on the death of either the estate owner (in some instances as the donor or founder of the trust), the trustees or the beneficiaries will not affect the continuation of the trust.[159] Also, trusts currently offer protection against other types of tax through Paragraph 80 of the Eighth Schedule and section 25B of the *Income Tax Act* which both allow trust income or capital gains to be taxed in the hands of the beneficiaries at a much lower rate than the 40% rate applicable to trusts.[160]

As mentioned above, trusts are used as an estate-"pegging" mechanism. The estate owner's property is bought by the trust, through the trustees, on a loan account and the growth of the asset will continue in the trust. In his will the estate owner then bequeaths the outstanding loan to the trust which "cancels" the loan. However, Paragraph 12(5) dealt with situations where the cancellation or reduction of a loan will give rise to a CGT liability. Paragraph 12(5) and its working will be examined in the following paragraph.

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156 Beachen 2013 http://www.ens.co.za/news/news_article.aspx?iID=1173&iType=4.

157 Beachen 2013 http://www.ens.co.za/news/news_article.aspx?iID=1173&iType=4. See also Visser *Cover* 78.

158 Senne 2013 http://www.polity.org.za/article/using-a-trust-as-an-estate-planning-tool-2013-07-30.

159 Visser *Cover* 78.

160 Hill 2012 http://www.thesait.org.za/news/95883/. Also see Gijsen 2013 http://www.moneymarketing.co.za/files/2013/04/Avoid-these-trust-mistakes-Money-Marketing-2-April-2013.pdf. According to Honiball and Olivier *The taxation of trusts in South Africa* 431 the *conduit* principle is a "taxation principle developed by case law in terms of which, internationally, the trustees serve as mere conduit for income derived by the trust and are not the beneficial owners of the income. Domestically, the principle was developed further by South African Courts to confirm that income keeps its nature despite flowing through the trust." Par 80 determines that when a beneficiary gains a vested interest in a trust's capital gain, the capital gain should be disregarded for the purposes of the trust's capital gain calculation and should be included into the beneficiary's capital gain calculation. However, on numerous occasions SARS has warned taxpayers that it is not satisfied with the use of the *conduit* principle. See Paulsen and Botha 2013 http://www.sataxguide.co.za/tax-changes-for-trusts-still-under-consideration/ where it was stated that "at present, the *conduit* principle operating in trust tax law, allows for income that accrues in a trust to be taxed in the hands of the beneficiary. The proposed amendments *(announced in the 2013 Budget Speech)* aim to eradicate income splitting opportunities afforded through this principle..." Also see Grobbelaar 2012 *TAXtalk* 20 for more reference to the advantage of the use of trusts an estate-planning tool.

5.2 Paragraph 12(5)

As mentioned in paragraph 1.1 above, Paragraph 12(5) was been repealed and replaced by Paragraph 12A. However, when the two tax court cases with different outcomes came before the court, it was still in working. The following paragraphs will provide insight into why Paragraph 12(5) existed and how the court interpreted and applied Paragraph 12(5).

5.2.1 Why did Paragraph 12(5) exist?[161]

Paragraph 40 is not the only instance where reference is made to Paragraph 12(5).[162] Paragraph 40 is subject to Paragraph 12(5). This was not the case with the introduction of CGT, but was added to Paragraph 40 in 2002[163]. SARS's *Explanatory Memorandum*[164] stated the following concerning the change:

> Paragraph 40 provides rules for the determination of capital gains and losses in the hands of the deceased, the estate and provides that assets that pass through to heirs and legatees do so at the base cost of the assets to the estate which is market value. Ostensibly this provision is at odds with paragraph 12(5) which deals with the waiver or cancellation of debt. Paragraph 12(5) provides that the debtor benefiting from the waiver of debt is deemed to have acquired the debt at a base cost of nil and to have immediately disposed of it at market value, thereby triggering a capital gain in the debtor's hands. For the purpose of clarity it is proposed that it be made clear that the provisions of paragraph 40 are subject to paragraph 12(5).

The fact that Paragraph 40 is expressly made subject to Paragraph 12(5) has the implication that a heir or legatee will realise a capital gain and the estate will not be able to claim a capital loss as it is deemed to have disposed of the asset at base cost.[165]

Furthermore, although Paragraph 38 deals with disposals and acquisitions by way of, *inter alia*, donations and transactions between connected persons not at arm's length price, it deems the assets to have been disposed of and acquired at market

161 Meyerowitz 2009 *The Taxpayer* 166.
162 Meyerowitz 2009 *The Taxpayer* 166.
163 By the *Revenue Laws Amendment Act* 74 of 2002.
164 SARS *Explanatory Memorandum on the Revenue Laws Amendment Bill* 60.
165 Olivier 2006 *Stell LR* 306.

value and is also made subject to Paragraph 12(5).[166] Clearly, Paragraph 12(5) has quite a wide scope.[167]

As mentioned in paragraph 4.7 above, SARS' aim with Paragraph 12(5) is to firstly ensure that a debtor whose debt is reduced or discharged will be subject to CGT, and secondly, to provide for symmetry in the tax system. With regard the first aim, Meyerowitz[168] is of the opinion that this is against the scope of the Eighth Schedule. The purpose of the Eighth Schedule is to tax the gain a taxpayer receives when selling a capital asset and not when the taxpayer acquires the asset. Paragraph 12(5) can only apply by creating a fiction that the following acts are deemed to have occurred: [169]

> (a) the debtor is treated as having acquired the creditor's claim to so much of his debt as is discharged for no consideration and therefore has acquired an asset at nil cost;
> (b) the debtor is treated as having disposed of his claim to himself for proceeds equal to the discharged amount.

In theory legislation can deem anything which is not as it seems to be, but Meyerowitz[170] states that there should be limits. In all the other instances where Paragraph 12 deems a transaction to be a disposal, assets are involved. However, this is not the case with Paragraph 12(5), as this involves a liability.[171] Meyerowitz[172] goes as far as stating that it is against common law and common sense for the same person to be debtor and creditor for the same debt.

Meyerowitz[173] is of opinion that there is no need for Paragraph 12(5) and it should be deleted altogether.

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166 SARS *Explanatory Memorandum on the Revenue Laws Amendment Bill* 60.
167 Meyerowitz 2009 *The Taxpayer* 166.
168 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 167.
169 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 167.
170 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 167.
171 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 167.
172 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 167.
173 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 167-168.

5.3 The court's application of Paragraph 12(5)

It might seem that the application of Paragraph 12(5) is quite simple and straight forward. However, in two tax court cases the court had different arguments and outcomes and the findings of the court came under a great deal of criticism. The following paragraphs will analyse these two court cases.

5.3.1 ABC Trust v CSARS ITC 1793[174]

5.3.1.1 Facts of the case

A few years before her death on 15 March 2002, the testatrix sold shares to the amount of R 2 628 340.00 to the ABC Family Trust (the appellant). The transaction was duly concluded in writing and according to the agreement the shares were sold to the trust on a loan account in favour of the testatrix. Furthermore, interest was to be determined from time to time and both the interest and the capital amount was payable on demand. According to her will, the testatrix bequeathed the outstanding amount (which was owed by the trust to her estate) to the trust. When the testatrix passed away, the executor of the estate executed the bequest.

The Commissioner for the South African Revenue Service (CSARS) regarded the bequest as a discharge of debt for no consideration and this created a capital gain in the hands of the trust.[175]

5.3.1.2 Grounds for appeal

It was argued on behalf of the trust that:[176]

(a) Paragraph 12(5) only applies where a debt or liability is written off by agreement and it does not apply to testamentary dispositions, at least not to legacies or heirs;[177]

174 Hereafter referred to as the *ABC Trust* case.
175 Par 4 and 5 of the judgement.
176 Par 15 of the judgement.
177 Par 15(a) and (b) of the judgement.

(b) if in fact Paragraph 12(5) does apply, in this case it is not a discharge of debt for no consideration. It was argued that this was because of the fact that when the outstanding amount was bequeathed and awarded to the trust it created a claim in favour of the trust. This had the effect that the liability the trust had against the testatrix or her estate was cancelled. Furthermore, it was rather a set-off which operated *ex lege* (because of the fact that her last will and testament became effective at the date of her death)[178] and not a disposition without value. Consequently, Paragraph 12(5) does not apply.[179]

5.3.1.3 Arguments and the court's decision

The Eighth Schedule of the *Income Tax Act* deals with cases in which taxable capital gains and assessed losses are calculated and determined.[180] At the centre of the determination is the disposal of an asset. On a number of occasions the Eighth Schedule provides for definitions for disposal.[181]

It was argued on behalf of the appellant that the discharge of the trust's obligation toward the testatrix did not amount to a disposal by the estate or an acquisition by the trust, but as a set-off.[182] This was argued because of the fact that the bequest to the trust created an obligation in the estate towards the trust and this was equal to the liability of the trust towards the estate, which created a set-off.[183]

However, the court did not accept this argument. In the first instance, the court stated that the set-off was created by an act on the part of the testatrix, namely the discharge of the amount due to the testatrix by the trust.[184] Thus, the testatrix

178 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 96.
179 Par 15(d) of the judgement.
180 Par 16 of the judgement.
181 Par 18 to 21 of the judgement. Par 11 of the Eighth Schedule determines, *inter alia*, that a disposal is an event, act of forbearance or operation of law and includes the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset.
182 Par 33 of the judgement.
183 Sett-off is defined as: "A debtor's right to reduce the amount of a debt by any sum the creditor owes the debtor; the counterbalancing sum owed by the creditor" (Garner (ed) *Black's Law Dictionary* 9th ed 1496). Discharge is defined as: "Any method by which a legal duty is extinguished; esp., the payment of a debt or satisfaction of some other obligation" (Garner (ed) *Black's Law Dictionary* 9th ed 530).
184 Par 34 of the judgement.

disposed of an asset by discharging the debt for no consideration. This was the reason why the claim against the trust was extinguished *ex lege* through set-off between the estate and the trust. In the second instance, the court stated that it was not the "act" of set-off which created a CGT liability, but the act of drawing up a last will and testament and its coming into operation at the date of the death of the testatrix.[185]

Paragraph 11(1) of the Eighth Schedule states:

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

Clearly this Paragraph includes the operation of law into the definition of the disposal of an asset. The court stated[186] that the estate's asset was extinguished by law, namely the set-off, which in turn was created by the disposition by the testatrix.

The appeal was dismissed and the trust was liable for CGT.

5.3.1.4 Criticism against the court's reasoning

Ger[187] states that the discharge or reduction of a debt in a will has always been debatable for two reasons. Firstly, an estate owner cannot discharge a debt after his death.[188] Because of the working of Paragraph 40, after the estate owner's death there is a deemed disposal of all the assets at market value to the estate owner's deceased estate. In accordance with the will, the assets will be disposed to the heirs and legatees. The will only takes effect after the estate owner's death and it has been argued that the estate owner cannot dispose of assets he no longer owns. Secondly, there is a significant difference between a testamentary discharge or reduction of a debt and a situation in which the estate owner is still alive when forgiving the debt.[189] It is argued that the provisions of the Act require some kind of

185 Par 34 of the judgement.
186 Par 34 of the judgement.
187 Ger December 2005 *De Rebus* 43.
188 Ger December 2005 *De Rebus* 43.
189 Ger December 2005 *De Rebus* 43.

action on the side of the estate owner.[190] When the estate owner is still alive, he knowingly discharges or reduces the debt. However, when it is a testamentary discharge or reduction, the estate owner is unintentionally disposing of a part of his estate. It is not clear whether this unintentional disposal can be seen as an action on the part of the estate owner as required by Paragraph 12.[191] A number of advisors recommended that estate owners bequeath the debt to the trust to create an automatic *ex lege* set-off and which would not be an action on the part of the estate owner.[192]

Ger[193] is of the opinion that although there was an action on the part of the estate owner, namely, the drawing up of a will, it is debatable whether this action constitutes a discharge of debt. Furthermore, if the trustees demanded payment of the money which was bequeathed to the trust and then used that money to repay the loan in favour of the estate owner, then there would have been an action on the part of the trust, through its trustees, and not the estate owner.[194] It is submitted that if the executors of the estate owner's estate and the trustees arranged the transaction in a different way and created a cash flow, then the outcome of this case might have appeared a lot different.[195]

According to Meyerowitz,[196] the reasoning of the court was flawed. He states:[197]

> Set-off applies when two parties are mutually indebted to each other, both debts being liquidated and due. It is then that the doctrine of compensation comes into operation. The one debt extinguishes the other *pro tanto* as effectively as if payment had been made...

In accordance with the *Administration of Estates Act*,[198] the executor listed the debt as an asset in the liquidation and distribution account and awarded an amount, equal thereto, to the trust in the distribution account.[199] Following this, there were two

190 Ger December 2005 *De Rebus* 43.
191 Ger December 2005 *De Rebus* 43.
192 Ger December 2005 *De Rebus* 44.
193 Ger December 2005 *De Rebus* 44.
194 Ger December 2005 *De Rebus* 44.
195 Ger December 2005 *De Rebus* 44.
196 Meyerowitz 2009 *The Taxpayer* 165.
197 Meyerowitz 2009 *The Taxpayer* 165.
198 *Administration of Estates Act* 66 of 1965.
199 Meyerowitz 2009 *The Taxpayer* 165.

routes to follow. Firstly, the trustees could have paid the debt before the payment of the bequest had become due and when it indeed became due, it could have claimed it back in terms of section 35 of the *Administration of Estates Act*.[200] Secondly, the executor could have claimed payment of the debts before the estate was required to pay the bequest to the trust.[201] According to Meyerowitz,[202] in either of these cases there would be no discharge without consideration. Likewise, there is no discharge without consideration when set-off takes place. Furthermore, Meyerowitz[203] is of the opinion that because Paragraph 20(3) applied, Paragraph 12(5) is not applicable. According to his reasoning, Paragraph 20(3) applies due to the fact that the debt arose from an acquisition of assets sold by the deceased to the trust.[204]

Williams[205] asks whether this judgement can in fact be regarded as correct. Williams states:[206]

> Arguably, it is not correct to say, as the judgement does, that where a testator bequeaths to a trust the balance of the testator's loan account, this constitutes a debt that 'has been discharged' by the testator, as contemplated in para 12(5) of the Eighth Schedule. It is true that there was an act by the testator, namely the drawing of a will, but that act did not, of itself, 'discharge' the debt.

Clearly, writers do not agree with the reasoning of the court in this case. Since the *ABC Trust* case, another case came before the tax court in Kimberley. A discussion of this case will follow in paragraph 5.3.2.

5.3.2 XXX Trust v CSARS ITC 1835[207]

5.3.2.1 Facts of the case

On 16 March 1992, the testatrix and her husband executed a joint will in which they stated that, after all the costs involved with the winding up of the estate have been

200 Meyerowitz 2009 *The Taxpayer* 165.
201 Meyerowitz 2009 *The Taxpayer* 165.
202 Meyerowitz 2009 *The Taxpayer* 165.
203 Meyerowitz 2009 *The Taxpayer* 165.
204 Meyerowitz 2009 *The Taxpayer* 165.
205 Williams *PWC Synopsis* 6.
206 Williams *PWC Synopsis* 6.
207 Hereafter referred to as the *XXX Trust* case.

paid, the residue of the estate will be inherited by the trust (the appellant) subject to a *usufruct* in favour of the survivor of them and after the death of the survivor of them, for one year in favour of the son where after the *usufruct* will lapse.

The testatrix passed away on 10 June 2003 while her husband was still alive. At the time of the testatrix's death, the trust had an outstanding loan account in favour of the testatrix in the amount of R 539 189.00. The executor in the estate did not demand and/or receive the payment of this claim for the winding up of the estate.[208] The liquidation and distribution account reflected the amount as a claim awarded to the trust as the sole heir of the residue of the estate. The account was finalised and the estate was wound up accordingly.

More than a year after the estate had been wound up, SARS (the respondent) issued a notice of assessment according to which the appellant was taxed in terms of section 26A of the *Income Tax Act* for capital gains on the outstanding amount.

5.3.2.2 Relevant legislation

According to section 26A of the *Income Tax Act*, the taxable capital gains (as determined by the Eighth Schedule) of a person for that year of assessment will be included in the taxable income of that person for that year of assessment. The parties are in agreement that the only relevant provisions of the Eighth Schedule are that of Paragraph 1, 11 and 12(5).[209]

Paragraph 1 and paragraph 11 provide for definitions of disposal and Paragraph 12(5) deals with the situation in which a debt has been reduced or discharged for no consideration. The respondents based their argument squarely on Paragraph 12(5) and stated that in terms of the will, the amount which the appellant was indebted to the testatrix had been discharged for no consideration and therefore the trust is liable to pay capital gains tax.[210]

208 Par 3 of the judgement.
209 Par 5 of the judgement.
210 Par 6 of the judgement.

5.3.2.3 Arguments and the court's decision

The respondents relied heavily on the decision in the *ABC Trust* case, as discussed above.[211] However, it was argued on behalf of the appellant that the wills in the *ABC Trust* case and the *XXX Trust* case fundamentally differed from one other and therefore these two cases have to be distinguished from each other.[212] Furthermore, it is critical to look at the wording of the will rather than the method used when the estate was wound up.[213]

It was argued on behalf of the respondent that if the executor demanded and received the payment of the outstanding amount, CGT would not be payable.[214] It was submitted that, in terms of the wording of the will, the executor chose not to collect the outstanding amount from the appellant, but rather to award it directly to the appellant, which now makes the appellant liable for CGT.[215] Even if the executor collected the outstanding amount and repaid it as part of the residue, Paragraph 12(5) could still not be applied, because it states that the "creditor" should have reduced or discharged the debt.[216]

Both counsel for the respondent and the appellant were in agreement that the intention of the testatrix, as reflected in the will, should be the deciding factor in this case.[217] This is so because of the fact that a court cannot consider a testator or testatrix's will in a vacuum, but the court has to place itself in the shoes of the testator or testatrix at the time the will was executed.[218] Thus, the court will examine the words used in a will and put the words into context to determine the intention of the testatrix.

The court is of opinion that the wording of the will is unmistakable.[219] The testatrix clearly intended the appellant to receive the residue of the estate subject to the *usufruct* in favour of the surviving spouse and later the son. Furthermore, it is clear

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211 Par 6 of the judgement.
212 Par 7 of the judgement.
213 Par 7 of the judgement.
214 Par 8 of the judgement.
215 Par 8 of the judgement.
216 Honiball and Olivier *The taxation of trusts in South Africa* 204.
217 Par 9 of the judgement.
218 Par 9 of the judgement.
219 Par 10 of the judgement.

that the claim (the outstanding amount) was not a separate bequest to the appellant as a legacy,[220] but it had to form part of the residue of the estate.

In addition, the court stated that besides the wording of the will, there is also an indication that the testatrix did not have the intention to specifically bequeath the outstanding loan account to the appellant as a legatee. Moreover, evidence has shown that the appellant was in a financial position to repay the outstanding amount if the testatrix demanded payment before her death.

The court came to the decision that the claim in favour of the appellant formed part of the residue of the estate and the testatrix did not intend to dispose of the debt for no consideration as required by Paragraph 12(5) of the Eighth Schedule of the *Income Tax Act*.[221] For this reason the *ABC Trust* case finds no application in the current case.

In the current case, while winding up the estate, the executor did not recover the claim, but awarded it to the appellant as the sole residuary heir. The court had to determine whether the awarding of the claim could not perhaps be brought under the ambit of Paragraph 12(5). However, the court stated that an executor has a wide discretion in the way he winds up an estate.[222] According to the liquidation and distribution account of the estate sufficient funds were available and the executor had no need to collect the outstanding amount from the appellant. Thus, the executor chose the less expensive route of not collecting the outstanding amount only to repay it to the same party. The results of the route the executor chose in this case would have been exactly the same had he chosen the more expensive route.

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220 De Waal and Schoeman-Malan *Inleiding tot die erfreg* 122-124 explains the difference between an heir and a legatee (that receives a legacy): an heir receives the whole inheritance, a proportional part or the residue of the inheritance; a legatee always receives certain or ascertainable assets or a certain cash amount. An heir can qualify for an inheritance through intestate succession; a legatee can only receive an inheritance through a will of an antenuptial contract. After the estate liabilities have been paid, the executor will award the legacies to the legatees and after that the heirs will receive their inheritance. In the event that there are only enough assets to be awarded to the legatees, the heirs will receive nothing. The heirs may be obliged to collation while the legatees are not legally obliged thereto.

221 Par 11 of the judgement.

222 Par 13 of the judgement.

For Paragraph 12(5) to be applied in a specific situation, it is required that an act by the creditor (the testatrix) should have existed whereby he or she consciously intended to discharge a debt for no consideration.[223] Thus, the intention of the testatrix is at the centre of this determination.

The appeal succeeded.

5.3.2.4 Criticism against the judgement

Ger[224] stated that both the *ABC Trust* and the *XXX Trust* cases miss the point of Paragraph 12(5). For Paragraph 12(5) to be applicable it is not important what the estate owner intended, but whether the estate owner committed an act (whether or not intentionally) with the result that the debt was discharged or reduced.[225] Whether a bequest in a will constitutes such an act, is debatable, because when the will takes effect the estate owner is already dead and is not capable of committing an act which will discharge or reduce any debt. These two cases rest on the way that the executors had administered the estates. In this regard, Honiball and Olivier[226] have also stated that although an executor has an obligation to adhere to the wishes expressed in the testator's will, the executor still has a discretion concerning the manner in which the administration is done. If the executors had claimed the outstanding amount from the trust before any award was made and the trustees in fact pay the debt, there would have been no set-off and most likely there would not have been a case either.[227]

Meyerowitz[228] is of the opinion that this judgement is also flawed. According to his reasoning, in both these cases the testatrix had the intention to benefit the trust and there is no distinction between the essential facts of these cases. Lacock J in the *XXX Trust* case should have held that the judgement in the *ABC Trust* case was incorrect and not follow it *or* that it in fact was correct, whichever one was correct in

223 Par 13.3 of the judgement of the *XXX Trust* case.
224 Ger July 2009 *De Rebus* 45.
225 Ger July 2009 *De Rebus* 46.
226 Honiball and Olivier *The taxation of trusts in South Africa* 203-204.
227 Ger July 2009 *De Rebus* 46.
228 Meyerowitz 2009 *The Taxpayer* 166.

his view.[229] However, he did not express himself on the correctness (or incorrectness for that matter) of the *ABC Trust* case, but had a different reasoning which led to a different conclusion.

5.4 Conclusion

It is clear that the use of trusts can provide a number of advantages to the estate owner when it is used for estate planning. The assets in the trust are protected from third parties; when assets are transferred to the trust growth of the assets are "pegged" in the estate owner's estate and estate duty and executor's fees might be reduced; and trusts continue unaffected at the death of the estate owner. To "transfer" the assets to the trust, the estate owner sells the asset to the trust on an interest-free loan in favour of the estate owner. No fixed time is set as to when the loan must be repaid and in his will the estate owner stipulates that the outstanding loan or the residue of the estate should be awarded to the trust.

The court interpreted and applied Paragraph 12(5) differently in two tax court cases. In the *ABC Trust* case the court interpreted the bequest of the loan account to be a discharge of a debt and thus a deemed disposal for CGT purposes, which brought it in line with Paragraph 12(5). Thus, the court applied Paragraph 12(5) and the trust was liable to pay CGT. In the *XXX Trust* case, where the residue of the estate was awarded to the trust, the court did not provide an interpretation of Paragraph 12(5), but the emphasis was added on the intention of the testatrix as expressed in her will. The court came to the conclusion that the testatrix did not have the intention to discharge the debt and thus, when her intention was determined, Paragraph 12(5) found no application.

Hence, what other options did the estate owner have to limit the effect of Paragraph 12(5)? This question will be answered in the subsequent paragraph.

229 Meyerowitz 2009 *The Taxpayer* 166.

6 Estate planning tools to limit the effect of Paragraph 12(5)

As seen from the discussion of the case law above, a CGT liability will arise in the hands of the trust when the testator bequeaths an amount equal to the outstanding loan amount back to the trust. At the beginning of this mini-dissertation the question was posed: Which measures or estate planning structures were available to the estate owner that wanted to erase a loan account without attracting CGT? The following options can be identified:

- Donate R 100 000.00 (or R 200 000.00 for married couples) cash annually to the trust;
- Bequeath the loan account to the trust;
- Bequeath the residue of the estate to the trust;
- Bequeath a cash amount equal to the outstanding amount to the trust as legatee;
- Bequeath a cash amount to the trust;
- Bequeath the loan account to one of the estate owner's heirs or to another trust.

All of these options will be discussed individually in the paragraphs to follow.

6.1 Donate R 100 000.00 (or R 200 000.00 for married couples) cash annually to the trust

Section 65(2)(b) of the *Income Tax Act* determines that a natural person will not pay donations tax on donations made to the sum of R 100 000.00 during a year of assessment. Due to the fact that donations between spouses are exempt from donations tax, this amount will be increased to R 200 000.00 per year for married couples.[230] The donation should specifically be a cash donation as Paragraph 1 of the Eighth Schedule excludes currency from the definition of an asset for CGT purposes. In practice, the money will be donated to the trust and the trustees in turn will utilise the money to repay the loan. However, for this transaction not to be regarded as a deemed disposal in light of Paragraph 12 of the Eighth Schedule it is

230 Joffe 2005 *Tax Breaks Newsletter* 1.

important that it not only be a journal entry into the financial books of the trust and the donor (being the estate owner), but that the money physically pass to the trust.[231]

When the money is donated to the trust and the trustees utilise the money to repay the loan, the outstanding loan account decreases every year and eventually, if the amount is not that high, the estate owner would have erased the loan account during his lifetime without attracting CGT. However, in some instances the loan account might not be extinguished and the estate owner would have to make another plan. The estate owner might decide to donate the outstanding amount to the trust in which case it will definitely trigger donations tax and CGT.[232]

Clearly, an annual donation is a very effective estate planning tool for decreasing the loan account annually and it has been used for a number of years. When this technique is used it is unlikely that CGT will be levied when an annual donation is made to the trust.

6.2 Bequeath the loan account to the trust

Some estate owners may decide to draft their wills in such a way that the exact outstanding loan amount is bequeathed back to the trust. When the estate owner dies, the deceased estate would no longer have a claim against the trust, but the trust would rather have a claim (as stipulated in Paragraph 12(5)(b)(i)) against the deceased estate which might be thought of to cancel the claim the estate owner's deceased estate had against the trust. However, the question remains whether a CGT liability will arise when these circumstances are tested against Paragraph 12(5). Even though it might be argued that this situation creates a set-off which operates *ex lege*, the court in the *ABC Trust* case did not agree. The court is of the opinion that the act of drawing up the will created a CGT liability in accordance with Paragraph 12(5). In line with the court's reasoning, as set out above, the trust was liable for CGT.

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231 Robertson 2012 http://www.fin24.com/Money/Money-Clinic/Donations-tax-explained-20120702.

232 Par 11(1)(a) specifically states that a donation is regarded as a disposal for CGT purposes.

In light of the *ABC Trust* case, it seems that bequeathing the exact outstanding amount back to the trust is not a good choice if the estate owner wants to limit the effect of Paragraph 12(5). Although critics are of the opinion that the reasoning in the judgement is flawed, it would be better if the estate owner does not take a chance to establish whether the court would come to another conclusion if his trust, through his trustees, is brought before the court on similar facts.

6.3 Bequeath the residue of the estate to the trust

When the estate owner states in his will that the residue of the estate will go to the trust, the trust will be a residual heir of the estate.[233] As stated in footnote 221, an heir will only receive their inheritance after all the estate liabilities have been paid and the legatees have received their legacies. Furthermore, if there are only enough assets to award to the legacies, the heirs will receive nothing. As a result it might happen that the loan account was not affected at all and remains an asset in the estate owner's estate and the outstanding amount will have to be claimed from the trust to administer the estate.

Once again, if the residue of the estate is awarded to the trust, it creates a claim in favour of the trust to the value of the residue. Furthermore, it can be argued that the outstanding loan account and the claim in the trust have now cancelled each other without attracting CGT.

With regard to the *XXX Trust* case it seems that it would be better to bequeath the residue of the estate rather than the exact amount to the trust. In this case the court found that Paragraph 12(5) was not applicable as the testatrix did not have the *intention* of discharging the debt. Still, if one considers the criticism against the court's decision, the question might be posed as to wheter the next court would have emphasised the intention of the testatrix as much and would have come to the same conclusion. It might have happened that the court disregarded the intention of the testator and went straight to the interpretation of the facts in the light of Paragraph

233 De Waal and Schoeman-Malan *Inleiding tot die erfreg* 122.

12(5) and apply it accordingly. Nonetheless, this may still be regarded as an estate planning tool which could limit the effect of Paragraph 12(5).

6.4 Bequeath a cash amount equal to the outstanding amount to the trust as legatee

Under these circumstances the estate owner will specify in his will that a cash amount equal to the outstanding loan amount should be awarded to the trust. Also in these circumstances the trust will acquire a claim equal to the amount which has been awarded to it in terms of the will.[234] The deceased estate has to award the bequest to the trust and the trustees will then repay the outstanding loan. In the event that the deceased estate is not in a position to award the bequest before the finalisation of the estate, the trustees will most likely have to make other arrangements to obtain the money to repay the outstanding amount and the bequest will be awarded after the estate has been finalised. These circumstances seem to be the same as in the event that the outstanding loan is awarded to the trust, as discussed in paragraph 6.2 above. However, in this case a cash amount will be awarded and the question may be posed as to whether it will have a different outcome in light of the discussion above and in light of the *ABC Trust* case.

Paragraph 1 of the Eighth Schedule provides for a definition of an asset for CGT purposes. Accordingly, currency is specifically excluded from this definition which indicates that CGT will not be applicable to a disposal when cash changes hands. A bequest of a cash amount should thus not be treated any differently. McAllister[235] state that the main reason that cash is excluded from the definition is to prevent situations where taxpayers claim for the loss of cash and, administratively, it would not have made sense to include cash in the definition. Thus, if cash is unconditionally excluded in the definition, then it would not make sense to include it in the definition in this case.

234 Par 12(5)(b)(i).
235 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 40.

6.5 *Bequeath a cash amount to the trust*

Another option an estate owner has is to bequeath a cash amount to the trust as legatee. When the estate owner dies and the executor awards the cash to the trust it is likely that a set-off will take place and the amount which the trust owed to the estate owner will be cancelled. Again, Paragraph 1 of the Eighth Schedule provides for the definition of asset and specifically states that currency will be excluded from the definition. McAllister[236] also states that bequeathing a cash amount to the trust would not amount to a reduction or discharge of a debt because cash is exempt from CGT. However, as stated in paragraph 6.1 above, it is important that the cash awarded to the legacies not only be a journal entry, but that the cash actually flow through to the trust.

Thus, making a cash bequest to the trust is an important estate-planning tool to limit the effect of Paragraph 12(5).

6.6 *Bequeath the loan account to one of the estate owner's heirs or to another trust*

An estate owner also has the option of bequeathing the loan account to his heirs or to another trust. Honiball and Olivier[237] are of the opinion that the negative CGT consequences of the judgement of the *ABC Trust* case can be avoided when the testator bequeaths the loan to one of his heirs, rather than to the trust. In this situation the outstanding loan will still be in existence, but it will be an asset in the heir's estate. However, the question may be posed as to what the heir will be able to do with the outstanding amount to prevent it from enlarging his or her estate. Something else which would have to be borne in mind is that when the outstanding loan account is awarded to the heir or to a different trust, all the rights the estate owner had will most likely also be awarded. If the agreement between the original trustees and the estate owner stated that the outstanding amount was payable on demand, the heir or the "new" trust might in fact demand the payment which might have a detrimental effect on the original trust. Therefore, it is important who the

236 McAllister *SARS Comprehensive Guide to Capital Gains Tax* 97.
237 Honiball & Olivier *The taxation of trusts in South Africa* 205.

estate owner chooses as his heir. Kempff[238] is also of the opinion that the outstanding loan should be bequeathed to “a spouse, a child or a different trust” in order to avoid a CGT liability.

Nevertheless, it seems that estate owners would no longer have to consider these options, because Paragraph 12(5) has been repealed and replaced by Paragraph 12A. It seems that Paragraph 12A allows estate owners to once again bequeath the outstanding loan amount back to the trust. Paragraph 12A will be examined in the following paragraph.

7 Paragraph 12A

It seems that the legislature also read Meyerowitz’s comment as stated in paragraph 5.2.1 above, because since the *ABC Trust* and the *XXX Trust* cases, Paragraph 12(5) has been deleted and Paragraph 12A been inserted in the Eighth Schedule with its effect from 1 January 2013.[239] Paragraph 12A is quite an extensive paragraph with seven subparagraphs as opposed to Paragraph 12(5), which only consisted of that one subparagraph. Paragraph 12A provides for definitions for “allowance asset”, “capital asset”, “debt”, and “reduction amount”.[240] Furthermore, Paragraph 12A(2)[241] stipulates when this paragraph will be applicable. Clearly Paragraph 12A provides for more certainty when it comes to the reduction or cancelation of a debt and it might be said that it now provides guidelines to the application thereof.

The application of Paragraph 12A is subject to Subparagraph 6, which provides for the exclusions. Consequently, Paragraph 12A also stipulates in which situations it

238 Kempff 2013 http://showme.co.za/lifestyle/cancelling-a-loan-in-your-will/.
239 Section 108(2) of the *Taxation Laws Amendment Act*.
240 Par 12A(1).
241 Par 12A(2):
Subject to subparagraph (6), this paragraph applies where a debt that is owed by a person is reduced by any amount and-
(a) the amount of the debt was used, directly or indirectly, to fund any expenditure-
(i) other than expenditure in respect of which a deduction or allowance was granted in terms of this Act; or
(ii) incurred in the acquisition, creation or improvement of an allowance asset; and
(b) the amount of that reduction exceeds any amount applied by that person as consideration for that reduction.

will not be applicable. According to Paragraph 12A(6) no CGT liability will arise where debt is owed by an heir or legatee of a deceased estate to that deceased estate;[242] when debt is reduced or discharged by way of a donation;[243] when the debt is reduced or discharged by an employer and the reduction or discharge is a fringe benefit;[244] where debt is owed by one company to another company in the same group of companies;[245] and when debt is owed by a company in the process or anticipation of a liquidation, winding up, deregistration or final termination of the existence of that company and the debt is reduced or discharged by a connected person in relation to that company.[246]

According to its *Explanatory Memorandum on the Taxation Laws Amendment Bill,*[247] SARS state that the reason for the change to the legislation is because of the fact that debtors keep on seeking relief up to a point where it has become an economic concern, and when taxes are added to this equation it contributes to the problem. Stiglingh[248] is also of the opinion that the government wants to implement a uniform system which supports local economic recovery. With regard to an estate owner reducing or discharging a debt, it seems that another reason might be that the outstanding amount will still be subject to estate duty.[249] Paragraph 12(6)(a) specifically states:

> 6. This paragraph must not apply to any debt owed by a person-
>   (a) that is an heir or legatee of a deceased estate, to the extent that-
>   (i) the debt is owed to that deceased estate;
>   (ii) the debt is reduced by the deceased estate; and
>   (iii) the amount by which the debt is reduced by the deceased estate forms part of the property of the deceased estate for the purposes of the *Estate Duty Act*, 1955.

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242 Par 12A(6)(a) provide for further requirements:
(i) the debt must be owed to the deceased estate;
(ii) the debt must be reduced by the deceased estate; and
(ii) the amount by which the debt was reduced must form part of the property of the deceased estate for purposes of the *Estate Duty Act*.

243 Par 12A(6)(b).

244 Par 12A(6)(c).

245 Par 12A(6)(d). Par 12A will still apply if the debt was reduced or discharged as part of a transaction, operation or scheme to avoid tax and then if the debt was acquired directly or indirectly from a person that does not form part of the group of companies.

246 Par 12A(6)(e).

247 SARS *Explanatory Memorandum on the Taxation Laws Amendment Bill* 44.

248 Stiglingh (ed) *et al Silke 2013* 315.

249 SARS *Explanatory Memorandum on the Taxation Laws Amendment Bill* 45. Also see Strydom and Van den Berg 2013 *Money Marketing* 2.

To clarify, SARS[250] explains it as follows:

> ...if the debt reduction or cancellation constitutes property of an estate and that debt reduction or cancellation is reduced or cancelled in favour of an heir or legatee by virtue of a bequest, then estate duty potentially applies.

When it comes to the reduction or discharge of debt in a will, Ostler[251] is of the opinion that Paragraph 12A should be interpreted with caution because it has not been tested by the courts. It is also stated that other authors are of the opinion that Paragraph 12A does not relate to the reduction or discharge of debt in a will and that CGT will still be applicable in those circumstances.[252] However, Carrol[253] is of the opinion that the *status quo* has been restored and estate owners can once again bequeath the outstanding amount back to the trust without attracting CGT.

It is important to remember that Paragraph 12A specifically states that the loan amount should be regarded as property in the estate in terms of the *Estate Duty Act*. This might increase the probability of an estate duty liability. A way to circumvent this situation will be to bequeath the outstanding loan amount to a third party (not being a family member or the trust) or to bequeath the specific outstanding amount in cash to the trust.[254]

8 Conclusion

As stated in paragraph 1.2.1, the main research question for this mini-dissertation was to determine which estate-planning tools were available to the estate that wanted to erase a loan account without attracting CGT. In answering this question, a number of secondary questions was formulated, namely:

- How did CGT develop?

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250 SARS *Explanatory Memorandum on the Taxation Laws Amendment Bill* 45.
251 Ostler 2013 http://www.schoemanlaw.co.za/wp-content/uploads/2013/06/Interest-Free-Loans-The-Situation-Post-March-2013.pdf.
252 Ostler 2013 http://www.schoemanlaw.co.za/wp-content/uploads/2013/06/Interest-Free-Loans-The-Situation-Post-March-2013.pdf
253 Carrol 2013 http://www.sanlam.co.za/wps/wcm/connect/Sanlam_EN/sanlam/newsletters/estate+planning+essentials/volume+50.
254 Ostler 2013 http://www.schoemanlaw.co.za/wp-content/uploads/2013/06/Interest-Free-Loans-The-Situation-Post-March-2013.pdf

- Why is there a distinction between proceeds of a capital- or income nature? Why is this distinction important?
- When is CGT levied?
- Why do estate owners use a trust as an estate planning tool? With regard to trusts and outstanding loan accounts, how was Paragraph 12(5) of the Eighth Schedule interpreted and applied by the courts?
- Which estate planning tools were available to limit the effect of Paragraph 12(5)?
- What does Paragraph 12A of the Eighth Schedule entail and what is the effect thereof on estate planning?

An overview of the conclusions reached throughout this research will follow.

CGT was introduced into the South African tax system on 1 October 2001. However, it seems that a limited form of CGT was already proposed in the 1960's. Over the years since 2001 there have been a number of CGT cases before the courts which assists with the development of CGT through the resolution of uncertainties. There are a number of reasons why CGT was introduced into the South African tax system, some of which are to provide for symmetry in the tax system by taxing gains from both income- and capital proceeds.

It is clear from the research that a distinction between proceeds of a capital- or an income nature is very important. This is due to the fact that these proceeds are dealt with under different provisions of the *Income Tax Act* and the tax rates for these two terms differ. Also, capital losses may be set-off against capital gains, which is not the case when a taxpayer has revenue losses. The *Income Tax Act* makes mention of proceeds of a "capital nature", but does not provide a definition for it. It has been left to the courts to determine whether proceeds are of an income- or capital nature. The courts have developed a number of tests over the years, but it seems the profit-making scheme test together with the intention of the taxpayer is the most popular test. According to the profit-making scheme test, proceeds will be of income nature if it seems that the taxpayer was using the asset to make a profit. The court can also attempt to determine what the taxpayer's intention with the asset was and if it, subjectively, seems that the taxpayer acquired the asset to sell it at a profit, then the proceeds will be of an income nature.

The research above indicates that CGT will be levied on the gain when an asset is disposed of for proceeds exceeding the base cost of that asset. CGT is thus based on four “building blocks”, namely an asset, a disposal, proceeds and base cost. Each of these terms was looked at separately. The definition of an asset is very wide and includes property of a movable, immovable, corporeal and incorporeal nature. A disposal is also defined widely to include a number of acts or events. Proceeds are defined as being equal to the amount received by or accrued to a person in respect of a disposal. It is clear that this definition also has a number of terms which had to be examined more closely. To finally determine what the capital gain is, it is important to know what the base cost of an asset is. The capital gain will be determined by subtracting the base cost from the proceeds received. The base cost of an asset is equal to the expenditure incurred to acquire the asset as well as other expenditure which may include maintenance costs and improvements.

These four “building blocks” are also important when a debt has been reduced or discharged. However, in the case where an estate owner bequeaths his outstanding loan account back to the trust it might, at first glance, be difficult to determine how these building blocks will be applied, because in the first place the debt is a liability, it does not seem if there is a disposal, there is no base cost consisting of the expenditure incurred for the acquisition, the maintenance or the improvement of the asset and it does not seem that there are proceeds as used in schedule 8. Nonetheless, the legislature creates all of these building blocks in the event of a deemed disposal. Paragraph 12(5) specifically creates an asset as the debtor (the trust) is deemed to have acquired a claim to the debt reduced or discharged; it is stated that the base cost will be nil; the proceeds will be equal to the amount which has been discharged or reduced; and claim which the debtor acquired is deemed to be disposed of.

As stated above, trusts are very popular and useful estate planning tools and also have a number of advantages when it is used or estate planning purposes. When an estate owner sells his property to the trust on a loan account, the estate owner most likely does not want this debt to be collected when he dies, because it might have a negative impact on the trust – the instrument being used to preserve his assets. To prevent the executor of his estate to collect the outstanding amount at the estate owner's death, the estate owner bequeaths the outstanding loan back to the trust or the estate owner might even bequeath the residue of the estate to the trust. Each of these proposals is the same as the tax court cases discussed in this mini-dissertation – the *ABC Trust* case and the *XXX Trust* case. In the *ABC Trust* case the court argued that the testatrix discharged a debt for no consideration when the loan account was awarded to the trust. The action on the part of the testatrix lies therein that she drafted a will which resulted in a debt being discharged. The court found that the trust is liable for CGT for an amount equal to the discharged amount. In the *XXX Trust* case the testatrix bequeathed the residue of the estate to the trust. The court in this case placed great emphasis on the intention of the testatrix. The court reached the conclusion that the testatrix did not have the intention to discharge the debt, but a set-off was able to take place when the trust received the residue of the estate. When the court came to the conclusion that the testatrix did not have the intention to discharge the debt, no further consideration was given to Paragraph 12(5). The court clearly interpreted these situations completely differently.

A few estate planning tools have been identified to limit the effect of Paragraph 12(5). The estate owner may choose to firstly, make an annual donation of R 100 000.00 (or R 200 000.00 for married couples) to the trust; secondly, bequeath the loan account to the trust; thirdly, bequeath the residue of the estate to the trust; fourthly, bequeath a cash amount equal to the outstanding amount to the trust as legatee; fifthly, bequeath a cash amount to the trust; or sixthly, bequeath the loan account to one of the estate owner's heirs or to another trust. The first option is a very good one if the initial loan amount is not very high as only the first R 100 000.00 (or R 200 000.00 for married couples) donation is tax-free per year. It might not be possible for the estate owner to diminish the loan amount and when it has not been dealt with in another way, the executor will claim payment of the outstanding amount. As mentioned above, the estate owner should not donate the outstanding amount to the trust as donations tax and CGT will be levied. When one looks at the outcome of the *ABC Trust* case, it seems that the second option is not a good choice. It is likely that the court will see this bequest as a discharge for no consideration and levy CGT.

With regard to the third option it seems to be a good choice to bequeath the residue of the estate to the trust in the light of the *XXX Trust* case. However, if one considers the criticism on this case, it might have been that the next court would not have followed the same line of argument if a similar case came before it. For Paragraph 12(5) to be applicable it is irrelevant what the testatrix's intention with the bequest was. With regard to the fourth option it seems appropriate to bequeath the exact outstanding amount in cash to the trust. This is observed because of the fact that cash is unconditionally exempt from CGT. The writer is of the opinion that the fact that the exact amount is stipulated is irrelevant. The focus is on the fact that cash is involved. The same reasoning can be provided for the fifth option. Option six may also be a good choice. In this regard the loan account will not be discharged, but it will not fall into the estate owner's estate. However, the estate owner should be careful who he chooses to bequeath the outstanding loan account to. If it is someone that does not have any regard for the estate owner's assets and his dependants then that person might decide to claim the outstanding amount in which case the trustees would perhaps have to liquidate some of the trust's assets. This will be in direct contrast to one of the purposes of setting up a trust, namely asset protection and preservation.

After the *ABC Trust* and the *XXX Trust* cases, Paragraph 12(5) has been deleted and replaced with a new Paragraph 12A. Writers are of the opinion that the *status quo* has been restored and estate owners can now freely bequeath their outstanding loan accounts back to their trusts. However, other writers are more cautious and will rather play safe, and Paragraph 12A has not been tested by the courts.

Many estate owners consider using trusts because of the tax advantages it possesses as opposed to an individual. However, this should never be the sole reason why the estate owner decides to utilise a trust for estate planning purposes. It is clear from the change in legislation with regard to Paragraph 12 and in light of the Minister of Finance's 2013 Budget Speech,[255] that legislation can very easily be changed and that trusts as a tool for tax avoidance is in the spotlight. It might happen that changes to the legislation on the taxation of trusts will have a very detrimental

255 Gordhan 2013 http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf.

effect on the affairs of the estate owner. Until such time there will be uncertainty. However, one thing remains certain, and that is that death and taxes are here to stay.

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