

An analysis of the risks associated with estate duty in retaining control over trust assets

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REMARKS

The reader is reminded of the following:

This dissertation is presented in article format, in accordance with the policies of the North-West University's Faculty of Economic and Management Sciences, and consists of one research article.

The research article and dissertation complies with the writing style requirements of the American Psychological Association (APA).

KEYWORDS

Estate duty, risk, trust, control over trust assets, estate planning.

ABSTRACT

The use of trusts to minimise estate duty and other taxes has recently come under scrutiny from government. The DTC has proposed amendments to income tax legislation to serve as a deterrent against using trusts to avoid estate duty. Such amendments will, however, only discourage the use of trusts if the trust assets generate a significant amount of income and the donor of the assets or the beneficiaries of the trust have little or no other taxable income.

The objective of this paper is to identify the estate duty risks associated with retaining control over trust assets. It was concluded that trust assets are only at risk of being included as deemed property in the estate of a deceased person where such person had, immediately prior to death, the legal competence to dispose of such property for the benefit of himself or his estate and that the conduct of the planner was not a relevant consideration in determining whether trust assets could be deemed property. However, the conduct of the estate planner with respect to trust assets could potentially lead to the inclusion of the property as actual property in his estate, particularly in circumstances where the trust was his *alter ego* and trust property was treated as his own.

ABBREVIATIONS

SARS	South African Revenue Service
SCA	Supreme Court of Appeal
CGT	Capital Gains Tax
DTC	Davis Tax Committee
GAAR	General Anti-Avoidance Regulations

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CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

South Africa's current Estate Duty Act 45 of 1955 came into effect on 1 April 1955 when it replaced the Death Duties Act of 1922. In terms of section 2 read together with the First Schedule to the Act, estate duty is levied at a rate of 20% of the dutiable amount of the estate of every person who dies. A person who was ordinarily resident in South Africa at the time of his death is generally liable for estate duty on all his property, irrespective of where in the world such property is situated. A person who was not ordinarily resident in South Africa at the time of his death is generally only liable for estate duty on South African property (section 3(2)).

Roeleveld (2012) states that South Africa is one of only a small number of countries that levies both estate duty and capital gains tax (CGT) upon the death of a person and advocates that one of these two taxes should be abolished. However, the Davis Tax Committee (DTC, 2015), tasked by the Minister of Finance to, *inter alia*, enquire into "the role and continued relevance of estate duty to support a more equitable and progressive tax system" (p. 5), contends that CGT is a tax on capital income whereas estate duty is a wealth tax. The DTC (2015) further argues that due to the large disparity of wealth in South Africa, it could not justify the abolishment of estate duty as it is, along with donations tax, the only direct wealth tax in South Africa.

The tax base on which estate duty is imposed, referred to as the dutiable amount, is determined by including the deceased's property, which consists of both the deceased's actual property as well as certain property deemed to be the property of the deceased (section 3(1)). The dutiable amount is reduced by the allowable deductions in section 4 and an abatement of R3.5 million (section 4A). Estate duty is therefore only levied on estates larger than R3.5 million. From 1 January 2010, the unused portion of a predeceased spouse's abatement may be used upon the death of the surviving spouse (section 4A(2)). High inflation coupled with a lack of any upward adjustment of the abatement in almost nine years, has likely placed an increased number of estates in the potential ambit of the Act.

Despite the fiscal drag created by the absence of a recent increase to the abatement, the contribution of estate duty to the fiscus has declined over the last 20 years in real terms and constitutes only 0.1% of total tax collections (DTC, 2015). One of the reasons for the decline

could be that individuals often engage in specific arrangements in order to minimise their liability for estate duty.

The most popular method employed to minimise a person's liability for estate duty is to surrender assets, particularly assets that are likely to increase in value, to an *inter vivos* trust during a person's lifetime (De Swardt, 2015; Davis, Beneke & Jooste, 2015). The apparent abuse of trusts to minimise liability for taxes featured in the Minister of Finance's annual Budget Speech (2013). The 2013 Budget Review announced government's intention to introduce legislative interventions to curb the use of trusts to avoid tax and estate duty (National Treasury, 2013). The DTC (2015) has made a number of recommendations on how extant tax legislation pertaining to trusts should be amended and have stated that "[t]axpayers must be allowed to make use of trusts when it makes sound sense to do so in the pursuit of a commercial benefit, as opposed to an estate duty benefit" (p. 7).

Sevenster (2014) warns estate planners that a key aspect of using a trust for estate duty is that the estate planner must relinquish control over trust assets. Retaining control over trust assets could result in the trust being "declared a sham or its assets exposed to attachment" as was the case in *Jordaan v Jordaan* (2001), *Badenhorst v Badenhorst* (2006).

In addition, the Act contains a provision that deems property to be included in the estate of the deceased if "the deceased was immediately prior to his death competent to dispose of the property for his own benefit or for the benefit of his estate (section 3(3)(d)). Van den Berg is of the opinion that many trusts are not properly structured or managed and are at risk of falling within the ambit of section 3(3)(d) (personal communication, July 7, 2014).

Interestingly, the DTC (2015) makes no mention of either the "sham trust" principle or section 3(3)(d) as a remedy against estate duty avoidance. According to the DTC (2015), the only possibilities for the South African Revenue Service (SARS) to contest an estate duty avoidance arrangement are either the application of the general anti-avoidance regulations (GAAR) contained in section 80 of the Income Tax Act or the application of the principle in *Commissioner for South African Revenue Service v NWK Ltd* (2010) where it was held that where transactions are simulated, regard must be given to the true substance of the transaction.

The DTC (2015) is of the opinion that the GAAR contained within the Income Tax Act or GAAR introduced for estate duty would be ineffective if a challenge proceeds to court due to the

absence of evidence as a result of the estate planner's death. In addition, the resultant uncertainty created by the introduction of GAAR would hamper sensible estate planning and result in "wasteful proliferation of legislation" (p.36). On the second possibility, that is, the simulated transaction argument, the DTC (2015) feels that SARS has a minimal chance of being successful due to recent judgments clarifying the principles established in *Commissioner for South African Revenue Service v NWK Ltd (2010)*.

The DTC (2015) suggests that existing loopholes in the estate duty system can be closed by amending income tax legislation pertaining to trusts. In particular, it is proposed that the so-called attribution provisions in section 7 and 25B of the Income Tax Act be repealed insofar it applies to South African resident trusts. The attribution provisions presently allow trusts to attribute trust income to beneficiaries and donors, thereby decreasing the tax levied on such income. Repealing these provisions will therefore result in increased income tax and will presumably discourage the use of trusts, the most popular estate duty avoidance tool.

In addition, the DTC (2015) suggests that the enforcement of the current estate regime could be improved if the revenue authority through employment and training of specialist estate duty assessors.

1.2 PROBLEM STATEMENT AND RESEARCH QUESTION

Individuals often engage in estate planning to ensure that beneficiaries derive the maximum benefit from their estates. The estate planning process often includes, *inter alia*, minimising the liability for estate duty and other taxes. Most modern estate plans involve surrendering the estate planner's assets to a trust (Davis et al, 2015)

Individuals using trusts to diminish their liability for estate duty have come under scrutiny from government and the DTC has proposed legislative interventions to discourage the use of trusts to avoid or reduce estate duty. The DTC has also suggested that the enforcement of the current estate duty system could be significantly improved by employing and training estate duty experts.

The problem addressed by this paper is that individuals who use trusts for estate planning purposes could possibly fail to adequately relinquish control over property surrendered to the

trust, which could result in trust property being included in the estates of such individuals, either as actual or deemed property, resulting in the imposition of estate duty on such property.

The research question that this paper aims to answer is what are the estate duty risks associated with retaining control over trust assets?

1.3 RESEARCH OBJECTIVES

In order to answer this research question, the following research objectives have been formulated:

- to evaluate how trusts are used for estate planning and to evaluate the potential impact of the DTC proposals on estate plans using trusts
- to evaluate the risk of SARS including trust property as deemed property in the estate of a deceased person.
- to evaluate the risk of the South African Revenue Service including trust property as actual property in the estate of a deceased person

1.4 RESEARCH METHOD

A qualitative research approach will be followed to accomplish the proposed research objectives. The research can be described as a conceptual study as it fully relies on a comprehensive literature review of secondary sources to produce findings that will contribute to the existing body of literature on the topic (Creswell et al., 2013). Inductive reasoning will be followed to draw conclusions from the existing body of literature on the topic.

1.5 OVERVIEW OF CHAPTERS

Chapter 1: Introduction and background, problem statement, research question, research objective and research method

This section states the purpose of the study and introduces the problem. It also presents the research objectives and methodology.

Chapter 2 (article): An analysis of the risks associated with estate duty in retaining control over trust assets

This chapter (article) analyse the risks associated with estate duty in retaining control over trust assets.

Chapter 3: Conclusion

This chapter summarises the findings of the study and addresses the research question formulated in chapter 1.

CHAPTER 2: RESEARCH ARTICLE

AN ANALYSIS OF THE RISKS ASSOCIATED WITH ESTATE DUTY IN RETAINING CONTROL OVER TRUST ASSETS

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Herman van Dyk is a Senior Lecturer and the Programme Leader in the Programme for Taxation at the Potchefstroom Campus of the North-West University in South Africa. He is a qualified Associate Chartered Accountant (England & Wales) and Chartered Accountant (South Africa).

ABSTRACT

The use of trusts to minimise estate duty and other taxes has recently come under scrutiny from government. The DTC has proposed amendments to income tax legislation to serve as a deterrent against using trusts to avoid estate duty. Such amendments will, however, only discourage the use of trusts if the trust assets generate a significant amount of income and the donor of the assets or the beneficiaries of the trust have little or no other taxable income.

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2.1 INTRODUCTION

South Africa's current Estate Duty Act¹ 45 of 1955 came into effect on 1 April 1955 when it replaced the Death Duties Act of 1922. In terms section 2 read together with the First Schedule to the Act, estate duty is levied at a rate of 20% of the dutiable amount of the estate of every person who dies. A person who was ordinarily resident² in South Africa at the time of his death is generally liable for estate duty on all his property, irrespective of where in the world such property is situated. A person who was not ordinarily resident in South Africa at the time of his death is generally only liable for estate duty on South African property (section 3(2)).

Roeleveld (2012) states that South Africa is one of only a small number of countries that levies both estate duty and capital gains tax (CGT) upon the death of a person and advocates that one of these two taxes should be abolished. However, the Davis Tax Committee (DTC, 2015), tasked by the Minister of Finance to, *inter alia*, enquire into "the role and continued relevance of estate duty to support a more equitable and progressive tax system" (p. 5), contends that CGT is a tax on capital income whereas estate duty is a wealth tax. The DTC (2015) further argues that due to the large disparity³ of wealth in South Africa, it could not justify the abolishment of estate duty as it is, along with donations tax, the only direct wealth tax in South Africa.

The tax base on which estate duty is imposed, referred to as the dutiable amount, is determined by including the deceased's property, which consists of both the deceased's actual property as well as certain property deemed to be the property of the deceased (section 3(1)). The dutiable amount is reduced by the allowable deductions in section 4 and an abatement of R3.5 million (section 4A). Estate duty is therefore only levied on estates larger than R3.5 million. From 1 January 2010, the unused portion of a predeceased spouse's abatement may be used upon the death of the surviving spouse (section 4A(2)). High inflation⁴ coupled with a lack of any

¹ References to the "Act" or "section" in this paper refer to the provisions of the Estate Duty Act 45 of 1955.

² The concept "ordinarily resident" is not defined in the Act. In *Cohen v CIR* (1946), an income tax case dealing with the interpretation of this term, it was held that a person is ordinarily resident in "the country to which he would naturally and as a matter of course return from his wanderings, as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home".

³ The South African Gini coefficient based on income per capita including salaries, wages and social grants was 0.69 in 2011 (Statistics South Africa, 2014).

⁴ Shortly after the last increase in the abatement, the South African Consumer Price Index was 11.5% during 2008 (Statistics South Africa, 2015).

upward adjustment of the abatement in almost nine years⁵, has likely placed an increased number of estates in the potential ambit of the Act.

Despite the fiscal drag created by the absence of a recent increase to the abatement, the contribution of estate duty to the fiscus has declined over the last 20 years in real terms and constitutes only 0.1% of total tax collections (DTC, 2015). One of the reasons for the decline could be that individuals often engage in specific arrangements in order to minimise their liability for estate duty.

The most popular method employed to minimise a person's liability for estate duty is to surrender assets, particularly assets that are likely to increase in value, to an *inter vivos* trust during a person's lifetime (De Swardt, 2015; Davis, Beneke & Jooste, 2015). The apparent abuse of trusts to minimise liability for taxes featured in the Minister of Finance's annual Budget Speech (2013). The 2013 Budget Review announced government's intention to introduce legislative interventions to curb the use of trusts to avoid tax and estate duty (National Treasury, 2013). The DTC (2015) has made a number of recommendations on how extant tax legislation pertaining to trusts should be amended and have stated that "[t]axpayers must be allowed to make use of trusts when it makes sound sense to do so in the pursuit of a commercial benefit, as opposed to an estate duty benefit" (p. 7).

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⁵ The last adjustment of the abatement to R3.5 million became effective on 1 March 2007.

arrangement are either the application of the general anti-avoidance regulations (GAAR) contained in section 80 of the Income Tax Act or the application of the principle in *Commissioner for South African Revenue Service v NWK Ltd (2010)* where it was held that where transactions are simulated, regard must be given to the true substance of the transaction.

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The DTC (2015) suggests that existing loopholes in the estate duty system can be closed by amending income tax legislation pertaining to trusts. In particular, it is proposed that the so-called attribution provisions in section 7 and 25B of the Income Tax Act be repealed insofar it applies to South African resident trusts. The attribution provisions presently allow trusts to attribute trust income to beneficiaries and donors, thereby decreasing⁸ the tax levied on such income. Repealing these provisions will therefore result in increased income tax and will presumably discourage the use of trusts, the most popular estate duty avoidance tool.

In addition, the DTC (2015) suggests that the enforcement of the current estate regime could be improved if the revenue authority through employment and training of specialist estate duty assessors.

⁶ Certainty is one of the four maxims of a tax system advocated by Smith (1776/1892) along with equity, convenience and economic efficiency. According to Smith, a substantial degree of inequity could be tolerated before a tax system contains a minor degree of uncertainty.

⁷ *Roschcon (Pty) Ltd v Anchor Auto Body Builders CC and Others (2014)* and *Bosch and Another v Commissioner of the South African Revenue Services (2012)*.

⁸ Trusts are currently taxed at a flat rate of 41% whereas individuals are taxed on a progressive sliding scale of 18% to 41%. Trusts are also not entitled to the primary, secondary and tertiary tax rebates applicable to individuals (section 6 of the Income Tax Act).

2.2 PROBLEM STATEMENT, RESEARCH QUESTION AND OBJECTIVES

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2.3 USE OF TRUSTS FOR ESTATE PLANNING AND IMPACT OF DTC PROPOSALS

Meyerowitz (1965) is often cited when the concept of “estate planning” is explained (for example, by Davis et al, 2015 and Olivier, Strydom and Van den Berg, 2006):

The arrangement, management and securement and disposition of a person's estate so that he, his family and other beneficiaries may enjoy and continue to enjoy the maximum from his estate and his assets during his lifetime and after his death, no matter when death may occur.

It is evident that this definition does not refer to the minimisation of estate duty or other taxes and Davis et al. (2015) states that the diminishing taxes and duty payable is not the sole or main concern of estate planning. However, as up to a fifth of an estate may end up in the hands of the tax collector, it is submitted that minimising the estate's liability for estate duty will certainly increase the estate available for the enjoyment of the beneficiaries and will therefore be viewed as a key objective of estate planning for purposes of this paper.

As noted by Davis et al. (2015) above, the use of a trust is a common feature of most estate plans. Olivier et al. (2006) attributes this to the flexibility associated with using a trust.

Estate planners who hold assets that are likely to experience significant growth in value during the estate planner's lifetime, are often advised to dispose of such assets to an *inter vivos* discretionary trust (De Swardt, 2015). Such disposal has to involve *quid pro quo*, as an outright donation of the assets to the trust would attract donations tax at a rate of 20%⁹ which would defeat the purpose of the disposal. Since newly-formed trusts would ordinarily not have the funds to purchase the assets from the estate planner, the sales consideration is often left outstanding on an interest-free loan account repayable on demand (Davis et al., 2015). This enables the estate planner to freeze the value of the growth asset in his estate, since such asset is exchanged for a loan account that will not increase in value. Indeed, the value of the loan account may decrease if the trust makes repayments on the loan.

2.3.1 Hypothetical example of using a trust to save estate duty

This elementary example presumes that an individual, who was ordinarily resident in South Africa during his entire lifetime and is unmarried, purchased 10 class A shares in Berkshire Hathaway Incorporated¹⁰ on 1 December 1995. The closing share price on that date was \$31 700 (Yahoo Finance, 2015) and the South African Rand/US Dollar exchange rate was R3.66:\$1 on that date (XE, 2015), resulting in a cost of R1 160 220 for the taxpayer. The

⁹ Imposed in terms of section 54 of the Income Tax Act (58 of 1962).

¹⁰ Berkshire Hathaway Incorporated is a holding company based in the United States of America and headed by Warren Buffet. This share was selected for the hypothetical example since it has historically experienced significant growth in value.

individual wishes that one relative should inherit this asset upon his death. Assume that the individual dies on 1 December 2015, twenty years after purchasing the share. On this date, the closing share price had increased to \$204 945 per share (Yahoo Finance, 2015) and the prevailing South African Rand/US Dollar exchange rate was R14.43:\$1 (XE, 2015). The value of the shareholding on date of the individual's death is therefore R29 573 564.

Had the individual retained ownership of the shares in his own name and not transferred the shareholding to a trust, his liability for estate duty would be R5 194 713 if assumed that his estate had allowable deductions in terms of section 4 to the amount of R100 000. Refer to table 1.

Had the individual transferred ownership of the shares to an *inter vivos* discretionary trust on the date of original purchase for a consideration equal to the market value of R1 160 220 and the trust had made no repayments on the loan, his liability for estate duty would be R nil. Refer to table 2.

Table 1: Estate duty calculation if individual retained ownership of shares in his own name

	Rand
Property included in estate: shares at date of death (section 3)	29 573 564
Less: allowable deductions (section 4)	(100 000)
Less: abatement (section 4A)	(3 500 000)
Dutiable amount	25 973 564
ESTATE DUTY	5 194 713

Table 2: Estate duty calculation if individual had transferred shares to trust on date of acquisition

	Rand
Property included in estate: loan receivable (section 3)	1 160 220
Less: allowable deductions (section 4)	(100 000)
Less: abatement (section 4A)	(3 500 000)
Dutiable amount (limited to nil)	Nil
ESTATE DUTY	Nil

In the first scenario, where the individual retained ownership of the shares in his own name, there would also be a liability for capital gains tax of R3 838 315. Refer to table 3.

If the shares had been transferred to trust on the date of original purchase, there would be no immediate capital gains tax consequences since the individual did not own the shares on the date of his death.

Table 3: Capital gains tax calculation if individual retained ownership of shares in his own name

	Rand
Proceeds on deemed disposal of shares ¹¹	29 573 564
Less: base cost ¹²	1 160 220
Capital gain	28 413 344
Less: annual exclusion in year of death	(300 000)
x 33.3% inclusion rate for individuals	9 361 744
INCOME TAX ON GAIN¹³	3 838 315

2.3.2 Potential impact of DTC proposals on estate plans using trusts

In order to address the use of trusts to minimise estate duty, the DTC (2015) has recommended that sections 25B and 7 of the Income Tax Act be repealed insofar it applies to South African resident trusts.

Concisely, section 25B codifies the so-called “conduit principle” and provides that if a beneficiary has or obtains¹⁴ a vested right to trust income, the beneficiary is subject to income tax on such income. If no beneficiary has a vested right to income, the trust is subject to income tax on such income. Section 25B is subject to section 7.

¹¹ The individual is deemed to have disposed of the shares at its market value at the date of his death (paragraph 40 of the Eighth Schedule to the Income Tax Act).

¹² The acquisition cost of the shares is deductible as base cost in terms of paragraph 20 of the Eighth Schedule to the Income Tax Act.

¹³ If assumed that the taxpayer falls within the highest marginal tax bracket of 41%.

¹⁴ A vested right may be obtained by way of exercise of the trustees’ discretion (section 25B(2) of the Income Tax Act).

Section 7 was originally intended as an anti-avoidance provision against arrangements in terms of which a taxpayer divested himself of an income-producing asset by way of a donation or similar disposal and effectively diverted his income to another party (*Ovenstone v Secretary for Inland Revenue, 1980*). The other party is often an *inter vivos* trust. Interest-free or low-interest loans also fall within the ambit of section 7 since the interest not charged is considered “gratuitous” and therefore a donation resulting in the partial application of section 7 (*Commissioner for the South African Revenue Service v Woulidge, 2000*). Furthermore, section 7 only applies in specific circumstances such as income diverted to minor children as a result of a donation (section 7(3)), income not vested in a beneficiary due to the donation being subject to a stipulation or condition (section 7(5)) and revocable donations (section 7(6)).

However, since trusts are now taxed at the highest rate of all taxpayers in South Africa, section 7 is no longer an anti-avoidance provision, but serves as a “concession for high net worth individuals” (DTC, 2015, p. 38). For example, an estate planner who has donated an income-earning asset to a trust can make use of section 7(5) to ensure that the income earned is attributed to him by imposing a condition that income does not yet vest in the beneficiaries of the trust. The income will consequently be taxed in the hands of the estate planner on a sliding scale that ranges from 18% to 41% whereas the income would have been taxed at a flat rate of 41% in the hands of the trust.

The repeal of section 25B will effectively eliminate the conduit principle and will result in all trust income being taxed at trust level, irrespective of whether such income has vested in beneficiaries. The repeal of section 7 will take away the possibility to divert trust income to the donor of the asset that generated the income and will similarly result in trust income being taxed at trust level at a flat rate of 41%.

Since sections 25B and 7 only apply to income¹⁵, the impact of their proposed repeal would depend on the type of income generated by the trust assets. If the trust assets are growth assets held for capital appreciation rather than to generate an income stream, such as vacant land or the Berkshire Hathaway¹⁶ shares used in the earlier hypothetical example, the repeal

¹⁵ The DTC’s recommendations did not include repealing the conduit provisions and attribution rules applicable to taxes on capital gains contained within paragraphs 80 and 68 to 72 of the Eighth Schedule to the Income Tax Act, respectively.

¹⁶ Berkshire Hathaway does not pay dividends, but rather reinvests earnings to generate further growth.

would have no impact and would not dissuade estate planners from using trusts to minimise their liability for estate duty.

Similarly, if the trust assets generate income that is not subject to tax, such as dividends generated by South African shares¹⁷ or foreign shares listed¹⁸ in South Africa, the repeal of section 25B and 7 would have no impact on the particular estate plans.

The proposed repeal of sections 25B and 7 would arguably only serve as a deterrent where the trust assets generate a significant amount of income and the donor of the assets or the beneficiaries of the trust have little¹⁹ or no other taxable income.

2.4 RISK OF INCLUSION OF TRUST PROPERTY AS DEEMED PROPERTY IN THE ESTATE OF A DECEASED PERSON

Davis et al. (2015) states that the most significant hindrance to successful estate planning is often the estate planner's need to retain control over assets that have been surrendered to a trust.

Failure to adequately relinquish control over trust assets could result in the deeming provision contained within section 3(3)(d) to be invoked. This section provides as follows:

Property which is deemed to be property of the deceased includes property (being property not otherwise chargeable under this Act or the full value of which is not otherwise required to be taken into account in the determination of the dutiable amount of the estate) of which the deceased was immediately prior to his death competent to dispose for his own benefit or for the benefit of his estate.

Davis et al. (2015) emphasises that South African courts have not yet provided a conclusive interpretation of section 3(3)(d). The predecessor provision to section 3(3)(d), that is, section 3(3)(a) of the now repealed Death Duties Act 29 of 1922, was however considered in *Creighton Trust v Commissioner for Inland Revenue (CIR) (1955)*. This judgment will be briefly considered below.

¹⁷ Dividends received from South African shares are exempt from normal tax in terms of section 10(1)(k) of the Income Tax Act.

¹⁸ Dividends received from foreign shares listed in South Africa are exempt from normal tax in terms of section 10B(2) of the Income Tax Act.

¹⁹ Taxable income above R701 300 (USD 48 600) is subject to personal income tax at 41%, the same rate applicable to trusts.

Section 3(3)(d) contains two essential requirements that have to be present before it can be invoked. Firstly, the deceased had to be competent to dispose of the property immediately prior to his death (competence requirement). Secondly, such disposal must be for his own benefit or for the benefit of his estate (benefit requirement).

Competence requirement

The Act does provide some further interpretation of this competence requirement. The concept “competent to dispose” is explained in section 3(5)(b) and (c) which provides as follows:

- (b) a person shall be deemed to have been competent to dispose of any property—
 - (i) if he had such power as would have enabled him, if he were *sui juris*, to appropriate or dispose of such property as he saw fit whether exercisable by will, power of appointment or in any other manner;
 - (ii) if under any deed of donation, settlement, trust or other disposition made by him he retained the power to revoke or vary the provisions thereof relating to such property;

- (c) the power to appropriate, dispose, revoke or vary contemplated in paragraph (b) shall be deemed to exist if the deceased could have obtained such power directly or indirectly by the exercise, either with or without notice, of power exercisable by him or with his consent;

Therefore, if the deceased had the legal competence to appropriate or dispose of trust property or if he had, in terms of the trust deed, retained the power to revoke or vary the provisions relating to the trust property, the competence requirement of section 3(3)(d) would be satisfied. The competence requirement is satisfied irrespective of whether the competence was exercised or whether the estate planner was aware that he possessed the competence (Olivier et al, 2006).

Benefit requirement

Although it is seemingly easy to satisfy the competence requirement, it must be emphasised that the competence requirement is qualified by the benefit requirement. Both requirements must be fulfilled before the provision can be invoked.

Although section 3(5) provides further clarification of the competence requirement, the Act does not interpret “for his own benefit or for the benefit of his estate” and, as noted earlier, there is no clear judicial interpretation of the provision. Section 3(3)(a) of the Death Duties Act, the precursor to the Estate Duty Act, contained a provision very similar to section 3(3)(d):

Any such property shall be deemed to be property passing on the death of any person if such person, notwithstanding that at the date of his death such property may have been held by or registered in the name of some other person (whether in the name of an individual or a body corporate or un-incorporate) directly or indirectly and for **his own benefit** had the **control** order, or **disposition** of the property, or the profits derivable therefrom (own emphasis).

In *Creighton Trust v CIR (1955)*, the donor had transferred movable assets to a trust established by him. The trust deed provided that trust income earned during the lifetime of the donor be paid to the donor. Upon the death of the donor, the remaining trust capital must be paid to a specific beneficiary, the clergy in the Diocese of Carlisle, England or other beneficiaries nominated by the donor, other than himself (clause 4). The trust deed reserved the donor’s right to appoint or substitute trustees during his lifetime (clause 5) and written approval from the donor was required before trustees could make investments (clause 3). In addition, the trust deed provided that the trustees could amend the trust deed with the donor’s consent, but could not be so amended as to enable the trustees to pay any of the trust capital back to the donor (clause 9).

The donor died 30 months after establishing the trust. The Commissioner for Inland Revenue argued that the donor did not divest himself of the trust property and that the trustees primarily held the assets for the donor’s benefit and subject to his control and such assets was therefore subject to duty by virtue of section 3(3)(a). The Commissioner’s argument was based on the fact

that the legal relationship created by the parties was no more than a *stipulatio alteri*²⁰ and that there could be no *vinculum juris* between the parties until acceptance by the beneficiaries. In addition, the donor had the power of unilateral revocation of the trust and therefore had the control and disposition of the trust property for his own benefit.

The court held that the beneficiaries acquired no vested rights in the property until after the death of the donor, referring to clause 4 of the trust deed. The requirement for trustees to obtain written consent before making investments (in clause 3) and the reservation of the donor's right to appoint or substitute trustees, resulted in the donor "virtually remain[ing] in full control of the property". The court concluded that the donor "had for his own benefit the control, order or disposition of the property" as contemplated in section 3(3)(a) of the Death Duties Act.

However, Davis et al. (2015) notes that despite the notoriety of section 3(3)(d), the authors have never witnessed its application. Olivier et al. (2006) is of the opinion that unwarranted emphasis is often placed on the concept of control, because control alone, without the benefit requirement, is not sufficient to invoke section 3(3)(d). An estate plan using a trust can only be at risk of falling foul to this provision if the estate planner is or can be a beneficiary of the trust (Olivier et al., 2006).

For example, an estate plan in terms of which the planner establishes a trust with three trustees, he himself being one and decisions are taken on a majority vote would not be at risk of section 3(3)(d), despite the fact that the estate planner appointed the other two trustees ensuring that they are agreeable to his wishes (Davis et al., 2015). Even though one could argue that the estate planner has *de facto* control, he has no legal competence to dispose of the property.

Another example where the estate planner could retain considerable influence is where he has the power to veto decisions of the other trustees. Both Olivier et al. (2006) and Davis et al. (2015) agree that the mere holding of this power is not sufficient to result in the application of section 3(3)(d).

Even if the trust established by the planner is a so-called "dog collar trust" where the planner retains the power to appoint and remove other trustees, this fact on its own would not invoke

²⁰ Refer to *Commissioner for Inland Revenue v Estate Crewe (1943)* where it was held that a trust is a contract akin to a contract for the benefit of a third party.

section 3(3)(d), because the trustees are not by law compelled to abide by the planner's wishes (Davis et al., 2016).

In conclusion, estate planners are often warned that treating trust property as their own and operating beyond their powers in the trust deed could result in the application of section 3(3)(d). However, it is evident that this provision does not apply to the actions of the estate planner, but rather to his *sui juris*, or legal competence. An estate plan using a trust is only at risk of falling foul to section 3(3)(d) if both the competence and benefit requirements have been met. Estate planners must therefore ensure that the trust deed do not confer upon them the legal competence to dispose of trust property for their own benefit or for the benefit of their estates. Davis et al. (2015) advises the inclusion of a proviso in the trust deed, which closely follows the wording of section 3(3)(d), that prevents the planner from benefitting himself or his estate.

2.5 RISK OF INCLUSION OF TRUST PROPERTY AS ACTUAL PROPERTY IN THE ESTATE OF A DECEASED PERSON

It was concluded in the previous section that the circumstances in which the revenue authority can include trust property in the estate of a deceased person as "deemed property" are relatively limited. The person must have possessed or retained legal competence to dispose of trust property for the benefit of himself or his estate. If he had not possessed or retained such competence, section 3(3)(d) cannot be invoked merely based on the conduct of the person with respect to the trust assets.

However, there have been other cases, unrelated to tax or estate duty, where the courts have disregarded the existence of trusts due to the actions of the estate planner with respect to trust assets. As a result, the court permitted the attachment of such assets as if it were the personal assets of the estate planner. Two such notable cases are discussed below:

Jordaan case

In *Jordaan v Jordaan (2001)*, a divorce case, the court had to decide whether assets that had been duly transferred to five trusts by the defendant (husband) could form part of the redistribution order in terms of section 7(3) of the Divorce Act 70 of 1979.

The defendant had established one trust with the specific aim of hiding assets from the plaintiff (wife) and to frustrate any potential claim that she may have. The court held that the trust was a fraudulent scheme to swindle the plaintiff and held that its assets must form part of the redistribution order.

The second trust was governed by a so-called “letter of wishes” which expressed the defendant’s want for the trustees to take account of his preferences with regard to the distribution of trust income and assets. Although the trustees, who were nominal trustees from a trust company, was not legally compelled to abide by the defendant’s wishes, the court held that the nominal trustees would hardly disregard the wishes of the defendant. The court consequently held that it was appropriate to also include the assets of the second trust when determining the personal asset value of the defendant for purposes of the redistribution order.

The third trust had a relatively small asset holding, but earned significant income. The court observed that the activities of the trust and the defendant were very closely linked and cited the fact that the trust owed a debt to the defendant’s child who needed financial support for her sport activities. The defendant had apparently remarked that he would remit the amount to his daughter if she treated him with the due respect. This example was intended to indicate the defendant’s absolute control over the activities and property of the trust.

The fourth and fifth trusts were also effectively controlled by the defendant. The defendant made decisions with respect to trust property on his own without consulting the other trustees. Vast amounts of money had flowed between the defendant and the various trusts without any formal decision by the trustees. No records of any resolutions were retained.

The Cape Provincial Division held that the trust was the *alter ego* of the defendant and that he regarded the trusts as a means whereby he could gain a financial advantage for himself, despite the fact that his powers were subject to the provisions of the trust deeds and legislation²¹. It was accordingly held that it was just and equitable to take the trust assets into account when deciding the scope of the redistribution order.

²¹ Most notably the Trust Property Control Act 57 of 1988.

Badenhorst case

The judgment in the Jordaan case was confirmed by the Supreme Court of Appeal (SCA²²) in *Badenhorst v Badenhorst* (2006), another case involving a redistribution order in terms of the Divorce Act. The court held that “[t]o succeed in a claim that trust assets be included in the estate of one of the parties to a marriage there needs to be evidence that such party controlled the trust and but for the trust would have acquired and owned the assets in his own name”. The court further held that *de facto* control is sufficient for such a claim to succeed and the control need not be *de iure*. The court found that the conduct of the affairs of the respondent (husband) indicated that he was in full control of the trust. He rarely consulted or obtained approval from his co-trustee and observed little consideration to the difference between trust assets and his own assets. For example, the respondent listed trust assets as his own when applying for credit and ascribed trust income and liabilities as his. He also insured trust property in his own name. The court held that the evidence showed that, but for the trust, ownership of all trust assets would have vested in the respondent and consequently, must be added to the respondent’s estate for purposes of the redistribution order.

Applicability to estate duty

The provisions of the Divorce Act give wide discretion to the court in deciding the scope of the distribution order. The court may order one party to transfer assets to another party “as the court may deem just” (section 7(3)). In determining the redistribution order, the court can also take into account “any other factor which should in the opinion of the court be taken into account (section 7(5)(d)). This scope is evidently wider than section 3(2) of the Estate Duty Act which states that property “means any right in or to property, movable or immovable, corporeal or incorporeal”. It remains questionable whether the conduct of a taxpayer with respect to trust property, specifically where he treated such property as his own or the trust as his *alter ego*, can result in such property being regarded as “property” as contemplated in section 3(2) without invoking the simulation doctrine.

²² The SCA is the second highest court in South Africa after the Constitutional Court. Decisions of the SCA are binding on lower courts.

Simulation

In *Commissioner for the South African Revenue Service v NWK Ltd (2010)*, the SCA handed down judgment in respect of a transaction that contained a number of illusory elements with no commercial purpose that was merely included to increase the taxpayer's interest deductions against its taxable income. The SCA held that the transaction was designed to hide the real agreement between the parties:

[T]he test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.

The SCA's judgment in the NWK case was subsequently clarified in the same court's judgment in the case of *Roshcon (Pty) Limited v Anchor Auto Body Builders CC and Others (2014)*. In the latter case, it was held that a simulated transaction is one that deliberately conceals its true nature and contains dishonest elements but is not simulated simply because it is designed to avoid tax or a peremptory law.

In *Commissioner for the South African Revenue Service v Bosch (2014)*, the SCA confirmed the principle that "there is nothing impermissible about arranging one's affairs so as to minimise one's tax liability, in other words, in tax avoidance" and also held that "simulation is a question of the genuineness of the transaction under consideration. If it is genuine then it is not simulated..."

Therefore, it is submitted that an estate planner is free to surrender his assets to a trust for the sole purpose of minimising his liability for estate duty. The simulation doctrine cannot be invoked to prevent him from doing so. However, where an estate planner transfers assets to a trust and meets all the legal requirements of the transfer, but treats trust assets as his own, the

estate planner is at risk of the transaction being perceived by the courts as a transaction that deliberately conceals its true nature and consequently reasoning it to be simulated. This could result in the trust being declared a “sham” and its existence disregarded when the scope of the estate planner’s property is determined for estate duty purposes.

2.6 CONCLUSION

The use of trusts to minimise estate duty and other taxes has recently come under scrutiny from government. The DTC has proposed that the repeal of the conduit and attribution rules in income tax legislation will serve as a deterrent to estate planners who intend to use trusts as an estate duty avoidance tool. This paper observed that the DTC proposals will only discourage the use of trusts if the trust assets generate a significant amount of income and the donor of the assets or the beneficiaries of the trust have little or no other taxable income.

The question that this paper has undertaken to answer what are the estate duty risks associated with retaining control over trust assets? It was observed that trust assets are only at risk of being included as deemed property in the estate of a deceased person where such person had, immediately prior to death, the legal competence to dispose of such property for the benefit of himself or his estate. The conduct or actions of the estate planner with respect to the trust assets are not relevant, but rather his legal capacity to dispose of the property.

However, the conduct of the estate planner with respect to trust assets could potentially lead to the inclusion of the property as actual property in his estate, particularly in circumstances where the trust was his *alter ego* and trust property was treated as his own. The risk of such inclusion increases if it can be proved that the trust arrangement deliberately concealed the true nature of the transaction and, as a result, is regarded as simulated.

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CHAPTER 3: CONCLUSION

3.1 OBJECTIVE OF THIS CHAPTER

The objective of this chapter is to provide a summary of key findings of the study and how these findings address the research questions formulated in Chapter 1.

3.2 RESEARCH FINDINGS

3.2.1 Research objective 1

The first research objective was to evaluate how trusts are used for estate planning and to evaluate the potential impact of the DTC proposals on estate plans. It was found that estate planners who hold assets that are likely to experience significant growth in value during the estate planner's lifetime, dispose of such assets to an *inter vivos* discretionary trust. The sales consideration is left outstanding on an interest-free loan account repayable on demand. The hypothetical example that was used is proof that where a trust is used for estate planning the estate planner might save estate duty. This structure enables the estate planner to freeze the value of the growth assets in his estate.

It was found that the potential impact of the DTC proposals will have no impact on the estate plans where a trust is used to keep growth assets for capital appreciation like the Berkshire Hathaway shares used in the hypothetical example in the article. Since sections 25B and 7 only apply to income, the impact of their proposed repeal would depend on the type of income generated by the trust. The repeal of section 25B and 7 will not stop estate planners to minimise their liability for estate duty.

3.2.2 Research objective 2

The second research objective was to evaluate the risk of SARS including trust property as deemed property in the estate of a deceased person. It was found that if an estate planner retain control over the assets of a trust there is a risk that the property can be included in the estate of the estate planner as deemed property. There is a provision in section 3(3)(d) of the Estate Duty Act that could be invoked if the estate planner retains control over the trust property. For section 3(3)(d) to be invoked, two essential requirements have to be present. The first is that the deceased had to be competent to dispose of the property immediately prior to his

death. The second requirement is that such a disposal must be for his own benefit or for the benefit of his estate.

3.2.3 Research objective 3

The third research objective was to evaluate the risk of SARS including trust property as actual property in the estate of a deceased person. It was found that an estate planner is free to surrender his assets to a trust for the sole purpose of minimising his liability for estate duty. The simulation doctrine cannot be invoked to prevent him from doing so. However, where an estate planner transfers assets to a trusts and meets all the legal requirements of the transfer, but treats trust assets as his own, the estate planner is at risk of the transaction being perceived by the courts as a transaction that deliberately conceals its true nature and consequently reasoning it to be simulated. This could result in the trust being declared a “sham” and its existence disregarded when the scope of the estate planner’s property is determined for estate duty purposes.

3.3 OVERALL CONCLUSION

The use of trusts to minimise estate duty and other taxes has recently come under scrutiny from government. The DTC has proposed that the repeal of the conduit and attribution rules in income tax legislation will serve as a deterrent to estate planners who intend to use trusts as an estate duty avoidance tool. This paper observed that the DTC proposals will only discourage the use of trusts if the trust assets generate a significant amount of income and the donor of the assets or the beneficiaries of the trust have little or no other taxable income.

The question that this paper has undertaken to answer what are the estate duty risks associated with retaining control over trust assets? It was observed that trust assets are only at risk of being included as deemed property in the estate of a deceased person where such person had, immediately prior to death, the legal competence to dispose of such property for the benefit of himself or his estate. The conduct or actions of the estate planner with respect to the trust assets are not relevant, but rather his legal capacity to dispose of the property.

However, the conduct of the estate planner with respect to trust assets could potentially lead to the inclusion of the property as actual property in his estate, particularly in circumstances where the trust was his *alter ego* and trust property was treated as his own. The risk of such inclusion

increases if it can be proved that the trust arrangement deliberately concealed the true nature of the transaction and, as a result, is regarded as simulated.

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