University of the Witwatersrand, Johannesburg

The effectiveness of trusts, including companies within a trust structure, as a tax saving mechanism in relation to investment property

Shanolan Naidoo

Student Number: 2275678

Supervisor: Misha Padia

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Abstract

This report analyses the tax benefits and disadvantages of utilising a trust as an investment vehicle for residential property investment versus purchasing these properties in one's individual capacity. It also assesses if the trust can be utilised as part of a wider structure involving companies to legitimately reduce the effective tax liability of the investor while still being able to extract value from the investment.

The tax consequences of the various investment vehicles (natural person, trust, company) have been assessed in relation to an investment property portfolio. This assessment includes current tax, capital gains tax, estate duty, anti-avoidance provisions (such as section 7C), specific property related legislation (such as sections 13sex), as well as specific scenarios involved in property investment (such as the fact that these will typically generate losses during the initial years of investment).

Based on analysis of the various types of taxes that has been performed, it is clear that there is no standard solution indicating that one investment vehicle is more suitable than any other. The most tax efficient vehicle is dependent on how much the individual earns in a tax year, whether the investment property portfolio is loss or profit making, the intention and business model involved (whether to hold for long term appreciation or to sell), the type of investment property being purchased (such as whether these would qualify for special allowances such as section 13sex), the value of the portfolio involved, whether these would generate capital gains or losses upon sales, etc.

Key words: Trusts, residential property, tax avoidance, South Africa, individual, tax liability, estate duty, rental income, ring-fencing of losses, capital gain, section 13sex, property investment, section 7C

Declaration

I declare that this research is my own unaided work.

It is submitted for the degree of Master of Commerce (specialising in Taxation) in the Faculty of Commerce, Law and Management at the University of the Witwatersrand, Johannesburg.

It has not been previously submitted for any other degree or examination at any other university.

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Shanolan Naidoo

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1. Chapter 1: Introduction and background of trusts

1.1. Introduction

The South African property market is currently experiencing increased demand as a result of pent-up demand as result of lockdowns and a desire for better work-from-home conditions due to the coronavirus, as well as the lowest lending rates in recent history (oobahomeloans, 2020). This increased demand has also led to increased interest in the buy-to-let by individual investors.

> At the launch of the 2019 filing season, SARS publicly stated that “Many taxpayers still do not declare rental income from properties and we will improve our data matching in this regard by collaborating with the Deeds Office” and that “This matching will also allow us to better enforce non-compliance in the declaration of Capital Gains Tax,” (Unicus Tax Specialists SA, 2020).

Further to this, on 11 March 2021, the South African Revenue Services (SARS) issued a further press release re-iterating the need for home-owners earning rental income from letting out their property to declare such income to SARS (South African Revenue Services, 2021).

Due to this growing market and increased focus from SARS, many individual taxpayers are looking to structure their residential property portfolios in a tax efficient manner.

> You can buy property in your own name (personal capacity) or in the name of a trust or a company. A trust is a legal entity that holds assets on behalf of its founder for the benefit of beneficiaries. The founder tasks a trustee or trustees with the management of the trust’s assets for the benefit of one or more beneficiaries (oobahomeloans, 2021).

Residential rental property investment, for the purpose of this report, refers to properties purchased for the purpose of letting out to natural persons for use as their primary place of residence. This research will analyse the various taxes (including current tax, pay as you earn, capital gains tax, estate duty) which residential property investment is subject to and assess the impact of these taxes when taxed directly in the individual’s capacity versus the individual utilising a trust as an investment vehicle. When it comes to VAT input claims, the supply of a "dwelling" is an exempt supply for VAT purposes, so you won't be able to claim input VAT on related costs. (TaxTim,

2021) The research will therefore not address VAT or transfer duty as these do not differ between natural persons and trusts (South African Revenue Services, 2020). This will only be assessed from an individual investor's perspective. The research will only address the residential property market i.e. purchasing property for the purposes of letting to other individuals for use as residence in exchange for a rental fee. The research will also not address the ownership or control aspect of their property, instead only focusing on the tax consequences thereof.

Chapter one of the report will outline the objective of this report and provide a background of trusts, how they originated and how these are typically used. Chapter two will assess the current tax implications of housing a residential rental property investment in a trust versus in the owner's individual capacity. Chapter three will investigate if any tax inefficiencies arise due to the fact that the particular investment being assessed typically generates tax losses in the initial years. Chapter four aims to investigate if recent anti-avoidance provisions introduced reduce tax savings previously achieved by trusts and to what extent. Chapter five will assess the capital gains tax implications of housing a residential rental property investment in a trust versus in the owner's individual capacity. Chapter six will assess the estate duty implications of housing a residential rental property investment in a trust versus in the owner's individual capacity. Chapter seven will investigate if further tax savings can be achieved by introducing a company within the tax structure. All aspects investigated in this report will be summarised and concluded upon in the last chapter, chapter eight.

1.2. Background of trusts

Many people consider trusts to be one of the most innovative legal instruments ever devised. They have a long history of expanding property rights and avoiding onerous state prohibitions and confiscations. A trust is, at its most basic level, a contract or agreement between two people. It describes property or wealth ownership, benefits, and management thereof. (TrustArte, n.d.)

> Most historians agree that the roots of the first concept or 'Trust' came from medieval England. When knights went to war and left their property at the disposal of other persons, it was necessary to implement the will of the initial owner (knight), whilst at the same time enabling the empowered person to manage this property effectively.

> However, the concept of trust is even older and was already present in Roman and Greek law. The Romans used the word Fiducia. The adoption of the trust law in ancient Rome resulted from cases where wealthy Romans trusted their friends to manage their property in favour of the principal's wife and heirs after their death, because under the Roman law, unless the wife was a Roman citizen, she could not inherit by herself. However, former friends broke the promise due the absence of the relevant legislation. (Lexon, n.d.)

Modern trusts are flexible and designed to accommodate the needs of the intended beneficiaries. Some of the main benefits of modern trusts include beneficiary protection, asset protection, assisting disabled beneficiaries, saving tax and family protection. Beneficiary protection aims to protect beneficiaries from their own actions due to immaturity or personal problems. Asset protection safeguards the assets in the trust from third party claims. Trust can also be utilised to assist disabled beneficiaries if they are unable to competently handle money or if receipt of a capital sum would impact their entitlement to benefits. Family protection refers to ensuring that income streams are protected to ensure that children or spouse have the necessary income or assets to meet their requirements. Tax savings primarily relate to savings on estate duty due to the assets of the trust not being aggregated with the founder's assets upon his death, although there are other potential tax savings. (Smithers, 2020)

The major objective for establishing a Trust is to preserve your estate and assets from creditors. A trust can help you secure your family's wealth, for example, by ensuring that your legacy is passed down to subsequent generations. This is especially advantageous in the event of a liquidation, sequestration, or divorce of the corporation. A trust can also be established to provide for dependents or relatives who are unable to care for themselves or manage their own financial matters on their own. An estate plan places your assets under the supervision of a board of trustees, who can act in your place for the benefit of your beneficiaries after you have passed away. (Standard Bank, n.d.)

- Having this in place provides financial protection for your loved ones in the case of your passing (or even absence or incapacity because of illness).
- The establishment of a Trust is particularly vital if you have minor children who will not be in a position to manage inheritances themselves.

- Your grandkids or great-grandchildren can be named as beneficiaries of a trust, which can be established for their benefit as well. (Standard Bank, n.d.)

Trusts are flexible legal constructions or arrangements that are frequently utilized for tax planning objectives, including, for example, to minimize estate duty on appreciating assets when transferring assets to heirs. However, the boundary between lawful tax planning and schemes that are, at the very least from a policy standpoint, regarded inappropriate avoidance arrangements can be quite thin at times, particularly in the case of trusts. Throughout the years, there has been an increase in the number of special anti-avoidance laws that have been implemented in regard to trusts. (Musviba, 2021)

This report will investigate the tax savings benefits of trusts and assess if savings are still prevalent despite the introduction of recent anti-avoidance provisions, such as section 7C of the Income Tax Act.

2. Chapter 2: Current tax consequences of individuals versus trusts

The purpose of this chapter is to analyse current tax consequences of trusts versus individuals.

Taxpayer’s must pay tax on any income received from renting out a property or even subletting a room in a home. This rental income must be declared to SARS, regardless of whether it is the taxpayer’s sole source of income or a supplement to a salary. Residential income includes AirBnB, holiday homes, bed-and-breakfasts, guesthouses, sub-renting part of a house, residential dwellings. (TaxTim, 2021) As previously indicated, this research report focuses on residential dwellings.

How tax is calculated on rental income

Any rental income received should be added to any other taxable income earned. Not only is the monthly rental income taxed, but so is any money received in addition to the monthly rental. A lease premium, for example, is a non-refundable lump sum payment made by the tenant to the owner or rental agent when they sign the tenancy agreement. In this case, the entire amount is taxed in the year it is received or accumulated. (TaxTim, 2021)

A rental deposit, on the other hand, is returned to the tenant at the end of the tenancy, so it is not taxable income and should not be reported on the owner's tax return. It will only become taxable income if the deposit is kept and not returned to the tenant (for example, for repairs). (TaxTim, 2021)

Tax deductions applicable to rental income

Fortunately, expenses can be deducted from taxable rental income while renting out a property, lowering the amount of tax payable. This excludes any capital and/or personal expenses, as these are not allowable deductions by SARS. Wear and tear deductions may apply to capital expenses (i.e. assets acquired for more than R7000). (TaxTim, 2021)

Renting out a home, whether it's a house, apartment, AirBnB, or even a single room, is similar to running a small business. In the Local Rental Income area of the tax return form for individuals, all income and costs must be reported. (TaxTim, 2021)

Costs that are deductible include electricity, rates & taxes, water, levies to the local municipality, AirBnB agent's & rental agent fees, accountant's fee, bond interest (SARS allows only the interest to be deducted against the rental income, not the larger bond/mortgage/capital repayment), advertising costs, insurance (this is for the property itself, not household contents), garden services, security and property levies, wear and tear on furniture and repairs and maintenance. (TaxTim, 2021)

Home improvements and renovations are not tax deductible, so these should not be mistaken with repairs and maintenance. When something is repaired, it is returned to its original (i.e. good) state, such as refurbishing a wooden floor, repainting a wall or ceiling, repairing existing plumbing & electrical wiring, repairing appliances such as a fridge or washing machine, roof repairs, replacing door handles, replacing a window, replacing broken tiles, etc. (TaxTim, 2021)

A home improvement is something done to a property that didn't exist before purchase, or something to extend or improve the life of the property. Home upgrades aren't just a quick repair; they're an investment that will raise the property's revenue earning capability and add value when it's time to sell (e.g. like adding on an additional room). Repairs are less extensive and less expensive than home upgrades. Some instances of home improvements include installing an air conditioning system, installing a security system, installing a swimming pool, adding or extending the property, adding a deck and renovating a bathroom or kitchen. (TaxTim, 2021)

While these improvement expenses cannot be deducted from taxable rental income, they are added to the property's base cost and will lower your Capital Gains Tax when eventually. All documentation and invoices should be maintained to support the increased base cost upon sale. (TaxTim, 2021) Capital Gains Tax is analysed further in chapter 4 of this report.

Assets with a purchase price greater than R7000 are capitalised and depreciated over multiple years, whilst individual products with a purchase price less than R7000 are written-off / expensed in the year of purchase. (TaxTim, 2021) This is consistent with paragraph 4.3.5 of Interpretation Note 47 (Issue 5), Wear-and-Tear or Depreciation Allowance. (South African Revenue Service, 2021)

If the expenses exceed the rental income, the loss should be able to be offset against other sources of income generated by the individual, as long as the loss is not "ring-fenced" under current anti-avoidance measures. (TaxTim, 2021) This is analysed further in chapter 3.1.1 of this report.

> If you buy a property primarily to generate rental income, you may claim all expenses related to the day to day running and maintenance of the property as a tax deduction. Some examples of these tax-deductible expenses are interest paid on the bond; levies, rates and taxes; and repairs. Capital expenses – such as improvements or extensions to the property – may not be deducted against rental income. (Igrow Wealth Investments, n.d.)

2.1. Types of incomes taxes which natural persons are subject to

“Under South African law a resident is defined by the Income Tax Act, 1962, as either an individual who meets the physical presence test or an individual who is ordinarily resident in South Africa under South African common law.” (OECD, n.d.)

“South Africa has a residence-based tax system, which means residents are, subject to certain exclusions, taxed on their worldwide income, irrespective of where their income was earned. By contrast, non-residents are taxed on their income from a South African source.” (South African Revenue Services, 2021)

For current tax purposes, individuals, or natural persons are taxed at the following rates (these are applicable for the 2022 tax year): (South African Revenue Services, 2021)

Taxable income (R)	**Rates of tax (R)**
1 – 216 200	18% of taxable income
216 201 – 337 800	38 916 + 26% of taxable income above 216 200
337 801 – 467 500	70 532 + 31% of taxable income above 337 800
467 501 – 613 600	110 739 + 36% of taxable income above 467 500
613 601 – 782 200	163 335 + 39% of taxable income above 613 600
782 201 – 1 656 600	229 089 + 41% of taxable income above 782 200
1 656 601 and above	587 593 + 45% of taxable income above 1 656 600

Individuals will be subject to the above current tax rates. Collection by SARS of these taxes can take place in various forms, such as PAYE withheld by the employer and paid over to SARS, provisional tax payments made by the taxpayer, of via assessments issued to the taxpayer.

It's also worth noting that if your taxable profit from rental income (rent minus expenses) exceeds R30 000 per year, you may be required to register as a Provisional Taxpayer and pay tax twice a year through the provisional tax system. (TaxTim, 2021)

2.2. Types of income taxes which trusts are subject to

2.2.1. Types of trusts being assessed for the purposes of this report

Trusts in South Africa can be classed in a variety of ways, and these classifications are summarized below. This classification system covers the following classifications:

- An "ownership trust," in which the founder or settlor transfers ownership of assets or property to a trustee or trustees, who are then responsible for holding the assets or property for the benefit of defined or determinable beneficiaries.
- A “bewind trust” is one in which the founder or settlor distributes ownership of assets or property to beneficiaries of the trust while retaining control over those assets or property in the hands of the trustee(s).
- A “curatorship trust is one in which the trustee(s) administers the trust assets for the benefit of a beneficiary who lacks the capacity to do so, such as a curator appointed to oversee the care of a disabled person. (South African Revenue Services, 2021)

Trusts can be described in a variety of ways, including:

- Their formation method:
    - Inter vivos trust is established during the course of a person's life.
    - Testamentary trust is established in accordance with the stipulations of a person's will and takes effect after their death.
- The rights and privileges they provide beneficiaries:
    - Vesting trust – In a vesting trust, the income (both of a revenue and capital nature) and assets of the trust are transferred to the beneficiaries. The trust's income and assets are distributed to the beneficiaries, who have vested rights in them.

- Discretionary trust – As the name implies, a discretionary trust is one where the trustee(s) has the discretion to decide whether and how much of the trust's income and assets, as well as its net trust capital, will be distributed to the beneficiaries. In these circumstances, the beneficiaries' rights to the trust's income, assets, and net trust capital are reliant on the trust's performance. (South African Revenue Services, 2021)

As this research focuses on individual residential property investors seeking the optimal tax structure, this report will only consider discretionary, inter vivos, ownership trusts. The research will also only focus on South African trusts and ignore offshore trusts. The tax rate on the taxable income of a trust other than a special trust is 45%. Trusts do not qualify for the tax rebates applicable to individuals. (PwC, 2020)

2.2.2. Income tax consequences of trusts

In terms of the 'conduit principle', income or capital that is realised inside a trust can 'flow-through', or be distributed to the beneficiaries of the trust, while retaining the nature of the income, resulting in the income or capital being taxed in the hands of the beneficiary and not in the trust (Stiglingh et al. 2016:845). The consequent tax advantage is that the natural person beneficiary qualifies for the limited interest exemption in terms of section 10(1)(i) of the Income Tax Act No. 58 of 1962 (Act) and the annual capital gains tax exclusion. (Brink, 2017).

According to the South African Revenue Services (SARS), individual tax rates for the 2022 tax year range from 18% to 45%, increasing based on the quantum of taxable income. Individuals also benefit from a primary rebate of R15 714, which effectively means that the first R87 300 of their taxable income is tax free. (South African Revenue Services, 2021) For example, if a rental property generated R100 000 of rental profits (assume this amount is taxable) and an individual (assume that this individual is under the age of 65) did not have any other taxable income, should this amount be taxed in the individuals personal capacity, he would only incur a tax liability of R 2 286 ((R 100 000 taxable income * 18% marginal tax rate) less R 15 714 primary rebate. Had this income been taxed in a trust, a tax liability of R 45 000 (R 100 000 taxable income * 45% tax rate) would have been incurred. In the above scenario, it is evident that if an individual is not subject to tax at the highest marginal tax rate for natural persons of 45%, from a tax perspective, it is disadvantageous to house investments in trust structure from a current tax perspective (unless taking advantage of the conduit principle which is discussed further below). If the individual is subject to the highest marginal tax rate of 45%, in the above example, a tax liability of R 45 000 would have been incurred regardless of whether the investment was held by a natural person or trust.

With regards to the 'conduit principle' described above, trustees may take advantage of this and distribute taxable income to beneficiaries which are natural persons and subject to lower marginal tax rate or qualify for exemptions or rebates. Therefore, there is opportunity to significantly reduce the tax liability payable on the income generated by the trust.

2.3. Section 13sex of the Income Tax Act

Section 13sex of the Income Tax Act reads as follows:

> "(1) Subject to section 36, there must be allowed to be deducted from the income of a taxpayer an allowance equal to five per cent of the cost to the taxpayer of any new and unused residential unit (or of any new and unused improvement to a residential unit) owned by the taxpayer if—
>
> > (a) that unit or improvement is used by the taxpayer solely for the purposes of a trade carried on by the taxpayer;
> >
> > (b) that unit is situated within the Republic; and
> >
> > (c) the taxpayer owns at least five residential units within the Republic, which are used by the taxpayer for the purposes of a trade carried on by the taxpayer:
>
> Provided that if a taxpayer completes an improvement as contemplated in section 12N, the expenditure incurred by the taxpayer to complete the improvement shall be deemed to be the cost to the taxpayer of any new and unused residential unit (or of any new and unused improvement to a residential unit), for the purposes of this section.

(2) There shall be allowed to be deducted from the income of the taxpayer an additional allowance of five per cent of the cost of a low-cost residential unit of a taxpayer for a year of assessment if deductions are allowable to that taxpayer in respect of that unit in terms of subsection (1) during that year of assessment.

(3) For the purposes of this section, the cost to the taxpayer of a residential unit (or an improvement thereto) shall be deemed to be the lesser of the actual cost to the taxpayer or the cost which a person would, if that person had acquired or improved the residential unit under a cash transaction concluded at arm's length on the date on which the transaction for the acquisition of the new and unused residential unit (or of the new and unused improvement to the residential unit) was in fact concluded, have incurred in respect of the direct cost of the acquisition or erection of the residential unit or improvement." (South African Revenue Services, 2021)

"(8) For the purposes of this section, to the extent that the taxpayer acquires a residential unit (or improvement to a residential unit) representing only a part of a building without erecting or constructing that unit or improvement—

(a) 55 per cent of the acquisition price, in the case of the unit being acquired; and

(b) 30 per cent of the acquisition price, in the case of the improvement being acquired,

is deemed to be the cost incurred by that taxpayer in respect of that unit or improvement, as the case may be." (South African Revenue Services, 2021)

Under the Income Tax Act, No. 58 of 1962 (the "Act"), certain building allowances are available to both owners and lessees of buildings for erecting buildings or making changes to buildings. The deduction allowed in respect of residential buildings or residential units, previously recognized under section 13ter of the Act but now provided for under section 13sex of the Act, is relevant for the purposes of this report. (Elliot, 2016)

Residential units acquired, or the construction of which began, on or after April 1, 1982, and before October 21, 2008, were covered under Section 13ter of the Act. Section 13ter of the Act established a depreciation schedule that allowed a deduction of 12 percent of the cost of a residential unit in the first year it was let or occupied, followed by a 2 percent deduction for each of the next 44 years. (Elliot, 2016)

The depreciation regime under section 13ter of the Act was replaced by section 13sex of the Act, which applies to any residential unit or improvement to a residential unit acquired on or after October 21, 2008, or the erection of which began on or after October 21, 2008. Section 13sex of the Act now allows for a 5% annual depreciation credit for new and unused residential units or improvements over a 20-year period. (Elliot, 2016)

In order to benefit from the allowances granted under sections 13sex and 13ter of the Act, the taxpayer must own at least five residential units, all of which must be located in South Africa. The residential apartments were required to be utilized by the taxpayer to be let to a tenant for the purpose of obtaining a profit for the taxpayer or to be occupied by a bona genuine full-time employee of the taxpayer under section 13ter of the Act. Section 13sex of the Act, on the other hand, stipulates that the residential units or upgrades be used entirely for the purposes of the taxpayer's business. (Elliot, 2016)

A situation that has arisen in practice is when a taxpayer purchases three residential units between 1 April 1982 and 21 October 2008 (i.e., within the effective dates for the application of section 13ter of the Act), and two additional residential units on or after 21 October 2008 (i.e., within the effective dates for the application of section 13sex of the Act). Clearly, the taxpayer meets the Act's section 13sex requirement of owning at least five residential units. Assuming that the residential units are located in South Africa and are used purely for the purposes of the taxpayer's trade, the taxpayer should be entitled to the 5% depreciation allowance each year for a period of 20 years after the purchase of the fifth residential unit. (Elliot, 2016)

This source suggests that as the first three residential units were bought before the statutory dates for the application of section 13sex of the Act, they will not be counted as part of the five residential units required for section 13sex to apply. (Elliot, 2016)

As a result, the 21st of October 2008 serves as a stringent cut-off date for all residential units purchased prior to that date, disqualifying such residential units from counting toward the Act's five-unit threshold. (Elliot, 2016)

Section 13sex applies to all taxpayers, therefore natural persons, trusts and companies would all qualify for this allowance.

2.4. Section 12J

In terms of section 12J of the Income Tax Act 58 of 1962 (Act), put simply, a person who invests in an approved venture capital company may claim an immediate income tax deduction equal to the amount invested (subject to limitations).

A venture capital company will only be approved as such if, among other requirements, the sole object of the company is the management of investments in companies that are qualifying companies.

A company is not a qualifying company if, among other requirements, it carries on any impermissible trade. Among other things, any trade carried on in respect of immovable property, other than a trade carried on as an hotel keeper is an impermissible trade.

In SARS view, the following are impermissible trades (Draft Guide at page 12):

- Letting of immovable property.
- Refurbishment or development of immovable property.
- Trading in immovable property. (Strauss, 2019)

Despite the above, many venture capital companies have managed to obtained approval in terms of s12J and offer property related investments which would qualify for a 100% deduction. It is also important to note that there will be CGT implications when this investment is sold at a later stage as the base cost of the investment will be reduced by the allowance claimed. (Smith, 2020)

In the 2021 budget speech, Finance minister, Tito Mboweni, confirmed that the section 12J allowance will no longer be applicable after its expiration on 30 June 2021. According to the minister, this is due to the fact that the allowance had not sufficiently achieved its objective of creating jobs, developing small business and creating economic activities, and instead, just provided significant tax deductions to the wealthy. Treasury found that most of the s12J investments were low risk, with guaranteed returns and would attract funding without the allowance. (Wasserman, 2021)

Section 12J makes reference to "taxpayer", therefore natural persons, trusts and companies would all have benefited from this allowance. (South African Revenue Services, 2021)

2.5. Trust versus natural persons in relation to income tax

Based on the facts set out above, the tax liability attributable to the taxable income may increase or decrease depending on how income is distributed in trusts, and the taxable income generated by the individuals in question. Certain aspects of current tax, such as capital gains tax, will be discussed in further detail below.

3. Chapter 3: How do anti-avoidance provisions affect the tax effectiveness of holding a property in a trust?

3.1. Would losses in a trust affect the tax effectiveness of the structure?

The purpose of this chapter is to analyse whether the tax benefit of rental losses would be more effective in a trust structure or an individual capacity.

> The costs associated with property ownership - including the relatively high cost of the interest on the finance used to pay for the property; levies and rates in the case of sectional title property, or rates, insurance and maintenance in the case of freehold property; and management fees paid to managing agents - make the ownership of investment properties for rental purposes an expensive exercise. As a consequence, in the first few years, the investor often finds it necessary to dig into his or her other sources of income to make up the difference between the rental income and the costs. (IOL, 2007)
>
> A bonded property will usually reflect a taxable loss for around the first five years of the investment. SARS lets you handle the loss in one of two ways:
>
> - Deducting the loss from your other income, reducing your total taxable income.

- “Ring-fencing” the loss.

> If you ring-fence the loss, it is not deducted from your other income, but carried forward until the rental property reflects a profit. The accumulated losses will be deducted from future rental profits before being included in your taxable income. You still get the tax benefit, but accrued over a longer term. (Igrow Wealth Investments, n.d.)

In accordance with the above statement, due to the high cost of financing, a rental property investor often generates taxable losses in the initial years of the investment.

A trust's loss cannot be allocated to its beneficiaries. The loss is kept in the trust and is carried forward as an assessed loss to the following year. (South African Tax Guide, n.d.)

3.1.1. Treatment of rental losses by natural persons

For individuals, if the expenses exceed the rental income, the loss should be able to be offset against other sources of income generated by the individual, as long as the loss is not "ring-fenced" under current anti-avoidance measures. (South African Revenue Services, 2021)

Section 20 of the Income Tax Act reads as follows:

> “(1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall, subject to section 20A, be set off against the income so derived by such person—
>
> > (a) any balance of assessed loss incurred by that person in any previous year which has been carried forward from the preceding year of assessment: Provided that no person whose estate has been voluntarily or compulsorily sequestrated shall be entitled to carry forward any assessed loss incurred prior to the date of sequestration, unless the order of sequestration has been set aside, in which case the amount to be so carried forward shall be reduced by an amount which was allowed to be set off against the income of the insolvent estate of such person from the carrying on of any trade;

(b) any assessed loss incurred by a person during the same year of assessment in carrying on any other trade either alone or in partnership with others, otherwise than as a member of a company the capital whereof is divided into shares" (South African Revenue Services, 2021)

Section 20 is subject to certain exemptions such as taxable income derived from a source within the Republic cannot be set off against losses incurred from carrying on a trade outside of the Republic and losses from trades may not be set off against retirement/severance benefits. (South African Revenue Services, 2021)

"'Trade is an activity which a person undertakes in order to earn income. It must be distinguished from a passive activity, like investment of surplus funds." (Haupt, 2019)

Section 1 of the Income Tax Act defines "Trade" as:

"includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature" (South African Revenue Services, 2021)

Case law such as *Timberfellers (Pty) Ltd v CIR (1994 (N) 59 SATC 153, ITC 1751, 2002 65 SATC 294 and CSARS v Smith, 2002 (6) SA 621 SCA* all provide further clarity when deciding if an activity constitutes a trade. (Haupt, 2019) For the purposes of this research, the definition outlined in section 1 specifically includes the "letting of any property", therefore natural persons may offset losses incurred from their rental portfolios against other taxable income which they may generate for the tax year in question. This, however, is subject to the provisions set out in section 20A of the Income Tax Act.

Section 20A, ring-fencing of assessed losses of certain trades, of the Income Tax Act reads as follows:

"(1) Subject to subsection (3), where the circumstances in subsection (2) apply during any year of assessment in respect of any trade carried on by a natural person, any assessed loss incurred during that year in carrying on that trade may not be set off against any income of that person derived during that year otherwise than from carrying on that trade, notwithstanding section 20 (1) (b).

(2) Subsection (1) applies where the sum of the taxable income of a person for a year of assessment (determined without having regard to the other provisions of this section) and any assessed loss and balance of assessed loss which were set off in terms of section 20 in determining that taxable income, equals or exceeds the amount at which the maximum marginal rate of tax chargeable in respect of the taxable income of individuals becomes applicable, and where—

(a) that person has, during the five year period ending on the last day of that year of assessment, incurred an assessed loss in at least three years of assessment in carrying on the trade contemplated in subsection (1) (before taking into account any balance of assessed loss carried forward); or

(b) the trade contemplated in subsection (1), in respect of which the assessed loss was incurred constitutes—

(i) any sport practised by that person or any relative;

(ii) any dealing in collectibles by that person or any relative;

(iii) the rental of residential accommodation, unless at least 80 per cent of the residential accommodation is used by persons who are not relatives of that person for at least half of the year of assessment;

(iv) the rental of vehicles, aircraft or boats as defined in the Eighth Schedule, unless at least 80 per cent of the vehicles, aircraft or boats are used by persons who are not relatives of that person for at least half of the year of assessment;

(v) animal showing by that person or any relative;

(vi) farming or animal breeding, unless that person carries on farming, animal breeding or activities of a similar nature on a full-time basis;

(vii) any form of performing or creative arts practised by that person or any relative;

(viii) any form of gambling or betting practised by that person or any relative; or

(ix) the acquisition or disposal of any crypto asset.

(3) The provisions of subsection (1) do not apply in respect of an assessed loss incurred by a person during any year of assessment from carrying on any trade contemplated in subsection (2) (a) or (b), where that trade constitutes a business in respect of which there is a reasonable prospect of deriving taxable income (other than taxable capital gain) within a reasonable period having special regard to—

(a) the proportion of the gross income derived from that trade in that year of assessment in relation to the amount of the allowable deductions incurred in carrying on that trade during that year;

(b) the level of activities carried on by that person or the amount of expenses incurred by that person in respect of advertising, promoting or selling in carrying on that trade;

(c) whether that trade is carried on in a commercial manner, taking into account—

(i) the number of full-time employees appointed for purposes of that trade (other than persons partly or wholly employed to provide services of a domestic or private nature);

(ii) the commercial setting of the premises where the trade is carried on;

(iii) the extent of the equipment used exclusively for purposes of carrying on that trade; and

(iv) the time that the person spends at the premises conducting that business;

(d) the number of years of assessment during which assessed losses were incurred in carrying on that trade in relation to the period from the date when that person commenced carrying on that trade and taking into account—

(i) any unexpected events giving rise to any of those assessed losses; and

(ii) the nature of the business involved;

(e) the business plans of that person and any changes thereto to ensure that taxable income is derived in future from carrying on that trade; and

(f) the extent to which any asset attributable to that trade is used, or is available for use, by that person or any relative of that person for recreational purposes or personal consumption.

(4) Subsection (3) does not apply in respect of a trade contemplated in subsection (2) (b) (other than farming) carried on by a person during any year of assessment where that person has, during the ten year period ending on the last day of that year of assessment, incurred an assessed loss in at least six years of assessment in carrying on that trade (before taking into account any balance of assessed loss carried forward).

(5) Notwithstanding section 20 (1) (a), any balance of assessed loss carried forward from the preceding year of assessment, which is attributable to an assessed loss in respect of which subsection (1) applied in that preceding year or any prior year of assessment, may not be set off against any income derived by that person otherwise than from carrying on the trade contemplated in subsection (1).

(6) For the purposes of this section and section 20, the income derived from any trade referred to in subsections (1) or (5), includes any amount—

(a) which is included in the income of that person in terms of section 8 in respect of an amount deducted in any year of assessment in carrying on that trade; or

(b) derived from the disposal after cessation of that trade of any assets used in carrying on that trade." (South African Revenue Services, 2021)

Determination of whether section 20A applies

Assessed losses are not automatically ring-fenced. In the determination of whether an assessed loss should be ring-fenced, a four-step process should be followed:

Step 1: Individual on the maximum marginal rate of tax – s20A(2)

Step 2: 'Three-out-of-five-years' requirement or 'listed suspect trade' – s20A(2)(a) and (b)

Step 3: Facts and circumstances test (or the 'escape clause') – s20A(3)

Step 4: 'Six-out-of-ten-years' (or the 'catch-all' provision) – s20A (Haupt, 2019)

Step 1 entails that the section is only applicable to individuals whose taxable income for the year is equal to or exceeds the level at which the maximum tax rate is applicable. This amount is R1 656 601 for the 2022 tax year. If the taxable income, before the set-off of assessed/current year losses, is lower than this amount, then the loss may not be ring-fenced. There is therefore no need to consider the number of years which losses have been incurred and to follow the remainder of the four-step process. (Haupt, 2019)

The requirements of step 2 can be met under two scenarios:

- During the preceding five year period (including the year in question), the taxpayer incurred an assessed loss in at least three of the five years of assessment (before considering any assessed loss brought forward) (Haupt, 2019); or
- The assessed loss is derived from a trade listed as a suspect trade in terms of section 20(2)(b) above. (Haupt, 2019)

If either criterion is met, the loss will be ring-fenced and may not be set-off against income from another trade. (Haupt, 2019) In respect of rental income for the purposes of this research, this trade will definitely meet the requirements of step 2 as it is listed as a suspect trade in accordance with section 20A(2)(b)(iii).

Step 3 provides an ‘escape clause’ to the taxpayer. Section 20A will not apply to the trade in question if there is:

- reasonable prospect of deriving taxable income
- within a reasonable time (Haupt, 2019)

The considerations for this determination are listed in accordance with s 20A(3) according to the extract from the Income Tax Act. “Importantly, s20A(3) cannot be used to escape the application of s20A, where the trade in question constitutes a suspect trade in terms of s20A(2)(b) and in carrying on that trade the person has, in the last ten years (ending on the last day of the relevant year of assessment), incurred assessed losses in at least six of those years of assessment.” (Cliffe Dekker Hofmeyr, 2021)

Step 4 specifies that (as detailed above), the ‘escape clause’ in accordance with step 3 is not available for a suspect trade where six of the last ten years have resulted in an assessed loss. These assessed losses would be permanently ring-fenced and will be carried forward, however, only future income from the same trade will be allowed to be off-set against these losses. (Haupt, 2019)

In accordance with section 20A(2)(b)(iii) of Income Tax Act 58 of 1962 (‘ITA’), rental losses may be ring-fenced for individuals if their taxable income and assessed losses equal or exceed the amount at which the maximum marginal rate of tax become applicable (R1 656 601 for the 2022 tax year), the individual has incurred an assessed loss from their rental trade in three of the preceding five years, and at least 80 per cent of the residential accommodation are not used by persons who are not relatives of that person for at least half of the year of assessment. (South African Revenue Services, 2010).

Based on the above, individuals would benefit from incurring these rental losses in their personal capacity as they would be allowed the deduction in the initial years when these losses are most likely to occur. The trusts will still be allowed these deductions, however, will not benefit from the cash benefit of these until the rental property turns a profit. From a current tax perspective, it is therefore more advantageous to hold these properties in one’s individual capacity while it is incurring losses. The effective and quantum of this cash benefit will differ depending on what tax bracket the individual is in.

3.2. Impact of section 7C of the Income Tax Act 58 of 1962 on the tax effectiveness of the trust.

The purpose of this chapter is to determine whether the introduction of section 7C has reduced the tax effectiveness of trust structures.

On 1 March 2017, section 7C of the Act came into effect. It applies when a natural person makes a loan to a trust to which he or she is connected. It states that if a natural person makes a loan to a trust with which he or she is affiliated, the loan will result in a donation if the interest rate is less than the official rate of interest. It covers any loan, advance or credit provided to a trust by a South African resident individual before, on or after that date. (Haupt, 2019)

In terms of the Income Tax Act, a connected person for the purposes of this section is defined in section 1 paragraph (d)(iv) as:

> "any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of—
>
> (aa) the equity shares in the company; or
>
> (bb) the voting rights in the company;"
>
> This section specifically deals with Interest Free- or Low Interest Loans to Trusts. The aim of Section 7C is to prevent the Estate Duty avoidance that could result when a person transfers a growth asset to Trust, in return for a fixed loan that does not grow in value, because no interest is charged on the loan. (Mahdi Meyer Steyn, 2018)

Section 7C(1A) states that if a person acquires a loan to a trust or company from another person, and that person is connected to the trust/company or previous lender, then section 7C will continue to apply if it applied to the previous lender. (Haupt, 2019) This proviso is aimed at preventing the circumvention of section 7C by simply channeling loans through an independent (in relation to the trust) intermediary.

“Section 7C(2) states that no deduction, loss, allowance, or capital loss may be claimed in respect if a loss made by the lender on a (low-interest or interest-free) loan to a trust, or on the disposal of the loan by the lender.” (Haupt, 2019) If the trust is unable to settle the loan or the lender waives the loan or a portion of it, the lender will be unable to claim any deduction or capital loss on the waiver. This will apply even if the trust realises a tax benefit as a result of the waiver. This will not apply to any loans granted at the official rate of interest (or higher). (Haupt, 2019) This is to dissuade natural persons from providing these low interest or interest free loans to trusts as there may potentially be sever ‘tax leakage’ when assessing the natural person and trust in combination i.e. the trust may incur an increased tax liability (in the year of waiver or in the future as a result of decreased losses) while the natural person will not receive the related tax benefit.

> Section 7C(3) states that if a trust (or a company – with effect from 19 July 2017) incurs interest on a loan made to it by the connected natural person (or company at the instance of that natural person) at lower than the official rate of interest, or the loan is interest-free, then the difference between the official rate of interest (as defined in section 1) and the interest actually incurred by the trust or company is treated as a donation by the natural person to the trust on the last day of the trust’s year of assessment (which is the end of February, whether the trust is local or foreign). (Haupt, 2019)

This encompasses the primary aim of this section as described above. “It is submitted that interest will be calculated on a daily basis and never capitalised or added to the capital amount of the loan.” (Haupt, 2019)

Section 7C(5) of the Income Tax Act lists all the exemptions of section 7C as follows:

- The loan is to a Section 30(3) tax-exempt Public Benefit Organization (PBO) or a Section 30C small business funding entity certified by the Commissioner.
- A person provided that trust with a loan, advance, or credit in exchange for a vested interest in that trust's receipts, accruals, and assets, and—
  - (i) the beneficiaries of that trust hold a vested interest in all of that trust's receipts, accruals, and assets in aggregate;

(ii) in terms of the trust deed governing that trust, no beneficiary of that trust can hold or acquire an interest in that trust other than a vested interest in the receipts and accruals and assets of that trust;

(iii) the vested interest of each beneficiary of that trust is determined solely with reference and in proportion to the assets, services or funding contributed by that beneficiary to that trust; and

(iv) none of the vested interests held by the beneficiaries of that trust is subject to a discretionary power conferred on any person in terms of which that interest can be varied or revoked. (Haupt, 2019)

- That trust satisfies the definition of a special trust set forth in paragraph (a) of the definition of special trust.
- If that trust or company used that loan, advance, or credit entirely or partially for the purpose of funding the acquisition of an asset, and that asset was used as a primary residence as contemplated in paragraph (b) of the definition of "primary residence" in paragraph 44 of the Eighth Schedule throughout the period during that year of assessment in which that trust or company used that loan, advance, or credit, the trust or company will be exempt from the application of the loan, advance, or credit provision. "If only part of the loan actually funds the primary residence, then only that part is excluded from the application of section 7C." (Haupt, 2019)
- In the event that the trust or company had been a bank as defined in section 24JA, the loan, advance, or credit was made to that trust or company under the terms of an arrangement that would have qualified as a sharia compliant financing arrangement, as defined by that section. (Haupt, 2019)
- That loan, advance or credit constitutes an affected transaction as defined in section 31 (1) that is subject to the provisions of that section. These affected transactions in terms of section 31 would only apply to loans to non-resident trusts by South African residents. The reason for the exclusion from section 7C is due to the fact that affected transactions will be deemed to carry interest at an arm's length rate. There is little certainty in term's of section 31 as to what constitutes an 'arm's length rate', therefore this does create an arbitrage opportunity between sections 31 and 7C. (Haupt, 2019)

- That loan, advance or credit is subject to the provisions of section 64E (4). Interest at the official rate on loans subject to section 64E will be considered a deemed dividend. Section 64E only applies loans to South African trusts, whilst loans to non-resident trusts may fall within the scope of section 31. If the loan is subject to neither, section 7C may apply. (Haupt, 2019)
- That trust was created solely for purposes of giving effect to an employee share incentive scheme. The trust cannot hold more than 20% of the company's shares as this would mean that all employee's would be a connected person the company. (Haupt, 2019)

<u>What are the tax implications of section 7C?</u>

The difference between the interest charged on the loan (if any) and the interest that would have been incurred if the loan had been charged at the official rate of interest would be recognized as a donation. This donation is assumed to have been made to the trust on the last day of that natural person's assessment year. The donations tax must be paid by the 31st of March each year, according to section 60 of the Act. This is an annual occurrence, and the natural person can deduct this amount from his or her yearly donations tax exemption (currently R100,000 per annum). On the last day of the trust's assessment year, the interest forgone by the qualifying lender of the loan will be recognized as a continuing and yearly donation to the trust. (Mazars, 2019)

It is vital to remember that the legislation applies to existing loans as of March 1, 2017, as well as any loans signed into after that date. (Mazars, 2019)

<u>When is section 7C applicable?</u>

The following conditions must be met in order for section 7C to apply:

- A loan, advance or credit must exist;
- That loan, advance or credit must be provided by a natural person, or at the instance of that person, by a company which is connected to that person
- The loan must have been provided directly or indirectly to:
    - A trust in which that natural person/company is a connected person;

- A trust in which a connected person who is a connected person to the natural person/company (who provided the loan) is a connected person;
- A company in which a trust holds at least 20% of the equity shares/voting rights as stated above; or
- A company in which a beneficiary of a trust holds at least 20% of the equity shares/voting rights as stated above; and

- The loan is subject to no interest (or interest below the official rate of interest) (Mazars, 2019)

<u>How interest-free loans to trusts reduce tax payable</u>

Assuming the entrepreneur or estate planner only has one growth asset worth R10 million. He or she establishes a discretionary trust with an initial cash donation of R1000, and he or she is one of five nominated discretionary beneficiaries. The trust is managed in accordance with the trustee's fiduciary obligations and responsibilities and the founder is one of three trustees (one of whom is an independent trustee). (South African Institute of Tax Professionals, 2017)

All other potential taxes that may become payable as a result of the transfer or sale of the growing asset, such as capital gains tax, VAT, transfer duty, and securities transfer tax, are ignored for the purposes of this illustration. The founder sells the trust the growth asset for R10 million, which is fair market value. The trust, on the other hand, does not have enough cash reserves or other financial resources to pay for the item. The seller or founder now enters into a loan agreement with the buyer or trust for the purchase money to be paid back. The terms are arranged in such a way that when the seller issues a written demand for payment, the purchase price becomes due and payable, and the outstanding purchase price bears interest as determined by the parties from time to time. The parties then agree that no interest will be charged on the outstanding purchase price. All of this occurs in the first year. (South African Institute of Tax Professionals, 2017)

Let's say the trust's market value is R39 million in year 20. It is, nonetheless, obligated to repay the founder's R10 million debt. The trust's net asset worth is therefore R29 million (R39 million minus the R10 million loan). (South African Institute of Tax Professionals, 2017)

What are the financial advantages? The founder's inheritance is valued at R10 million, which is the amount owed on the outstanding debt. In the event of the founder's death, the loan is the only asset that will be subject to estate duty. Because a trust is not a natural person (but rather a legal person or business) for estate duty purposes, no estate duty can be imposed on trust assets. Only assets owned by the deceased or deemed to be part of the deceased's estate are covered by the Estate Duty Act. (South African Institute of Tax Professionals, 2017)

In this case, the estate duty savings are R29 million (growth within the trust) x 20% (estate duty rate) = R5.8 million. The founder will not be responsible for donations tax because of the disposal and funding arrangement utilized (an interest-free loan). If the founder had instead given the trust the growing asset entirely, R1 980 000 in contributions tax would have been due (R10 million – R100 000 [amount not subject to donations tax] x 20% [donations tax rate]). (South African Institute of Tax Professionals, 2017)

In summary: In summary, the above-mentioned scenario saves R5.8 million in estate duty and R1 980 000 in donations tax over a 20-year period. (South African Institute of Tax Professionals, 2017)

<u>Amount saved by using a loan trust arrangement</u>

As shown in the example, one of the many advantages of discretionary trusts is the reduction of estate tax. A potential donation tax is also avoided by funding the trust through an interest-free loan agreement. The proposed new Section 7C of the Income Tax Act appears to be primarily motivated by the elimination of these benefits. (South African Institute of Tax Professionals, 2017)

According to the above, it is evident that section 7C has inhibited the transfer of wealth to trust for estate duty planning purposes and does increase the tax payable by trusts in the form of the additional donations tax. It is important to note that there are several ways of funding the assets in a trust and section 7C is specifically aimed loans from connected persons, targeting the direct transfer of wealth from an individual to a trust.

4. Chapter 4: How would the trust structure affect the quantum of capital gains tax payable?

The purpose of this chapter is to analyse capital gains tax consequences of trusts versus individuals.

4.1. What is capital gains tax?

Capital Gain Tax was introduced into the Income Tax Act on 01 October 2001 and applies to the sale of all capital assets on or subsequent to that date. In summary, if a capital asset is sold at a profit, the profit is subject to CGT, and if sold at a loss, the capital loss can be set off against other capital profits. Capital losses can be carried forward to the following year if there are no capital profits to set these losses off against in the year incurred. Capital gains tax is not a separate tax from income tax, however, only a portion of it is included in the taxpayer's taxable income. That portion is then subject to income tax. (Haupt, 2019)

> Capital gains tax is a tax on the difference between the price an asset was purchased for and the amount for which it was sold. So if you're a property seller, you can find out what your capital gains are, by subtracting the base cost of the property (which includes incurred costs such as renovations, transfer costs and attorney fees) from the amount you sold it for.
>
> Bear in mind that capital gains tax is not a separate tax, but rather forms part of your income tax, and becomes payable when you receive your income tax assessment. (oobahomeloans, n.d.)
>
> When you dispose of a property you have bought to rent out for profit – one other than your primary residence – you will be liable for capital gains tax on the profit from the sale. The cost of any capital improvements can be added to the base cost of the property to reduce the taxable portion of the profit. A capital gain is taxed at a much lower rate than a profit generated by speculating in property. (Igrow Wealth Investments, n.d.)

4.2. Rationale for implementation of CGT

The principles of equality, efficiency, and simplicity guide tax policy and change. CGT was carried out for a variety of reasons, including:

a) International benchmarking - CGT was implemented in several of South Africa's trading partners, as well as other African countries, many years ago. These jurisdictions adopt the 'comprehensive income' notion as the optimal tax base, which means that all revenue, including capital gains, should be included in income tax.

b) horizontal equity - regardless of the type of income, all taxpayers should face identical tax obligations, and this concept of fairness gives a convincing rationale for taxing capital gains;

c) Vertical equity is a notion that refers to the equity that exists between taxpayers who earn different amounts of money. Taxpayers with more ability to pay taxes should bear a greater share of the burden of taxation, and because capital gains tax (CGT) may be ascribed to the wealthiest persons, the introduction of CGT improves vertical equity and supports the progressivity of the income tax system;

d) a shift from income to capital — during a period in which capital gains were not taxed, many people reclassified their income as capital in order to escape the tax consequences; the introduction of CGT puts a stop to this form of tax avoidance;

e) economic efficiency – if capital gains are excluded from the income tax base because they are regarded as non-taxable income, this will lead to tax avoidance and inequity in the economy because capital will flow to sectors where tax-free capital gains can be realized, thereby reducing a taxpayer's overall tax burden. The result will be a greater proportion of capital being invested in assets that generate returns in the form of capital gains rather than income-producing assets;

f) simplicity - It is important to keep tax systems as simple as possible. Although capital gains tax (CGT) is a complex tax, it can be avoided by designing the tax in a way that minimizes its administrative burden. One method of accomplishing this, and thereby fulfilling the principles of a good tax system, is to eliminate preferential taxation of capital gains; and

g) tax base broadening – more individuals will be brought into the tax net as a result of this expansion. (Ramson, 2014)

4.3. Annual exclusion

Paragraph 5 of the Eight Schedule states that the annual exclusion applies only to natural persons and ‘special trusts’. The annual exclusion is R40 000 per annum, In the year that a person dies, the annual exclusion is increased to R300 000 The annual exclusion is not a deduction, but a reduction. It reduces a person’s total capital gains (to arrive at an aggregate capital gain) before the 40% inclusion rate is applied to any net capital gain remaining. If the person’s capital losses exceed his or her capital gains, the excess of the loss over the profit is reduced by the annual exclusion to arrive at an aggregate capital loss. This reduced loss is then carried forward to the next year of assessment after adding any assessed capital losses brought forward. (Haupt, 2019)

4.4. Primary residence exclusion

CGT is typically levied on assets that you own that increase in value over time. However, if your primary residence is sold for less than R2 million, or if the capital gain that you realize from the sale is less than R2 million, you will not be required to pay any capital gains tax (CGT) on the sale. (Mullins, 2017)

What is a primary residence?

In order to take advantage of the exclusion, the property being sold must meet the definition of a "primary residence" included in the Income Tax Act.

As defined in paragraph 44 of the Eighth Schedule to the Income Tax Act, a primary residence is a structure that is owned by the taxpayer (this can include a boat, caravan or mobile home). A plot that is completely devoid of structures would not fall under this definition. (Mullins, 2017)

Additionally, the person who has an interest in the residence must be one of the following:

• A natural person; or

• A beneficiary of a special trust (which is a type of trust established for people with disabilities who are unable to manage their own financial affairs or a testamentary trust where the youngest beneficiary is still a minor); or

• The person's spouse. (Mullins, 2017)

In addition, the person must:

• Ordinarily reside in the residence as his or her "main" residence; and

• Use the residence "mainly for domestic purposes" or as their ordinary residence in order to qualify.

As a result, a vacation home would not be considered a primary residence under the definition. (Mullins, 2017)

A real right to a residence, such as a long-term lease lasting more than ten years, as well as a right of use or occupation are all examples of an interest in a residence. When it comes to share block companies, an interest in them is considered a real right, and the sale of shares in a share block company may qualify for the primary residence exclusion if the other requirements are met. (Mullins, 2017)

A building that is "mainly for domestic purposes," as defined by case law, means that more than half of the measured floored area must be used for domestic activities. (Mullins, 2017)

Additionally, there may be legitimate reasons for a taxpayer to be absent from their primary residence, such as work or vacation. This does not automatically disqualify their home from being considered a primary residence for the purposes of the exclusion, though it may. Each case will be evaluated on the basis of its own set of facts and circumstances. (Mullins, 2017)

Moreover, the intent of the taxpayer is critical, and while the terms "ordinary resident" and "ordinarily reside" are not technically the same for tax purposes, the underlying principles are the same, and this can be used to make a convincing argument. Currently, South Africa relies on this principle for the term "ordinarily reside" in the absence of court interpretations. (Mullins, 2017)

The court determined that the term "ordinarily resident" refers to a place where a person considers it to be his or her true home, as opposed to a place where he or she returns after a period of wandering or wanderings. (Mullins, 2017)

In accordance with the above, it is important to note that the exclusion is only available to natural persons, meaning that companies and individuals would not qualify for this exclusion. Careful consideration should therefore be given to the decision of whether to place a primary residence in a trust as this has more severe tax implications when compared to investment property.

> Many people with family trusts received advice years ago to transfer their family homes into their trust. This was done at a time when trusts were slightly more tax efficient than they are today and before SARS started removing any tax advantages that trusts might have had. One of the consequences of SARS's current treatment of trusts is the exclusion of the primary residence rebate. An individual who sells his primary residence does not have to include the first R2 million of any gain made, but only if it meets the requirements set out - one of these being that the property had to be registered in the individual's name. Having your primary residence inside a trust will mean that any gain made on the sale will have to have all of it included or distributed. (Sevenster, 2013)
>
> <u>What about the land?</u>
>
> The land on which the primary residence is situated does form part of the primary residence as long as it is used mainly for domestic or private purposes, together with the residence.
>
> The land considered for domestic purposes is, however, limited to two hectares. If the land exceeds two hectares, the gain will have to be apportioned between the non-domestic component and the primary residence component. This is common in situations where a small holding or farm is sold with a homestead on it. When selling such a type of property, it is extremely important to ensure that the wording on the sale agreement allocates a specific value to the homestead component of the selling price.
>
> To qualify for the primary residence exclusion on the land component, both the land and the residence situated on it must be sold at the same time and to the same person.
>
> <u>How many primary residences can you have at a time?</u>
>
> The primary residence exclusion may only be claimed for one residence at a time (see paragraph 45(3) of the Eighth Schedule of the Income Tax Act). Thus, in a case where a

taxpayer commutes for work from Johannesburg to Cape Town and his or her family lives in Cape Town, while he or she has a residence in both cities, he or she will have to choose which of the two residences will be his or her primary residence. It cannot be both.

Another similar consideration is where, in terms of customary law, a person may have four spouses who all reside in different residences.

In such instances, the taxpayer will also have to choose which of the residences is the primary residence.

<u>The exception to the rule</u>

There are exceptions where you may qualify to hold two primary residences at the same time (see paragraph 48 of the Eighth Schedule of the Income Tax Act). The exceptions are as follows:

• If you are building a new home, while still residing in another home

• If you are trying to sell your previous home, while residing in a new primary residence or intending to reside in a new primary residence

• The residence has become inhabitable due to fire, flood or another similar reason and you have had to temporarily reside somewhere else

In the above situations, to continue to qualify as a primary residence, the period that you did not ordinarily reside in the primary residence is limited to two years.

<u>What about a house that belonged to a deceased person?</u>

A deceased estate can deduct the primary residence exclusion.

<u>What are the consequences of letting out your residence?</u>

Paragraph 50 of the Eighth Schedule of the Income Tax Act states that a residence can be let out for a period of no more than five years, while still being considered a primary residence, if either the taxpayer, his or her spouse or the beneficiary of a special trust has

> resided at the residence in question for at least one year before and one year after the period of absence. You will not qualify if you had another primary residence during your absence, nor if your temporary absence was at a location closer than 250 km from the residence, unless it was outside the Republic of South Africa.
>
> The primary residence exclusion will be reduced by the percentage of time that the residence was let out. So, if you owned the primary residence for 10 years, of which it was let out for three years, the primary residence exclusion will reduce from R2 million to R1.4 million. (Mullins, 2017)

In the context of this research, the preceding paragraph regarding the letting out of property is of particular importance. Should a property investor let out his primary residence for the purposes of earning rental income, it may impact his ability to claim the full primary residence exclusion for capital gains purposes.

4.5. Trusts versus individuals for CGT purposes

According to SARS, for the 2022 tax year, individuals are subject to a maximum capital gains tax (CGT) rate of 18% versus trusts (other than special trusts) of 36%. (South African Revenue Services, 2021). Although the highest marginal tax rates for both individuals and trusts are 45%, the difference in the effective tax rate is as a result of the CGT inclusion rate of 40% for individuals versus 80% for trusts.

> The "conduit principle" with regard to trusts has been written about extensively and is also at the centre of National Treasury's proposed changes to the taxation of trusts. In simple terms, income or gains that are realised inside a trust, can "flow through", or be distributed to the beneficiaries of the trust, while retaining the nature of the income.
>
> This means that dividends received get passed on as dividends and taxed as dividends, that interest earned and distributed gets taxed as interest, and that capital gains that are distributed get taxed as capital gains. These amounts are then taxed in the hands of the beneficiaries and not the trust. The fact that the nature of the income is also retained is very important, as natural persons receive certain exemptions, exclusions and/or rebates on certain items and get taxed differently.

In terms of paragraph 80 of the Eighth Schedule of the Income Tax Act, where a capital gain is vested in a beneficiary of the trust, the trust will not have that gain included in its own tax calculation, but it will be taxed in the hands of the beneficiary.

This means that where a trust deed authorises the trustees to do so, the trustees are able to distribute the capital gains of the trusts, vesting it in the beneficiaries. It is also possible to distribute the gains to multiple beneficiaries, each paying at their assumed lower marginal tax rate and each having their own annual exclusion of R40 000. Substantial capital gains tax savings can thereby be achieved.

It is important to keep in mind that to achieve savings of this nature, the capital gain has to be allocated to a resident natural person in the year in which it was realised by the trust. Many trusts have beneficiaries that include another trust. If the gain passes to another trust first and then to an ultimate beneficiary of the second trust, the higher effective tax rate applies. (Sevenster, 2013)

An annual exclusion of R40 000 capital gain or capital loss is granted to individuals. R2 million gain or loss on the disposal of a primary residence is also listed as a specific inclusion. (South African Revenue Services, 2021) In order for the primary residence exclusion to apply, "the owner must be an individual or special trust. However, the estate planning, limited liability, or other considerations that led to the property being placed in a company or trust may outweigh the advantage of the primary residence exclusion." (South African Revenue Services, 2020) This is particularly relevant to the residential property investment market as should the founder place his primary residence within the trust, the primary residence exclusion would not apply if sold. Based on the lack of the primary residence exclusion and annual exclusion, as well as the significantly higher CGT inclusion rate, it is evident that the trust will incur much higher CGT than an individual would. This can be particularly harmful in respect of residential property.

5. Chapter 5: How would the trust structure affect the quantum of estate duty payable upon the death of the founder?

The purpose of this chapter is to analyse estate duty consequences of trusts versus individuals.

5.1. What is Estate Duty?

The Estate Duty Act came into operation on 1 April 1955 and replaced the Death Duties Act of 1922. In terms of the Act estate duty is payable in respect of the estate of every person who dies and

- who was ordinarily resident in the Republic at the date of his death; or
- who was not ordinarily resident, but owned assets in the Republic at the date of his death. (Haupt, 2019)

The assets belonging to a person who is ordinarily resident in South Africa at the date of his death, fall into his estate, no matter where in the world these assets are situated. If assets are situated in South Africa, it is subject to estate duty no matter where the owner was resident at the time of his death. (Haupt, 2019)

In the event of the death of a natural person (a taxpayer), that person is referred to as a 'deceased person,' and all of his or her assets will be deposited in an estate as of the date of death. This type of estate is referred to as an estate of a deceased person (also referred to as a ‘deceased estate'). Assets in a deceased estate can include, among other things, immovable property (a house), movable property (a car, furniture, etc.), cash in the bank, and other financial assets. The person in charge of administering a deceased person's estate is referred to as an "Executor." Once the Executor has completed all of the administration in the deceased estate, the remaining assets (after paying off all of the debts) will be distributed to the beneficiaries according to their rights under the Will. (South African Revenue Services, 2021)

A beneficiary can be made up of either heirs or legatees, depending on the situation. Legatees are individuals who are entitled to a specific asset from the estate of a deceased person. An heir is a person who inherits the remaining portion of a deceased person's estate (that is, after all disposals to a legatee are finalised). (South African Revenue Services, 2021)

Estate Duty is imposed on the worldwide and deemed property of a natural person who is ordinarily resident in South Africa, as well as on non-residents' South African property. Various deductions are allowed to determine the net value of the estate under Section 4 of the Estate Duty Act, 1955. To determine the dutiable value of the estate, an abatement of R3.5 million is allowed against the net value of the estate. The Estate Duty is imposed on the dutiable value of an estate at a rate of 20% on the first R30 million and 25% on the dutiable value of an estate exceeding R30 million. (South African Revenue Services, 2021)

A Trust can provide you with the following benefits in terms of estate planning:

- This allows you, the Trust's founder, to divest yourself of your assets while transferring ownership and control of those assets to the Trust.
- Even though the beneficiaries named in your Will are legally entitled to the assets, they are not required to include the assets in their respective estates if they pass away in the future. The deceased beneficiary's share may be divided among the other beneficiaries who are named in the Trust document, or if the deceased beneficiary has children or other heirs, the Trust document may specify that the deceased beneficiary's share is distributed to those children or heirs instead.
- Because a Trust is not a living person with an estate, it is not subject to estate duty. The Estate Duty Act does not apply to the assets of a Trust, so they are not taxed. (Standard Bank, n.d.)

5.2. How is estate duty calculated?

The summary of the estate duty calculation is as follows:

	Rands
Property – section 3(2) – (valued per section 5)………………………………..	XXX
Deemed property – section 3(3) read with section 3(5) - valued per s 5)……...	XXX
GROSS VALUE OF PROPERTY……………….……………………………..	XXX
Less: Deduction – section 4…………………………..……………………..	(XXX)
NET VALUE OF ESTATE………………………………………………………..	XXX
Less: Abatement – section 4A……………………………………..………………	(XXX)
DUTIABLE AMOUNT OF THE ESTATE……………………….……………………	XXX

The above is in accordance with *Notes on South African Income Tax* (Haupt, 2019). Estate duty is levied on the dutiable amount at a rate of 20% of the first R30 million and 25% of the dutiable amount exceeding R30 million. (Haupt, 2019)

Section 3(2) of the Estate Duty Act defines “property” as “any right in or to property, movable or immovable, corporeal or incorporeal”. This research focuses on South African residents and will therefore no analyse the exemptions granted to persons not ordinarily resident in terms of section 3 of the Estate Duty Act.

Section 3(3) outlines certain deemed property which forms part of the gross value of the estate. Section 4 of the Estate Duty Act outlines certain deduction that a taxpayer may qualify for when determining the net value of the estate.

Section 5 of the Estate Duty Act provides guidance surrounding determining the value of property which forms part of the estate. Section 5(1)(g) states “in the case of any other property, the fair market value of such property as at the date of death of the deceased person”. This would be of particular concern for residential property investors as these usually seek rental yield and capital growth (Property24, 2019). “From 2007 to 2019, house prices rose by about 57%”, while from 2000 to 2006, national housing prices rose by an average of 20% annually (GlobalPropertyGuide, 2020). Should natural person property investors achieve their goal of capital growth, which is one of their primary aims as described above, the increased market values would be included in the gross value of their estates and subject to estate duty upon their death.

In terms of section 4A of the Estate Duty Act, a R3.5 million primary abatement is applied to the net value of the estate in order to derive at the dutiable amount. Where a person has a pre-deceased spouse, the second-dying spouse receives an abatement of R7 million, reduced by any abatement claimed by the predeceased spouse. (Haupt, 2019)

For individuals, “South Africa is one of the few countries in the world that imposes both estate duty and capital gains tax on the assets of a person on death.” (Roeleveld, 2012) In South Africa, both estate duty and capital gains tax upon a taxpayer’s death is payable, resulting a form of ‘double taxation’ (Thorpe, 2015). There have been several research reports or investigations into whether it is appropriate to levy both CGT and estate duty upon a taxpayer’s death (Thorpe, 2015)

(Roeleveld, 2012) (Ramson, 2014) (Bruwer, 2017). CGT implications have been discussed in further detail in the preceding chapter.

Earlier in the chapter, it was confirmed that estate duty only becomes payable upon the death of a taxpayer. A trust or company will therefore not attract estate duty as these are legal personas and do not end with the death of a natural person. This is consistent with the information above.

Trust assets are only at risk of being included as deemed property in a deceased person's estate if that person had the legal competence to dispose of such property for the benefit of himself or his estate immediately prior to death, and that the planner's conduct was not a relevant factor in determining whether trust assets could be deemed property. However, the estate planner's actions with respect to trust assets could result in the property being included as deemed property in his estate, especially if the trust was his alter ego and trust property was treated as his own, the trust arrangement was viewed as simulated, or there was no intention to create a trust. (Van Dyk & Calitz, 2016)

From the above, there are potentially significant tax savings on estate duty when assets are housed in a trust as opposed to an individual's capacity. The trust structure will only be of benefit where, had the property been held in the natural person's personal capacity, the dutiable amount would have been in excess of the R3.5 million abatement. If less than the abatement amount, no estate duty would have been applicable in either scenario. SARS has attempted to close these loopholes with the introduction of section 7C as described in chapter 4 above. This will require individual founders to explore alternative methods to fund their trusts in order to reduce their estate duty payable upon their death.

6. Chapter 6: Would introducing companies within the trust structure result in a tax benefit?

The purpose of this chapter is to determine whether any tax benefits can be derived by introducing a company within a trust structure.

6.1. Current tax implications

All registered businesses in South Africa must pay corporate, business, or company tax to the South African Revenue Service (SARS for short). In general, businesses based in South Africa must pay South African corporate tax on their worldwide earnings. South Africa's corporate tax rate is a flat 28 percent for all businesses. In South Africa, however, trusts (excluding special trusts) pay a 45 percent tax rate. (Expatica, 2021)

When the trust purchases an investment, it must decide whether to do so directly or through a company (or CC). It should, in general, own income-generating investments through a company. As a result, trust owns the company, and the company owns the investment. The reason for this is that the company's income is taxed at a rate of 28 percent before it can be re-invested, whereas if the trust earned the income directly, it would be taxed at a rate of 45 percent before it could re-invest. (Harbour & Associates, 2021)

The government announced in the February 2020 National Budget that, over the medium term, it would implement measures aimed at restructuring the corporate income tax (CIT) system by broadening the base, with the goal of lowering the CIT rate in a revenue-neutral manner. In this regard, the February 2020 Budget announced a number of measures, and the February 2021 Budget announced that the CIT rate would be reduced from 28 percent to 27 percent, effective for tax years beginning on or after April 1, 2022. (PricewaterhouseCoopers, 2021)

The above reduction in the corporate tax rate will done by broadening the tax base by limiting interest deductions and assessed losses. Treasury will also give consideration to further decreased to make the South African tax system more appealing. This will be done in a revenue neutral manner and will leverage the insights of the Davis Tax Committee as these are undertaken. (National Treasury - Republic of South Africa, 2021)

Therefore, if the trust is income earning, such as a rental portfolio, and plans to re-invest profits into its business model, then introducing a company within a trust structure would be much more advantageous as these profits would be subject to a corporate tax rate of 28% as opposed to 45% for trusts.

Section 12E of the Income Tax Act does provide for reduced tax rates (sliding scale) for companies which meets the requirements of a ‘small business corporation, however, in the context of this research, this would not be applicable. This is due to the fact that according to section 12E(4)(a)(iii), “not more than 20 per cent of the total of all receipts and accruals (other than those of a capital nature) and all the capital gains of the company, close corporation or co-operative consists collectively of investment income and income from the rendering of a personal service” (South African Revenue Services, 2021). In accordance with section 12E(4)(c)(i), investment income is defined as “any income in the form of dividends, foreign dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature” (South African Revenue Services, 2021).

South Africa has historically been generous with taxpayers' use of assessed losses, allowing them to be set off against current income and carried forward to future income. Section 20 of the Income Tax Act 58 of 1962 deals with assessed losses. Section 20 allows a taxpayer to offset a previous year's assessed loss against current year's taxable income. So, if a taxpayer has a large loss from previous years, that loss can be deducted from future taxable income. As announced in the 2020 Budget Speech, the government intends to limit corporate taxpayers' ability to offset past assessed losses. Clause 19 of the Draft Taxation Laws Amendment Bill (Draft TLAB) for 2021 proposes to limit the use of assessed losses by corporations. According to the explanatory memorandum to the Draft TLAB (Memo), the Government proposes limiting the use of assessed losses to help lower the corporate tax rate below the current 28%. The Memo also says the proposal is in line with global tax trends. According to the Draft TLAB, corporations can only set off up to 80% of any prior year's assessed loss. Regardless of the assessed loss, corporate taxpayers must pay tax on at least 20% of their taxable income in any given year. However, it allows taxpayers to use the majority of their assessed losses and carry the remainder forward to future tax years. The full assessed loss can still be used, but over time. The proposals appear to be part of a package of measures aimed at creating fiscal space for a lower corporate tax rate. It is yet to be seen if corporate and investors value the lower tax rate over tax flexibility, which takes into account the economic position of businesses that have suffered significant past losses and may face future cash flow issues. (Cliffe Dekker Hofmeyr, 2021) This proposed amendment is an extremely important consideration when housing a rental portfolio in a company as these are generally loss-making in the initial years while servicing high debt obligations. This amendment, should it be passed, could also significantly affect the cashflow position of an entity. The proposed amendment refers to corporate taxpayers, however it is unclear if this will impact natural persons and trusts.

Companies are automatically registered for provisional tax as defined by SARS. (South African Revenue Service, 2021). Although individuals and trusts are also required to register as provisional taxpayers once their rental income exceeds R30 000 per year (as indicated in paragraph 2.1 above), this is an important cashflow consideration which should not be ignored.

6.2. Capital gains tax implications

"Companies are subject to capital gains tax at a rate of 22.4%. Trusts pay a capital gains tax of 36%, while special trusts and individuals are liable for a rate of 18%." (Expatica, 2021)

Capital gains are included in a taxpayer's taxable income at a set rate. The CGT taxing rules, which went into effect in 2001, were designed to tax gains at low inclusion rates. The inclusion rates for individuals and companies and trusts remained constant for more than a decade after CGT was introduced, at 25% for individuals and 50% for companies and trusts. Since then, the inclusion rates have risen dramatically. Companies' capital gains are included in taxable income at 80 percent (22.4 percent effective tax rate) following the last rate increase in 2016, whereas individuals' CGT inclusion rate is at a more palatable 40 percent (maximum 18 percent effective tax rate). The most vulnerable are trusts. Trusts have an effective CGT rate of 36%, based on an inclusion rate of 80%. (La Grange, 2020)

It is also important to note that companies, similar to trusts as described in chapter 4, will not qualify for an annual exclusion primary residence exclusion as these only benefit natural persons.

6.3. Estate duty implications

In accordance with section 5(1)(f)(bis), "the value of any property for the purposes of the inclusion thereof in the estate of any person, determined as at the date of death of that person, shall be, in the case of shares in any company not quoted on any stock exchange, the value of such shares in the hands of the deceased at the date of his death, subject to the following provisions, namely—

(i) no regard shall be had to any provision in the memorandum and articles of association, founding statement, association agreement or rules of the company, as the case may be, restricting the transferability of the shares therein, but it shall be assumed that such shares were freely transferable;

(ii) no regard shall be had to any provision in the memorandum and articles of association, founding statement, association agreement or rules of the company, as the case may be, whereby or whereunder the value of the shares of the deceased or any other member is to be determined;

(iii) if upon a winding-up of the company the deceased would have been entitled to share in the assets of the company to a greater extent pro rata to shareholding or membership than other shareholders or members, no lesser value shall be placed on the shares held by the deceased than the amount to which he would have been so entitled if the company had been in course of winding-up and the said amount had been determined as at the date of his death;

(iv) no regard shall be had to any provision or arrangement resulting in any variation in the rights attaching to any shares through or on account of the death of the deceased;

(v) there shall be taken into account any power of control exercisable by the deceased and the company whereunder he was entitled or empowered to vary or cancel any rights attaching to any class of shares therein, including by way of redemption of preference shares, if, by the exercise of such power he could have conferred upon himself any benefit or advantage in respect of the assets or profits of the company." (South African Revenue Services, 1955)

In accordance with section 5(5) of the Estate Duty Act, "for the purposes of subsection (1)(f)bis, the term "shares" includes any members' interests or any class of shares, stock, debenture stock, debentures or right to purchase members' interests or to subscribe for or purchase shares, stocks or debentures, and the term "company" includes any company or close corporation incorporated in the Republic or elsewhere."

An asset, in this case a share, is considered to be part of a shareholder's deceased estate after his or her death because it is considered to be one of the assets owned by the shareholder. When a person dies without leaving a will, his or her assets are administered by the executor of the will in accordance with that act and the deceased's wishes, or they are administered by the administrator of his or her deceased estate in accordance with the Intestate Succession Act 81 of 1987 when a person dies without leaving a will. As a result, shares can be transferred from the estate of a shareholder to the heirs or nearest survivors of the shareholder who has passed away. (Abrahams and Gross, 2020)

If an individual own's shares in his individual capacity, the market value of the shares will form part of his estate upon his death. However, if the company's shares are owned by a trust, this will not be subject to estate duty.

In summary, introducing a company which is owned by a trust provides current tax savings if the company intends to re-invest profits into its business model. If the company wishes to distribute its profits, it will be subject to an effective tax rate of 42.4% which is the combination of the corporate tax rate of 28% and dividend withholding tax of 20%, which is still a tax saving when compared to the trust current tax rate of 45%.

7. Chapter 7: Conclusion

7.1. Conclusion

This research set out to investigate if a trust structure, or a company within a trust structure, would result in tax advantages when compared to a natural person, specifically related to investment property.

Based on analysis of the various types of taxes that have been assessed in the preceding chapters, it is clear that there is no standard solution indicating that one investment vehicle is more suitable than any other. The most tax efficient vehicle is dependent on how much the individual earns in a tax year, whether the investment property portfolio is loss or profit making, the intention and business model involved (whether to hold for long term appreciation or to sell), the type of investment property being purchased (such as whether these would qualify for special allowances such as section 13sex and section 12J), the value of the portfolio involved, whether these would generate capital gains or losses upon sales, etc.

For current tax purposes, whether a benefit will be achieved via a trust structure depends on a comparison to that specific natural person. As the trust is taxed at a rate of 45%, there is little benefit in creating a trust structure if the natural person is currently being taxed at a low marginal rate. A natural person at the highest marginal tax rate can realise tax benefits by creating a trust structure, by distributing the income of the trust to beneficiaries who have a lower marginal tax rate through the ‘conduit principle’. A further incentive for natural persons at the highest marginal rate to create a trust structure is that their losses may be ring-fenced in terms of section 20A of the Income Tax Act. Introducing a company within a trust structure definitely adds benefits when compared to being taxed directly in the hands of a trust of natural person being taxed at 45%, due to the company being able to distribute after-tax profits subject to an effective tax rate of 42.4% (combination of current tax at 28% and dividend withholding tax at 20%). Companies could provide an even greater benefit in future years with the corporate tax rate scheduled to reduce to 27% for years commencing 01 April 2022. The added benefit of introducing a company is that, should the investor wish to re-invest profits into the property portfolio, rather than extracting these, these would only be subject to 28% as opposed to natural persons and trust, allowing for accelerated growth of the portfolio. Sections 13sex and 12J on the Income Tax Act are unaffected by the investment vehicle but can be factored into investment vehicle decision making process by assessing whether these benefits can best be utilised (e.g. these allowances/benefits may be of better use for an individual earning a taxable salary in a high tax bracket versus a trust generating a loss where there is no immediate cash benefit as losses will just be carried forward. For companies, it is also important to consider the changes that treasury is considering imposing on the utilisation of assessed losses. This is of particular importance for a rental portfolio which generally reports assessed losses in the initial years of trading.

Section 7C of the Income Tax Act has reduced the tax effectiveness of trusts in that it inhibits the transfer of wealth from an individual to trusts, often resulting in more income tax being borne by the natural person.

For capitals gains tax purposes, which is part of income tax, it appears that the most efficient tax vehicle would be the natural person holding these assets in his own name. This is due to the inclusion rate of 40% for individuals versus 80% for trusts and companies. This means that a natural person at the maximum marginal tax rate of 45% would have an effective capital gains tax rate of 18%, versus 22.4% for companies and 36% for trusts. Companies and trusts also do not benefit from annual exclusions and the primary residence exclusion. Capital gains can be significant when dealing with investment property, therefore it is extremely important for the investor to consider his intention and business model prior to deciding on the investment vehicle. The capital gains advantages for a natural person may not outweigh the advantages of a trust or company.

For estate duty purposes, the trust is clearly the preferred option as no assets owned by the trusts will incur estate duties. However, once again, this will depend on the specific circumstances surrounding the investor. For a natural person who does not foresee his estate exceeding R3.5 million at the time of his death, there will be no estate duty benefit due to the R3.5 million exemption of the dutiable amount currently allowed. If it the estate is expected to exceed R3.5 million, the added costs of maintaining a trust structure over a lifetime may exceed the estate duty benefit expected at death. The lack of estate duty is one of the primary drivers for the creation of trusts. The expected value of the estate at death and the intention of the investor will play a key role in determining the optimum investment vehicle.

7.2. Recommendations for further investigations

The following elements should be subject to further investigation as not fully investigated for the purposes of this research.

Control of assets – When creating a trust structure, it will have to satisfy the South African Revenue Service and the Master of the High Court of the legitimacy and lawfulness requirements. The individual or founder may potentially lose an aspect of control of the underlying assets in order for the natural person and trust to not be seen as the same juristic person for tax purposes.

Future legislation changes – As illustrated by the upcoming change in corporate tax rate and the proposed changes to the utilisation of assessed losses, legislative changes can have a huge impact in determining which investment vehicle to pursue. There have also been indications of possibly scrapping estate duty due to the fact that it generates relatively immaterial tax revenue. Tax rates, exemption and exclusion amounts or new legislation could also drastically impact this decision-making process.

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