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At a glance

Financial Planning and Advice

This month our focus is on estate planning. Deon van Vuuren, legal adviser in the Western Cape, reminds us of the 'one-year wonder', specifically in the context of anti-avoidance provisions contained in the Income Tax Act. After reading the article reality may show that it may well have lost its wonder. Andre Schoeman, our legal adviser in the Free State, tackles the often misunderstood topic of massing estates with the purpose of creating a limited interest over it – if the topic is a mouthful, then this article will definitely help to demystify this practice, quite commonly used in the farming community. I trust you will find both articles useful and interesting.

Happy reading!

One-year wonders: Off the radar?

By Deon van Vuuren, Legal Adviser, Western Cape

We have all heard of or seen the use of 'term' usufructs in practice (referring to a usufruct being created for a specific term). This article will look at the use of term usufructs and the viability thereof from an advice perspective. The most common would be the so-called "one-year wonder". Recently, the use of this structure has been surfacing more often as advisers seek to rely on the potential estate duty savings it offers.

In the 2009 Budget Speech, delivered by Minister Trevor Manuel, it was mentioned that SARS is aware of the use of term usufructs (specific reference was made to the one-year wonder) to circumvent estate duty and that they planned to implement measures to counter it. Since then, however, some argue that no steps have been taken to implement the measures as mentioned. It has been proposed that the reason for not implementing the planned measures is that SARS will be receiving the Capital Gains Tax (CGT) when the trust eventually sells the asset with a relatively low base cost (see below for an explanation on the workings of this concept).

Numerous writers, advisers, and specialists have indicated since the 2009 budget that SARS is not fond of the one-year wonder, and planners moved away from the schemes. That being said, the fact that no measures have been taken to counter the structure have caused some advisers to return to this once "taboo" structure.

The workings of a one-year wonder

A typical one-year wonder clause in a will stipulate that property is bequeathed to a trust subject to the lifelong usufruct of the client's spouse. Upon the death of the spouse, the usufruct is to roll over to a child of the client for a period of one year where after the trust receives full ownership of the property. The trust thus receives the bare dominium value at the client's passing.

This results in the full value of the usufruct being deducted in the deceased estate of the client as a bequest to the client's spouse in terms of section 4(q) of the Estate Duty Act. There are other tax consequences that advisers might not be aware of, such as the possible Value-added Tax (VAT) implications, CGT implications and transfer duty implications.

Upon the death of the spouse, the cessation of the usufruct that the spouse enjoyed will be calculated by using the factor for a one-year period, which leads to far less estate duty payable than where the usufruct would have ceased in its entirety.

When the usufruct ceases after rolling over for the one-year period to the child, there won't be any estate duty, donations tax, CGT, or VAT payable. However, the trust acquires the property at a base cost equal to the bare dominium value, which will result in more CGT being payable if and when the trust disposes of the property.

The main focus is thus estate duty, while the implications of the other applicable taxes, as mentioned above, are often overlooked.

The other important factor that this structure relies on is that the client's heirs pass away in the order envisaged when drafting his will. Should this not be the case, i.e. the child passing away before the spouse, the entire plan to pay as little estate duty as possible, will fail.

Example: one-year wonder	Mr U Fruct owns property of R10 million at time of death. He bequeaths the property to his trust with the usufruct to his spouse for her lifetime. Upon her death, the use will go to his daughter for ONE YEAR ONLY, where after the usufruct will cease. At the time of his wife's death, the value of the property has increased to R12m.
Mr U Fruct	Fixed property – R10m Section 4(q) deduction iro value of usufruct to spouse – R8 068 716

Mrs I Fruct (66 anb)	**Fruct Family Trust**
Value of usufruct: = R10 000 000 x 12% = R1 200 000 x 6,72393 (factor iro life expectancy) = R8 068 716 Upon her death value of use to daughter is included in her estate as an asset: = R1 285 776.00	Value of bare dominium: =R10 000 000 – R8 068 716 = R1931 284

Mrs I Fruct (daughter)	Value of usufruct: = R12 000 000 x 12% = R1 440 000 x 0.8929 (factor for 1 year) = R1 285 776

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Summary:

- Mr Fruct will enjoy a section 4(q) deduction of R8 068 716 and therefore only R1 931 284 of the property value will be included in his net estate
- Mrs I Fruct will only have an inclusion of R1 285 776 in her estate compared to the R8 068 716 value she received
- The Fruct Family Trust receives the property's bare dominium valued at R1 931 284 and once the one-year use to the daughter has expired, the trust will receive the full value without consequence. However, if the trust sells the property, the base cost will be limited to R1 931 284 and therefore a large CGT bill awaits.

The risk:

One of the biggest risks in advising on a one-year wonder to ensure sufficient liquidity in a deceased estate (or implementing life cover to provide liquidity in a client's estate) and relying on the possibility that the one-year wonder will succeed, lies in the fact that – should the structure be regarded by SARS as an impermissible avoidance arrangement – the adviser might be leaving the door open for clients to lodge a claim for losses suffered as a result of his/her advice.

Although there have been instances (very recently) where wills with a one-year wonder have been accepted and the estates properly administered, one might still ask the question, whether it will be permitted in future in view of various comments, reports and case law around the future use of term usufructs after the 2009 budget speech submission.

Advisers who view the 'silence' after the 2009 budget speech (in terms of no legislated measures being forthcoming) as a tacit approval of the structure, might very well be mistaken.

Legislative measures:

The general anti-avoidance provisions as contained in section 80A of the Income Tax Act gives SARS the authority to deem a tax avoidance arrangement as impermissible if the main purpose was to obtain a tax benefit and it was entered into or carried out in a manner that is not for a bona fide purpose, lacks commercial substance in the context of business, or creates rights or obligations that wouldn't normally be created between persons dealing at arm's length.

Although no direct measures have been implemented, as mentioned above, one has to appreciate the fact that SARS can, based on the wide scope of Section 80A, deem an arrangement such as a one-year wonder impermissible. This creates a massive risk when one needs to rely on the manner in which an arrangement will be dealt with at a particular stage in the future.

Davis Tax Committee (DTC) reports:

In the first interim report on estate duty of the DTC, it was mentioned that it could not be established how many taxpayers would be subjected to estate duty in South Africa. More importantly, it was stated that it will be useful to determine *"The degree to which current estate duty receipts resulting from "deemed property interests" are being included in estates as a result of testamentary dispositions made in the past (for example the cessation of usufructs)"*. This surely is an indication of the intention to curb avoidance measures by using usufructs.

In the DTC's final report on estate duty it was recommended that SARS establish comprehensive records of all bare dominium and trust / usufruct arrangements. Usufruct arrangements was also cited as one of the reasons that the number of assessed estates above R 15 000 000 is so low.

It was mentioned that usufruct arrangements are implemented to make use of the deduction for spousal bequests under section 4(q) of the Estate Duty Act. As we all know, the DTC also made the recommendation to repeal section 4(q). As they stated, the repeal of section 4(q) will result in the benefit of usufruct arrangements falling away.

One can assume that usufruct arrangements / avoidance schemes are still "on the radar".

What about the advice?

A recent judgment in the Supreme Court of Appeal (SCA), Centriq Insurance v Oosthuizen and another, confirmed the fiduciary duty placed on a financial adviser. Although the case did not deal with the operation of a one-year wonder, the SCA confirmed the findings of the Free State High Court that generally, a financial services provider will be under an implied (if not express) contractual duty to exercise reasonable care and skill in carrying out the services required of him. The standard of care and skill will be, in most respects, those to be expected of a similar provider engaged to provide the relevant services.

This creates a precedent for the actions, advice, and recommendations of a financial adviser to be tested against what could be expected of a "reasonable financial adviser" who acts with care and skill when advising clients. This poses a threat to the implementation of structures that might be questioned.

Conclusion

The questions one then needs to ask is whether financial advisers who advise their clients to implement structures such as a one-year wonder or any other arrangement that may be seen as an avoidance arrangement, will be able to defend themselves against possible recourse for providing the advice.

If all the requirements of an impermissible avoidance arrangement, as contained in section 80A of the Income Tax Act are met and taking the above recommendations and judgement into account, will an adviser be able to defend a claim by saying that the "reasonable financial adviser" would not have been aware of the risk in implementing a one-year wonder?

Massing of estates with the intent to create a usufruct, and the consequences thereof

By Andre Schoeman, Legal Adviser: Free State

In practice, a farmer and his wife often draft a joint will and stipulate that at the death of the first dying their respective estates should be consolidated and administered as one massed estate. The massed estate is then bequeathed in a certain way, subject to a usufruct (over the whole or a particular portion of the massed estate) in favour of the surviving partner.

After the death of the first dying, the survivor has a choice to adiate (accept) or repudiate (reject) in terms of the joint will. Massing is only carried out if the terms of the joint will are accepted by the survivor, after the death of the first dying spouse. Should the survivor repudiate the terms of the will, massing does not take place and the survivor retains his/her assets, which would have been massed otherwise and also forfeits all benefits that he/she would have received as a result of massing.

It seems like the possible consequences of donation tax is not always thoroughly considered in the event of estate massing. It is important to note that if the survivor's estate is reduced by adiation, the amount by which the survivor's estate is reduced will be deemed to be a donation by the survivor to the beneficiary/heir and the survivor will be liable for donation tax. Such donation comes into effect at adiation and donation tax must be paid within three months after adiation.

Example

Mr. and Mrs. Massing, married out of community of property, has determined in their joint will that if Mr. X dies first, the farms, movable property as well as liquid assets must be massed and inherited by their the Massing Family Trust, of which Mrs. Massing will be one of the income beneficiaries and the children the capital beneficiaries. The will further stipulates that the house is bequeathed to Mrs. Massing and that the beach cottage is subject to a lifetime usufruct in favour of Mrs. Massing. The remaining cash funds, after completion of the estate, must be divided equally between the children.

The assets and liabilities of Mr. and Mrs. Massing on the date of death of Mr. Massing is as follows:

Mr. Massing		Mrs. Massing	
Assets		Assets	
Farm 1	R10 500 000	Farm 4	R11 500 000
Farm 2	R20 800 000	Movable assets	R250 000
Farm 3	R35 000 000	Other assets	R1 000 000
Beach Cottage	R1 500 000		
House	R1 200 000		
Farming Assets	R11 000 000		
Liquid Assets	R2 000 000		
Total	R82 000 000	Total	R12 750 000
Liabilities		Liabilities	
Mortgages	R10 000 000	Nil	
Production loan	R15 000 000		
Hire purchase	R5 000 000		
Total	R30 000 000		

Position if Mrs. Massing adiates:

Value of assets that Mrs. Massing donates as a result of adiation:

Farm 4	R11 500 000
Movable assets	R250 000
Farming assets	R1 000 000
TOTAL	R 12 750 000

Value of assets that Mrs. Massing receives as a result of adiation

House	R1 200 000
Value of usufruct on beach cottage	R 1 231 489
TOTAL	R 2 431 489

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The difference between what she is receiving from Mr. Massing's estate vs what she is giving, is R 10 318 511. Consequently, it is deemed that she donates an amount of R 10 318 511 to the trust and has to pay donation tax to the amount of R 2 043 702 to SARS within three months after adiation (R10 318 511 – R100 000 (annual exclusion) x 20%).

Executors' fees are also payable on the total massed estate, therefore: 3.5% + VAT x (R 82 000 000 + R12 750 000) = R 3 813 687. The executor's fee deductible for estate duty purposes will only be calculated in respect of the first dying. If it is accepted that Mr. Massing dies first only 3.5% + VAT X R 82 000 000 = R 3 300 500 can be claimed as a deduction even though R3 813 687 is actually payable due to the adiation.

In terms of section 9HA of the Income Tax Act, income tax in respect of the farming assets will also be payable. As far as estate duty is concerned, it is important to note that there is no saving upon the death of the first dying. Only the bequest to the surviving spouse may be deducted in terms of section 4(q) of the Estate Duty Act.

The above scenario of the estate duty situation will look as follows (excluding final costs):

Gross assets	R 82 000 000
Less	
Liabilities	R 30 000 000
Executors' fees	R 3 300 500
Transfer costs	R 1 035 000
Capital gain tax (assumption)	R 10 000 000
Article 9HA (@45%)	R 4 950 000 (on R11 000 000 farming assets)
Article 4(q)	R 2 431 489 (beach house usufruct and house)
Article 4A	R 3 500 000
Dutiable estate	R 26 783 011
Estate duty payable	
(First R 30 000 000 million @ 20%)	R 5 356 602
(Above R 30 000 000 @ 25%)	R 0

Conclusion

The above illustration emphasises the possible consequences of massing and the donations tax payable as a result. Estate massing should definitely be considered in the planning process and is one of the mechanisms that can be used to:

- Save estate duty by reducing the estate of the survivor;
- Create a more meaningful and effective inheritance: In particular, spouses married in community of property may, by merging their respective undivided halves into a common asset, ensure that such an asset is already inherited as a merged entity at the death of the first dying. Subject to a usufruct in favour of the survivor, it will protect against only the half of first dying assets inheriting at his/her death with the possible result of shared ownership.

About Leverage

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