



## CHAPTER 1 INTRODUCTION

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### 1.1 BACKGROUND AND PURPOSE OF STUDY

The taxation of inherited wealth is one of the oldest fiscal instruments and can be traced back to the ancient civilisations of the Egyptians, Romans and Greeks.<sup>1</sup> The taxation of transfers on death, which has over time been supplemented by a tax on *inter vivos* gifts,<sup>2</sup> will for the purposes of this study be collectively referred to as “wealth transfer taxation”.

This type of taxation has evolved over many centuries and can presently still be found in many tax jurisdictions in various diverse forms. What is noteworthy is that two main approaches to taxing wealth transfers developed, namely transferor-based taxation levied on deceased estates or donors, and recipient-based taxation levied on the individual beneficiaries of the wealth. Although tax reform in the area of wealth transfer taxation has been prolific over the past century, it seems as if a universal approach is far from a realistic possibility. As will appear more fully in the discussion in Chapter 3 below, tax review commissions in various countries have reviewed this type of taxation, and their recommendations were far from being uniform. To add insult to injury, some countries have abolished their wealth transfer taxes in the past few decades, which has sparked an international debate as to whether or not this type of taxation is conceptually justifiable.

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<sup>1</sup> Van Nispen and Shuttevaer (1969) 124 succinctly state that “[d]e successiebelasting nu is ouder dan de weg na Rome”.

<sup>2</sup> Although the term “gift” is commonly used internationally, the synonym “donation” is more often used in a South African context. These two terms will therefore be used interchangeably throughout this thesis.



In the words of Richard Bird: “[d]eath may still be certain, but death taxes no longer are!”<sup>3</sup>

The South African tax system currently provides for wealth transfer taxation by virtue of estate duty on deceased estates in terms of the Estate Duty Act<sup>4</sup> and donations tax on donations *inter vivos* in terms of Part V of the Income Tax Act.<sup>5</sup> Since the introduction of the existing wealth transfer tax system in 1955, its nature and character had been examined by three government-appointed commissions of enquiry, reporting on aspects of the tax structure, namely:

- the Commission of Enquiry into Fiscal and Monetary Policy in South Africa, chaired by DG Franzsen (the “Franzsen Commission”), which issued two reports under the title *Taxation in South Africa* in 1968 (the “First Franzsen Report”) and 1970 (the “Second Franzsen Report”);
- the Commission of Inquiry into the Tax Structure of the Republic of South Africa, chaired by CS Margo (the “Margo Commission”), which issued a single wide-ranging report in 1986 (the “Margo Report”);
- the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, chaired by MM Katz (the “Katz Commission”), which issued nine interim reports during the period 1994–1999, of which the reports issued in 1994 (the “Interim Katz Report”), in 1995 (the “Third Interim Katz Report”) and in 1997 (the “Fourth Interim Katz Report”) are of particular relevance for this thesis.

As Chapter 3 will reveal in more detail, all three of the tax reform commissions endorsed the existence of wealth transfer taxation in the South African tax system. In addition, all three commissions favoured a transferor-based approach to taxing wealth transfers. Because the Margo Commission had been informed that, in the government’s opinion,

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<sup>3</sup> Bird (1991) *Can Publ Pol* 323.

<sup>4</sup> Act 45 of 1955.

<sup>5</sup> Act 58 of 1962.

estate duty was “terminally ill”,<sup>6</sup> the recommendations to be made by the commission were highly anticipated. The report detailed a number of areas in need of reform, including the lack of taxing wealth transfers under an integrated regime. As a consequence, the commission proposed that estate duty and donations tax should be replaced with a “capital transfer tax”.<sup>7</sup> The government accepted this recommendation in principle,<sup>8</sup> but failed to act on it.

In the 1993 Budget Review it was reported that the Taxation Advisory Committee had recommended that the possibility be investigated that the existing Estate Duty Act and the donations tax provisions of the Income Tax Act be combined and adapted so as to provide for a more effective wealth transfer tax system. Apparently, draft legislation was being drawn up.<sup>9</sup> Furthermore, the Katz Commission supported the Margo Commission’s idea of an integrated capital transfer tax.<sup>10</sup> It was, nonetheless, concluded that there is “no pressing need” to proceed with the legislative process and that this can be done as and when there are resources available within the South African Revenue Service (hereafter SARS) to do so.<sup>11</sup> However, to date nothing has materialised.

Although many of the minor recommendations by the commissions were enacted by virtue of amendments to the existing legislation, some of the major issues that were identified were left unattended to, as will more fully appear from the discussion in Chapter 7 below.

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<sup>6</sup> Hansard (Volksraad Debatte) 19 (1985) 7661; Editorial (1986) *Taxpayer* 61.

<sup>7</sup> Margo Report (1986) pars 20.50 and 20.53.

<sup>8</sup> White Paper on the Margo Report (1988) 16 and 53.

<sup>9</sup> Budget Review (1993) par 3.2 as referred to by Meyerowitz (1993) *Taxpayer* 48.

<sup>10</sup> Third Interim Katz Report (1995) pars 7.1.12 and 7.4.1 and Fourth Interim Katz Report (1997) par 5.1.

<sup>11</sup> Fourth Interim Katz Report (1997) par 5.9.



The introduction of capital gains tax into the South African tax system in 2001,<sup>12</sup> which provided for a deemed disposal of all the deceased's assets to his or her deceased estate at the moment of death, has awakened the speculation that estate duty may be abolished in the not too distant future. Mazansky commented that it is foreseeable that the revenue derived from capital gains tax payable on death could at some point in the future prompt estate duty and donations tax to land in the "fiscal dustbin".<sup>13</sup>

At the outset, this study will investigate the conceptual justification of wealth transfer taxation in the South African context. It is noteworthy that this area has received little attention in South Africa, unlike the United States, where it prompted lively debate, as will more fully appear in the discussion in Chapter 4 below. Because it will be concluded that this type of taxation is essential for purposes of the South African tax system, the study will explore some key policy issues that relate to the current wealth transfer tax system. The first issue relates to the lack of integration between the taxation of *inter vivos* transfers (under the donations tax regime) and the taxation of transfers on death (under the estate duty regime). The current regimes will be evaluated to assess the discrepancies between the two regimes; this will assist in identifying ways and means of improving the integration of *inter vivos* transfers and transfers on death. Furthermore, this thesis will re-open the debate between transferor-based taxation and recipient-based taxation in the South African context, especially because of the theoretical appeal that underpins recipient-based taxation, as will be explored more fully in Chapter 4.

## 1.2 EXPOSITION

Chapter 2 provides a general background relating to the origin and essence of taxation, its objectives and its central tax policy considerations. The discussion will also provide a brief exposition of a contemporary tax system comprising the taxation of income,

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<sup>12</sup> Eighth Schedule to the Income Tax Act.

<sup>13</sup> Mazansky (2002) *Executive Business Brief* 17.



consumption and wealth, with specific reference to the South African context. This is important, because “any measures or proposed amendments should be considered within the context of the system as a whole, and be judged as to its contribution towards the advancement of the overall economic and fiscal objectives”.<sup>14</sup> The various treatments of the unrealised gains upon death or the making of a donation will be reviewed in order to give the reader an understanding of the interaction between capital gains taxation and wealth transfer taxation.

Chapter 3 provides a historical overview of wealth transfer taxation from the time of the Roman Empire through the Middle Ages to the evolution and development of this type of taxation in a selection of countries. The discussion will demonstrate the gradual evolution of transferor-based taxation and recipient-based taxation on an international level and will also point to the decline of wealth transfer taxation in a number of leading jurisdictions over the last few decades, which stimulated the debate on the conceptual justification for this form of taxation.

Chapter 4 evaluates all the policy considerations relevant to this debate, and will conclude that some form of wealth transfer taxation is justified and desirable for the South African tax system. In particular, it will be shown that the levying of capital gains tax upon a wealth holder’s death does not replace the function and role of a wealth transfer tax. Although wealth transfers may conceptually be taxed in a comprehensive income or a direct consumption tax, these options are not currently on the cards for the South African system.

The aim of Chapters 5 and 6 is to provide a contemporary overview of the South African wealth transfer tax system. Chapter 5 deals with the provisions of the donations tax regime, while Chapter 6 deals with the main characteristics of the estate duty regime.

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<sup>14</sup> Interim Katz Report (1994) par 1.5.4 (d).



Chapter 7 outlines some key policy issues and problem areas relevant to the current South African wealth transfer tax system. To illustrate the lack of integration between the taxation of *inter vivos* transfers and the taxation of transfers on death, the discrepancies between the estate duty regime and the donations tax regime are outlined. This leads to the conclusion that the lack of integration is not conducive to horizontal equity in the system. The second issue relates to the debate on the choice between transferor-based taxation and recipient-based taxation. Because of the theoretical appeal of recipient-based taxation demonstrated in Chapter 4, the question is posed whether the current transferor-based approach should be retained or whether it should be replaced by a recipient-based system. Because such a question cannot appropriately be answered without consideration of problem areas experienced under the current system, the discussion will outline a number of current issues.

Chapters 8, 9 and 10 contain a comparative discussion of the contemporary wealth transfer tax systems in the United Kingdom, the Netherlands and Ireland respectively. The fact that South African estate duty was largely premised on the English example necessitates an overview of the United Kingdom wealth transfer tax system as a point of departure. Also, the United Kingdom system provides a classic example of a well-rooted transferor-based wealth transfer tax system. The recipient-based system in the Netherlands was chosen for the comparative survey because the South African common law is rooted in the Roman-Dutch law that was applied in the province of Holland in the seventeenth and eighteenth centuries. Although wealth transfer tax legislation in South Africa was not based on the Dutch precedent, the numerous similarities in some basic property law concepts (such as a usufruct and *fideicommissum*) render the Dutch system of comparative interest. It is also of paramount importance to consider the main characteristics of a recipient-based tax. The Dutch system, being one of the oldest systems in continental Europe, provides a well-documented and well-debated example. The system in Ireland is of comparative interest because it provides an example of a traditional common-law legal system that successfully replaced its transferor-based estate duty with a recipient-based acquisitions tax.



Chapter 11 contains conclusions and reform proposals on the key policy issues identified in Chapter 7. Firstly, a comparative exposition is provided of the level of integration that exists between the taxation of *inter vivos* transfers and transfers on death in the systems of the countries surveyed. It will be shown that, generally, the rules relating to the jurisdictional basis, unilateral double taxation relief provisions and valuation rules apply equally to all wealth transfers. However, all three systems differentiate between *inter vivos* transfers and transfers on death to provide for flexibility in certain areas. Most significantly, both types of transfers are taxed under a single legislative regime in all three systems. It is concluded that, although integration under the South African system may be improved with a few amendments to the estate duty and donations tax regimes, the taxation of *inter vivos* transfers and transfers on death should ideally be integrated under a single legislative structure, such as provided for in the United Kingdom, the Netherlands and Ireland. On the transferor-based tax/recipient-based tax debate, it is concluded that South Africa should replace its transferor-based regimes with an (integrated) recipient-based system. To arrive at this conclusion, a number of policy considerations are evaluated. In addition, it will be shown that some of the significant problem issues identified in Chapter 7, which are actually common to wealth transfer taxation in general, are more appropriately dealt with in a recipient-based tax.

### 1.3 LIMITATION OF SCOPE

This study focuses on the taxation of the gratuitous transfer of wealth. Other transfer taxes, such as the tax payable on the transfer of immovable property (known in South Africa as transfer duty) or shares and securities (known in South Africa as a securities transfer tax), are therefore specifically excluded from this study.

It should furthermore be noted that this study is limited to the taxation of the gratuitous transfer of capital, and not the *ownership* or *profit* of capital, which are accommodated in taxes such as periodic net wealth taxes or capital gains taxes. Although a reference to the treatment of capital gains tax on death and the making of a donation is necessary to assess whether it can serve as an alternative to wealth transfer taxation (this is also undertaken in



order to provide a more complete view of the tax system as a whole), capital gains taxation in South Africa will be referred to where relevant and will not be critically assessed.

Chapter 7 outlines a number of significant problem areas that exist under the current South African wealth transfer tax system. This is done mainly to assess whether the current transferor-based approach should be replaced by a recipient-based approach. However, this study will not attempt to provide solutions for all these issues.

Aspects of compliance and tax administration are also generally excluded from the focus of this study.

This thesis does not take into account any development in the law that occurred after 1 January 2010.



## CHAPTER 2

### THE HISTORICAL DEVELOPMENT, OBJECTIVES AND POLICY CONSIDERATIONS OF TAXATION IN GENERAL

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**2.1 INTRODUCTION**

The existence of taxation within a modern economy has become a widely accepted reality. As a point of departure, this chapter examines the historical development of taxation in general, with emphasis on the taxation of income, wealth and consumption. This provides the reader with a contextual understanding of a modern tax system and the interaction of wealth transfer taxation with the other taxes in the system. For the sake of completeness, a reference to the contemporary South African tax system is provided.

In view of the fact that any proposal for tax reform should take cognisance of policy considerations, the objectives and essential principles of taxation are outlined, with special reference to the South African context. This is followed by a brief discussion of the South African constitutional considerations applicable in the realm of taxation.

**2.2 A GENERAL ORIENTATION TO TAXATION AND AN OVERVIEW OF THE TAXATION OF INCOME, WEALTH AND CONSUMPTION****2.2.1 General Orientation*****2.2.1.1 The Origin, Historical Development and Theoretical Basis of Taxation***

The idea of taxation developed closely with the idea of an orderly society and the institution of a government with authority.<sup>1</sup> In ancient times the mere power of the sovereign was the foundation of its entitlement to commit acts of aggression against its

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<sup>1</sup> Piek and Franzsen in Van Jaarsveld and Oosthuizen *eds* (1988) 903; Brautigam in Brautigam, Fjelstad and Moore *eds* (2008).

subjects, including its claim against their resources.<sup>2</sup> Apparently the first known system of taxation can be found in Ancient Egypt around 3000 BCE–2800 BCE, where the pharaoh conducted a biennial tour of the kingdom, collecting contributions from the people. Apparently, the tax was at some point calculated by measuring the rise and fall of the Nile River.<sup>3</sup> In the ancient Roman and Greek Empires, contributions were initially collected in indirect ways, such as through spoils of war, harbour dues, tolls and customs on trade and commerce.<sup>4</sup> During the reign of the Roman Emperor Diocletian (284–305 CE), the first extensive direct taxes were imposed on Roman citizens based on heads (*capita*) and land (*iuga*), to provide funding for the increasing expenditure needs of the empire. After the decline and fall of the Western Roman Empire (*circa* 476 CE), the capitation and property taxes, being symbols of oppression, became unenforceable and disappeared completely.<sup>5</sup>

With the subsequent rise of various empires and kingships, for example the empire of Charlemagne in Europe and the Saxon kings in England, contributions to the sovereign were initially voluntary.<sup>6</sup> It was unacceptable for a sovereign to impose taxation on its subjects, unless in times of war<sup>7</sup> or in exchange for a specific benefit.<sup>8</sup> Indirect collection

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<sup>2</sup> Adriani and Van Hoorn Vol 1 (1954) 184–186; Hepker (1973) 11 refers to a clay tablet found in Iraq which dates 3 500 years ago with the inscription: “You can have a Lord, you can have a King, but the man to fear is the tax collector.”

<sup>3</sup> Croome PhD Thesis (2008) 1 n 2 and accompanying text.

<sup>4</sup> Seligman (1921) 4; Brissaud (1969) 100; Sabine (1980) (in general); Piek and Franzsen in Van Jaarsveld and Oosthuizen *eds* (1988) 904; Doyle (2008) par 1.2.1. War victories allowed the Romans to seize the wealth of the conquered people. Taxes through spoils of war therefore initially fell on those living in the provinces controlled by the Roman Empire. See Coffield (1970) 1, 4.

<sup>5</sup> Klein-Wassink in Jongsma and Verburg *eds* (1975) 93–94.

<sup>6</sup> Seligman (1969) 2; Klein-Wassink in Jongsma and Verburg *eds* (1975) 94; Piek and Franzsen in Van Jaarsveld and Oosthuizen *eds* (1988) 903–904.

<sup>7</sup> Hepker (1973) 11; Theron LLD Thesis (1994) 12 n 7. A well-known “war tax” in England was known as “Danegeld”. The tax was originally introduced in 845 to protect England against the Danish invaders, but it was later retained as a form of land tax. See Hepker (1973) 12; Sabine (2006) 11; Brautigam in Brautigam, Fjelstad and Moore *eds* (2008) 7 and Doyle (2008) par 1.2.1.

<sup>8</sup> Buehler (1948) 318.



of revenue through excise taxation on, for example, salt, beer, soap, candles, leather and meat became the principal way of filling the ruler's coffers.<sup>9</sup> These voluntary contributions were based on the principles of the social contract,<sup>10</sup> the so-called "contractual taxation".<sup>11</sup> However, the difficulty with contractual taxation is that it requires a consensual undertaking by the citizen<sup>12</sup> and could therefore not serve as a foundation for *inter alia* the redistribution of resources.<sup>13</sup>

During the Middle Ages, the idea developed that taxation is actually an inherent and indispensable power of the government to coerce its subjects to surrender their property without their consent, a process of "forced exchange", or "coercive taxation".<sup>14</sup> This

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<sup>9</sup> Smith (1776) book v ch ii pt ii art iv, available at <http://www.adamsmith.org> (accessed on 20 June 2008); Klein-Wassink in Jongsma and Verburg *eds* (1975) 94.

<sup>10</sup> Brissaud (1969) 476 explains the concept of the *social contract* as follows: "[It] properly so assumed that men lived at first in a state of nature or anarchy, as was sometimes fancied according to the traditions of the classical antiquity (golden age, etc); they escaped from it through the social contract, that is to say, by an agreement in virtue of which they bound themselves to live in society, each man surrendering his rights to the community and promising to obey the sovereign whom it should give. The state of nature and the social contract, – it is upon these chimeras that our modern liberties rest."

<sup>11</sup> Epstein (1986) *Soc Philos Pol* 49 n 1; Musgrave (2000) 136; Wolfram in Racheter and Wagner *eds* (2002) 50–54; Brautigam in Brautigam, Fjelstad and Moore *eds* (2008) 12–15. The two predominant theories underpinning contractual taxation are the *exchange theory* and the *insurance theory*. According to the *exchange theory*, subjects surrender their resources to the government in exchange for the protection of their liberty and property. See Adriani and Van Hoorn Vol 1 (1954) 187–188 and Loeckx and Van Dionant (1980) 97–98. Klein-Wassink in Jongsma and Verburg *eds* (1975) 96 mentions that this theory is closely related to the "benefit-principle" (see par 2.4.2.1.1). The *insurance theory* is based on the idea that taxation offers an insurance premium for the protection of liberty and property by the government. See Adriani and Van Hoorn Vol 1 (1954) 186; Van Nispen and Schuttevaer (1969) 35 and Loeckx and Van Dionant (1980) 98.

<sup>12</sup> Wagner in Racheter and Wagner *eds* (2002) 43 explains that taxation cannot be imposed on a voluntary basis: "People would have strong incentives to take free rides on the contributions of others. As a result, such common valued services as civil order and national security, which requires expenditures on military, police, and courts, are likely to be under funded." See also Buehler (1948) 319; Epstein (1986) *Soc Philos Pol* 49; Franzsen LLD Thesis (1990) 10; Theron LLD Thesis (1994) 16; Mack in Racheter and Wagner *eds* (2002) 9–26 and Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 116.

<sup>13</sup> Musgrave (2000) 136.

<sup>14</sup> Adriani and Van Hoorn Vol 1 (1954) 190; Van Nispen and Schuttevaer (1969) 35–37; Wagner (1973) 43; Klein-Wassink in Jongsma and Verburg *eds* (1975) 95; Loeckx and Van Dionant (1980) 99; Epstein (1986) *Soc Philos Pol* 51–54; Piek and Franzsen in Van Jaarsveld and Oosthuizen *eds* (1988) 904, 906–912; Franzsen LLD Thesis (1990) 10; Theron LLD Thesis (1994) 12, 17; Mack in Racheter and Wagner

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ideology was reinforced with the development of nation-states and an increased need for public revenue. This theory implies that an express provision conferring on a government a power to tax is not essential.<sup>15</sup> The fiscal legislation need furthermore not conform to the “canons of taxation”.<sup>16</sup> However, a government does not have unlimited powers as far as taxation is concerned in view of the modern idea that a government should be accountable to its citizens, requiring fiscal legislation to comply with the relevant country’s constitutional restrictions.<sup>17</sup> The concept of accountability is significant in the realm of taxation, if one considers that taxation, as a means of oppression, has played an important role in numerous revolts, revolutions and wars.

### 2.2.1.2 Description of Taxation

Providing a comprehensive definition of taxation is challenging. It can best be described as a monetary-based<sup>18</sup> compulsory contribution<sup>19</sup> payable by the public as a whole or a

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*eds* (2002) 11; Brennan and Buchanan (2006) 4, 10; Moore in Brautigam, Fjelstad and Moore *eds* (2008) 37.

<sup>15</sup> Croome PhD Thesis (2008) 9 refers to a quotation from Hyatali CJ in *Attorney General of Trinidad and Tobago v Ramesh Dipraj Kumar Mootoo* (1976) 28 WIR 326: “The power to tax rests upon necessity, and it is inherent in any sovereignty. The legislature of every free State will possess it under the general grant of legislative power, whether particularly specified in the Constitution among the powers to be exercised or not. No constitutional government can exist without it.”

<sup>16</sup> In *Partington v Attorney-General* (1869) LR 4 HL 100, 21 LT 370 it was stated that: “[I]f a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be, even though the so-called ‘canons of taxation’ as propounded by Adam Smith in *The Wealth of Nations*, namely equity, neutrality, certainty and administrative efficiency, have not been observed.” See par 2.4.2 for a discussion on the “canons of taxation”.

<sup>17</sup> Epstein (1986) *Soc Philos Pol* 50; Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 116. See also Hettich and Winer (1985) *Natl Tax J* 432.

<sup>18</sup> Some of the ancient taxes were, however, levied in kind. See Adriani and Van Hoorn Vol 1 (1954) 101; Loeckx and Van Dionant (1980) 70; Franzsen LLD Thesis (1990) 12 n 17 and accompanying text; Theron LLD Thesis (1994) 25; Thuronyi (2003) 48; Moore in Brautigam, Fjelstad and Moore *eds* (2008) 35.

<sup>19</sup> Buehler (1948) 320; Adriani and Van Hoorn Vol 1 (1954) 100; Loeckx and Van Dionant (1980) 70; O’Brien Report (1982) 67; Franzsen LLD Thesis (1990) 12; Theron LLD Thesis (1994) 25; Thuronyi (2003) 48; Messere, De Kam and Heady (2003) 7; Croome PhD Thesis (2008) 30; Moore in Brautigam, Fjelstad and Moore *eds* (2008) 35.

substantial sector thereof<sup>20</sup> to a government (at a national or sub-national level).<sup>21</sup> Its primary purpose is to defray government expenditures,<sup>22</sup> but it can also serve as an instrument to attain socio-economic and political objectives.<sup>23</sup> Taxes are levied in terms of specific legal rules,<sup>24</sup> which should comply with the constitutional law of the relevant jurisdiction.<sup>25</sup> They are not levied as a *quid pro quo* for specific defined benefits provided by the government,<sup>26</sup> but should rather be utilised for public benefit.<sup>27</sup>

### 2.2.1.3 The Development of the Various Tax Bases

Seligman refers to the development of five traditional faculties or “tax bases”<sup>28</sup> throughout history. In primitive communities, where there were no very rich and no very poor and where individual revenue was derived from individual exertion, polls (numbers) formed a satisfactory test of ability in taxation. The development of private property and the differentiation of economic classes led to the second stage of faculty development,

<sup>20</sup> *Maize Board v Epol (Pty) Ltd* 2009 (3) SA 110 (D) 120G.

<sup>21</sup> Loeckx and Van Dionant (1980) 69; O’Brien Report (1982) 67; Franzsen LLD Thesis (1990) 12; Theron LLD Thesis (1994) 25; Thuronyi (2003) 45; Messere, De Kam and Heady (2003) 7; Moore in Brautigam, Fjelstad and Moore *eds* (2008) 35.

<sup>22</sup> Adriani and Van Hoorn Vol 1 (1954) 101; Loeckx and Van Dionant (1980) 71; Theron LLD Thesis (1994) 26.

<sup>23</sup> Franzsen LLD Thesis (1990) 12; Theron LLD Thesis (1994) 26.

<sup>24</sup> Loeckx and Van Dionant (1980) 70; Franzsen LLD Thesis (1990) 13; Theron LLD Thesis (1994) 25; Croome PhD Thesis (2008) 30.

<sup>25</sup> Croome PhD Thesis (2008) 1.

<sup>26</sup> Contributions to the government that are levied for specific benefits are called redistributions or consumption levies. See Buehler (1948) 319–320; Adriani and Van Hoorn Vol 1 (1954) 106; Loeckx and Van Dionant (1980) 70; O’Brien Report (1982) 67; Franzsen LLD Thesis (1990) 13 n 22 and accompanying text, 13–14; Theron LLD Thesis (1994) 26–29; Thuronyi (2003) 46; Messere, De Kam and Heady (2003) 7; Croome PhD Thesis (2008) 1; Moore in Brautigam, Fjelstad and Moore *eds* (2008) 35.

<sup>27</sup> *Maize Board v Epol (Pty) Ltd* 2009 (3) SA 110 (D) 120H.

<sup>28</sup> A “tax base” can be described as the collective value of taxable assets or taxable activities subject to the levying of taxation. According to the Margo Report (1986) par 5.1 this is “either a flow or a stock of wealth to which the public sector can lay partial claim”. Doyle (2008) par 1.5.3 describes a tax base as “some quantifiable collection of like items upon which tax is levied”. The asset(s) in respect of which a tax applies within a tax base is referred to as the “tax object(s)”. See Franzsen LLD Thesis (1990) 14–15.



namely property. A third development was the notion to tax expenditure. The fact that a tax on expenditure became an increasingly heavy burden on the least wealthy classes contributed to the development of the next stage, namely the notion of taxing the produce of property, irrespective of who owned the property. This development was a forerunner of the taxation of net profits, or income.<sup>29</sup>

Although taxes can be classified and categorised in various ways, the following paragraphs provide a general overview of the three main tax bases contained in modern tax systems, namely the taxation of income, wealth and consumption.

### 2.2.2 The Taxation of Income

Broad-based income taxation is a relatively modern innovation. Apparently, the first true progressive direct income tax was introduced in Britain by William Pitt the Younger in 1799, to pay for weapons and equipment in preparation for the Napoleonic wars.<sup>30</sup> It developed in the early nineteenth century principally in England, Sweden and some of the German and American states.<sup>31</sup> Many industrialised countries imposed an income tax only towards the end of the nineteenth century or early in the twentieth century.<sup>32</sup>

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<sup>29</sup> Seligman (1921) 5–18; Seligman (1969) 10–18. See also Piek and Franzsen in Van Jaarsveld and Oosthuizen *eds* (1988) 904–905.

<sup>30</sup> Sabine (1980) 115–117; Holmes PhD Thesis (2000) 154. See Sabine (2006) for a discussion on the history of the income tax in England from its beginning in 1799 to the present day.

<sup>31</sup> Thuronyi (2003) 231.

<sup>32</sup> Thuronyi (2003) 231. E.g. the first US income tax was imposed in July 1862. See also Vivian (2006) *SA Journal of Economics* 82.



### 2.2.2.1 *The Income Tax: Various Approaches*

Historically, two distinctly different notions of *legal* income developed, namely the English source-based concept (influenced by the trust concept) and the American accretion-based concept.<sup>33</sup>

According to the “source concept”,<sup>34</sup> which originated in an English agricultural economy, income is described as the fruits produced by capital.<sup>35</sup> According to this approach a receipt is considered to be income only if it is periodic in nature and derived from personal exertion, activities or capital.<sup>36</sup> The capital itself, namely the source of the income, is excluded from the tax base. Under this approach, income includes salaries, wages, interest, rent, trade profits, royalties and dividends.<sup>37</sup> According to Seligman, inheritances are irregular returns and “in a logical [source-type] income tax there is no room for such accidental or fortuitous revenues”.<sup>38</sup>

The source-based notion of income was adopted in continental European systems such as the ones in the Netherlands, France, Germany, Italy and Spain.<sup>39</sup> The distinction between income and capital under the source concept was furthermore influenced by principles of English trust law, when the idea developed that landowners could limit their heirs to the enjoyment of the property only.<sup>40</sup> The understanding of income, as opposed to capital, in

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<sup>33</sup> Holmes PhD Thesis (2000) Ch 5; Thuronyi (2003) 235–240; Lang in Essers and Rijkers *eds* (2005) 18.

<sup>34</sup> The Margo Report (1986) par 5.26 refers to the “production flow concept of income”.

<sup>35</sup> Holmes PhD Thesis (2000) 174; Thuronyi (2003) 236 n 18, 237. Apparently this concept was based on the theory of the classical economists. See Vivian (2006) *SA Journal of Economics* 90.

<sup>36</sup> Thuronyi (2003) 27.

<sup>37</sup> Holmes PhD Thesis (2000) 174.

<sup>38</sup> Seligman (1969) 133–134. See also Holmes PhD Thesis (2000) 434 and Thistle (2007) *Ga J Int & Comp L* 715–716. There are some exceptions. Apparently, Denmark includes the receipt of a gift as taxable income in the hands of the recipient. See Holmes PhD Thesis (2000) 434 n 46.

<sup>39</sup> Thuronyi (2003) 27, 236–237, 240.

<sup>40</sup> Holmes PhD Thesis (2000) 174. Thuronyi (2003) 233 refers to a third “trust concept” of income. It is submitted that the trust concept is not a separate category of income. Principles of trust law merely influenced the differentiation between income (separated from the source) and capital (the source).



the earlier decisions of the English Courts on the subject of trust law was transposed to the interpretation of the concept of income under the income tax law in 1921.<sup>41</sup> The trust law distinguishes between income received by beneficiaries (life tenants), and capital held by the holders of the remainder interest (remainder-men).<sup>42</sup> This development influenced the judicial interpretation of legal income in the United Kingdom, Canada and Australia in particular.<sup>43</sup>

The dramatically different accretion-based concept originated in the United States.<sup>44</sup> This notion of income does not contain the sharp distinction between income and capital that originated in England and Europe.<sup>45</sup> Holmes explains that this is attributable to the fact the “[o]wnership of land did not carry the same social prestige that it did in England and Europe ... Wealth accumulation in England would traditionally have been retained as a means of deriving a stream of rental or farming income”,<sup>46</sup> whereas in America “gains from the sale of capital assets [often] constituted the profit contemplated from a transaction”.<sup>47</sup> As a result, this concept of income has also included capital gains and profits in the carrying out of business operations.<sup>48</sup> The judiciary, however, consistently held that unrealised increases in the value of assets do not constitute income for purposes of the United States income tax.<sup>49</sup> Although inheritances and gifts were conceptually

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<sup>41</sup> See Holmes PhD Thesis (2000) 179–193 for a detailed discussion on this transposition.

<sup>42</sup> Holmes PhD Thesis (2000) 174; Thuronyi (2003) 238.

<sup>43</sup> Thuronyi (2003) 236, 240.

<sup>44</sup> Thuronyi (2003) 236.

<sup>45</sup> See Holmes PhD Thesis (2000) 221–228 for a comprehensive discussion of the development of the concept of income in the US.

<sup>46</sup> Holmes PhD Thesis (2000) 221.

<sup>47</sup> Holmes PhD Thesis (2000) 222.

<sup>48</sup> Arnold and Edgar (1995) *Can Publ Pol* 61. Holmes PhD Thesis (2000) 226 quotes from the Supreme Court decision *Eisner v Macomber* (1920) 252 US 189 (206–207): “Income may be defined as the gain derived from capital, from labour, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets.”

<sup>49</sup> Holmes PhD Thesis (2000) 227 refers to e.g. the decision of *Town v Eisner* (1918) 245 US 418.



included in the tax base,<sup>50</sup> these accretions were statutorily excluded from the income tax base from 1913.<sup>51</sup>

Income taxes (whether source-based or accretion-based) are usually structured on either a global or a schedular basis. In a global income tax income consists of all types of income, whatever its nature or source, and deductions are allowed irrespective of the type of income in respect of which they were incurred, producing a taxable amount to which a tax rate is applied. On the other hand, a schedular income tax provides for various categories of income, often taxed at different rates and in terms of different rules. It is also common for income tax systems to evince elements of both a global and a schedular system.<sup>52</sup>

In South Africa, nearly 60 percent of national revenue is currently derived from a direct income tax,<sup>53</sup> currently levied in terms of the Income Tax Act of 1962.<sup>54</sup> In view of the fact that the first income tax enacted for the South African Union in 1914 was based on the Land and Income Tax Assessment Act of 1895 from New South Wales,<sup>55</sup> which was in turn based on English income tax legislation, the South African concept of income was formulated on the English source-based concept of income. Under the current act, “gross income” consists of receipts and accruals other than receipts and accruals of a capital

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<sup>50</sup> Eisenstein (1956) *Tax Law Rev* 227 n 22; McCaffery (1999) *Tax Notes* 1430; Gale and Slemrod in Gale, Hines and Slemrod eds (2001) 14.

<sup>51</sup> Apparently the US Congress concluded in 1913 that the common man-on-the-street understanding of income probably does not include gifts. See Kornhauser (1992) *Conn Law Rev* 12; Holmes PhD Thesis (2000) 447–448; Darnell (2004) *Seton Hall Law Rev* 671 n 51.

<sup>52</sup> Thuronyi (2003) 233–235.

<sup>53</sup> See the statistics available at <http://www.treasury.gov.za/documents/national%20budget/default.aspx> (accessed on 17 March 2009). For the 2007/2008 year of assessment, taxes from income contributed to 57.9% of the total tax revenue. See National Treasury (Republic of South Africa) *2009 Estimate of National Revenue* 3, available at <http://www.treasury.gov.za/documents/national%20budget/2009/enr/enr.pdf> (accessed on 17 March 2009).

<sup>54</sup> Act 58 of 1962.

<sup>55</sup> Vivian (2006) *SA Journal of Economics* 82.

nature.<sup>56</sup> Although the current income tax can predominantly be classified as a global income tax, providing for the application of a tax rate to a taxpayer's taxable income (consisting of all types of income), the system has over the years adopted elements of schedular taxation (such as the provision for the separate taxation of capital gains within the income tax system, as will be discussed more fully below).<sup>57</sup>

### 2.2.2.2 *Comprehensive Income Tax*

In 1966, the Canadian Royal Commission on Taxation, chaired by K LeM Carter (the "Carter Commission"), conceded that the essence of ability-to-pay is founded on the changes in the economic or spending power of a taxpayer and proposed that the existing Canadian (English-based) legal concept of income should be broadened and based on the *economic* Haig-Simons concept of income, which is even broader than the American accretion-concept.<sup>58</sup> According to the Haig-Simons concept of income (sometimes referred to as "S-H-S income"), "income" is defined as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question".<sup>59</sup> In short, income equals consumption plus change in net wealth. This formulation of income, which has widely been accepted in economic theory,<sup>60</sup> is very broad and conceptually includes market income (business income), such as earnings derived from trade profits

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<sup>56</sup> Income Tax Act s 1.

<sup>57</sup> See par 2.2.3.3.2.

<sup>58</sup> See in general Carter Report Vol 1 (1966) 6 and Vol 3 (1966) Ch 8 and Meade Report (1978) 127–147 for a discussion on the basic features of a comprehensive income tax.

<sup>59</sup> Simons (1938) 50. This concept of income was initially developed by the German economist Georg von Schanz (in 1896) and further developed by the American economists Robert Haig and Henry Simons in the 1920s and 1930s. See Musgrave (1967) *Harv Law Rev* 44 47 n 7; Goode in Pechman *ed* (1977) 1–30 and Holmes PhD Thesis (2000) 55–74.

<sup>60</sup> Goode in Cnossen and Bird *eds* (1990) 62; Holmes PhD Thesis (2000) 35; Lang in Essers and Rijkers *eds* (2005) 18; Steenekamp *Income Taxation* in Black, Calitz and Steenekamp *eds* (2008) 154–155.

and the fruits of capital,<sup>61</sup> unrealised accrued capital gains,<sup>62</sup> imputed income<sup>63</sup> and income from gifts and inheritances (i.e. “transfer income”).<sup>64</sup>

The Carter Commission’s proposal attracted wide support under theorists and policy-makers,<sup>65</sup> and was also considered by various official tax review commissions.<sup>66</sup> Three ways of treating gifts and inheritances in a comprehensive income tax base were identified. In terms of the first approach, inheritances and gifts received would be perceived as additions to taxable capacity and would be included as income in the hands of the recipient, whereas the gift or bequest would not be deductible in the transferor’s hands (constituting a form of voluntary consumption).<sup>67</sup> Although, according to the second approach, a gift or bequest would also be included as income in the recipient’s hand, the making of the gift or bequest would not be regarded as consumption in the hands of the transferor, due to the fact that it does not involve an expenditure on

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<sup>61</sup> “Market income” includes all gains derived from market transactions, either through the use of skills or labour or through the investment of capital. Market income would therefore encompass any gain derived through an action of a taxpayer executed with the intention to make a profit. For inclusion in economic concept of income see Carter Report Vol 1 (1966) 13–14; Lang in Essers and Rijkers *eds* (2005) 18 and Freedman in Essers and Rijkers *eds* (2005) 193.

<sup>62</sup> Goode in Pechman *ed* (1977) 19; Holmes PhD Thesis (2000) 379.

<sup>63</sup> “Imputed income” comprises the value of benefits derived from non-market transactions, such as a taxpayer’s enjoyment of his own assets and self-performed services. For inclusion in economic concept of income see Goode in Pechman *ed* (1977) 19; Holmes PhD Thesis (2000) 521; Lang in Essers and Rijkers *eds* (2005) 19 and Roxan *Imputed Income* in Essers and Rijkers *eds* (2005) 249.

<sup>64</sup> Carter Report Vol 3 (1966) 465; Goode in Pechman *ed* (1977) 19; Meade Report (1978) 137; Holmes PhD Thesis (2000) 421; Lang in Essers and Rijkers *eds* (2005) 20.

<sup>65</sup> See e.g. Wagner (1973) 44, 52; Musgrave (1967) *Harv Law Rev* 44; Pechman (1967) *Harv Law Rev* 63; Bittker (1967) *Harv Law Rev* 925; Galvin (1968) *Harv Law Rev* 1016; Goode in Pechman *ed* (1977) 19 n 40 and 29; Dodge (1978) *Harv Law Rev* 1177; Davies (1984) *Rutgers Law J* 849; Popkin (1986) *Indiana Law J* 63; Epstein (1986) *Soc Philos Pol* 60; Goode in Cnossen and Bird *eds* (1990) 62; Holmes PhD Thesis (2000) 242; Dodge (2003) *SMU Law Rev* 554.

<sup>66</sup> The Meade Report (1978) 31 praised the concept in principle, but observed that it may lead to some strange results. The O’Brien Report (1982) 31, 117 endorsed and adopted the idea as a key element of its tax reform proposals.

<sup>67</sup> This was the approach preferred by the Carter Report. See Ch 3 par 3.2.3 n 54. See also Bittker (1967) *Harv Law Rev* 945–946; Musgrave (1967) *Harv Law Rev* 100; Meade Report (1978) 41, 42 table 3.2 (approach no 2), 137; Dodge (1978) *Harv Law Rev* 1177, 1186; McIntyre in Cnossen and Bird *eds* (1990) 151; Thuronyi (1990) *Tax Law Rev* 73–74, 150–151; Holmes PhD Thesis (2000) 452.

marketable consumer goods or marketable savings. The gift or bequest would therefore qualify as a deduction against income in the hands of the transferor.<sup>68</sup> According to the third approach, the gift or bequest would not be included in the tax base of the recipient and would also not be deductible in the hands of the transferor.<sup>69</sup>

However, practical difficulties, such as inflation,<sup>70</sup> fluctuating income<sup>71</sup> and whether to tax accretions when they accrue or when they are realised,<sup>72</sup> as well as socio-economic and political policy considerations, have prevented Canada and other countries from adopting a pure comprehensive income tax approach.<sup>73</sup> Legislators have, nonetheless, over the years broadened their respective tax bases by adjusting the traditional concept of income or by imposing additional taxes on capital gains,<sup>74</sup> thereby reforming in the direction of a comprehensive income tax.<sup>75</sup> Although the Carter Report's recommendations were never

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<sup>68</sup> McIntyre and Oldman (1977) *Harv Law Rev* 1598 n 90; Meade Report (1978) 41, 42 table 3.2 (approach no 1); McIntyre in Cnossen and Bird *eds* (1990) 151–153; Rose in Essers and Rijkers *eds* (2005) 66.

<sup>69</sup> Meade Report (1978) 41, 42 table 3.2 (approach no 3); Thuronyi (1990) *Tax Law Rev* 76.

<sup>70</sup> Inflation can erode capital gains. See Roxan *Influence of Inflation* in Essers and Rijkers *eds* (2005) 223 *et seq* for a comprehensive discussion.

<sup>71</sup> Hettich and Winer (1985) *Natl Tax J* 423.

<sup>72</sup> The comprehensive concept of income conceptually recognises economic gains when they accrue on an unrealised basis, whereas the traditional legal concepts of income concentrate on cash inflows. See O'Brien Report (1982) 205 and Holmes PhD Thesis (2000) 291. Commentators and policy-makers generally agree that the taxation of gains should rather be provided for on a realisation basis. See Meade Report (1978) 129; O'Brien Report (1982) 33, 205–206; Holmes PhD Thesis (2000) 379; Freedman in Essers and Rijkers *eds* (2005) 198–199 and Lang in Essers and Rijkers *eds* (2005) 30. Even Henry Simons, one of the fathers of the comprehensive concept of income, has claimed that “[t]he realization criterion is not only indispensable to a feasible income-tax system but relatively unobjectionable in principle where it results only in postponement of assessment, or in cancellation of earlier ‘paper profits’ against subsequent paper losses”. See Simons (1938) 162 (also quoted by Holmes PhD Thesis (2000) 379 n 1).

<sup>73</sup> Messere (1993) 219. Doyle (2008) par 1.6 mentions that the O'Brien Report's proposal for a comprehensive base for Ireland was largely ignored. See also Gassner in Essers and Rijkers *eds* (2005) 35.

<sup>74</sup> See par 2.2.3.3.2 for a discussion on the taxation of capital gains.

<sup>75</sup> Sandford (2000) 43; Thuronyi (2003) 240. The provision for debt forgiveness as a capital gain is an example of a selective application of the comprehensive concept of income. See Holmes PhD Thesis (2000) 460.

adopted, it made a worldwide impact on international tax policy. Sandford mentions that “[n]o other official report on taxation has ever been so widely considered or acclaimed”.<sup>76</sup>

The Margo Commission considered, but rejected, a comprehensive income tax for the South African tax system.<sup>77</sup> The Katz Commission did not even consider the possibility.

### 2.2.3 The Taxation of Wealth

Historically, property taxes have been divided into two basic categories, namely the taxation of the ownership of property and the taxation of the movement or transfer thereof.<sup>78</sup> A third category developed alongside the modern income tax, whereby the net increase in the monetary value of a taxpayer’s property, or wealth,<sup>79</sup> is subjected to taxation.

#### 2.2.3.1 Property Taxation

The property tax base includes real property as well as personal property.<sup>80</sup> A contemporary form of the taxation of property ownership is what is commonly referred to as a recurrent tax on immovable property or “property tax”, which embraces a periodic

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<sup>76</sup> Sandford (1987) *Br Tax Rev* 164.

<sup>77</sup> Margo Report (1986) pars 5.19 and 12.10.

<sup>78</sup> Riley (1991) 2.

<sup>79</sup> The fiscal term “wealth” is used interchangeably with the word “capital”, meaning the net monetary value of assets owned. Sandford (2000) 94 explains that: “Economists tend to think of capital as a stock of assets to be used for future production and wealth as a stock of assets to be drawn on for consumption – but the assets are the same.” When the terms “capital” and “wealth” are used in the sphere of taxation, they refer to fixed capital (as opposed to circulating capital) and generally embrace all kinds of property and rights in and to property. See also Riley (1991) 2 and Steenekamp *Taxation of Wealth* in Black, Calitz and Steenekamp eds (2008) 184.

<sup>80</sup> Steenekamp *Taxation of Wealth* in Black, Calitz and Steenekamp eds (2008) 187.

tax charged upon the owner (or in some instances the occupier) of immovable property.<sup>81</sup> These taxes have crystallised as an ideal way to finance local government expenditures.<sup>82</sup>

In South Africa, “rates” are levied at the local government sphere in terms of the recently introduced Local Government: Municipal Property Rates Act.<sup>83</sup> This form of taxation is a major source of revenue for municipalities. Nearly R22.5 billion was generated for the 2006/2007 local government fiscal year, representing approximately 44 percent of the cash receipts of municipalities.<sup>84</sup>

### ***2.2.3.2 Transfer Taxation***

Unlike property taxation, the taxation of the acquisition or alienation of property requires something more than mere ownership. A chargeable event, for example a transfer on death or in consequence of a sale or donation, imposes a liability upon the taxpayer. These taxes, commonly referred to as transfer taxes, can be classified as property transfer taxes or wealth transfer taxes.

#### *2.2.3.2.1 Property Transfer Taxes*

Property transfer taxes apply to the gross value of the assets transferred, without taking any liabilities into account.<sup>85</sup> Taxes on the acquisition of immovable property are commonly encountered. Common-law countries generally tend to levy a stamp duty on

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<sup>81</sup> See in general Thuronyi (2003) 330–331; Steenekamp *Taxation of Wealth* in Black, Calitz and Steenekamp eds (2008) 187–194.

<sup>82</sup> This has occurred particularly in English-influenced countries. See Bird (1991) *Can Publ Pol* 322; Messere, De Kam and Heady (2003) 173; Thuronyi (2003) 330.

<sup>83</sup> Act 6 of 2004.

<sup>84</sup> Steenekamp *Taxation of Wealth* in Black, Calitz and Steenekamp eds (2008) 187.

<sup>85</sup> Rudnick and Gordon in Thuronyi ed Vol 1 (1996) 293 n 5.



the deed of sale, usually at rates below 2 percent.<sup>86</sup> Civil-law countries, on the other hand, usually levy a tax on the acquisition of the immovable property at rates often exceeding six percent.<sup>87</sup> Transfer taxes can also extend to the transfer of property other than immovable property. A transfer tax or duty is often levied on the transfer of securities in companies and similar corporate entities.

In South Africa, a tax (“transfer duty”) is levied on the transfer of immovable property in terms of the Transfer Duty Act.<sup>88</sup> The transfer of listed and unlisted securities is taxed under the Securities Transfer Tax Act.<sup>89</sup>

#### 2.2.3.2.2 *Wealth Transfer Taxes*

Wealth transfer taxes are taxes on inheritances, gifts and estates. These taxes have been known at different places and times by a great variety of names.<sup>90</sup> They are usually levied directly and on a net basis, by taking the accompanying liabilities and special circumstances of the taxpayer or recipient into account.<sup>91</sup>

Some countries impose a tax on the acquisition of an inheritance or a gift in the hands of a beneficiary, at rates which typically differ depending on the relation between the transferor and the beneficiary. These taxes are usually referred to as a “succession duty”, an “inheritance tax” an “acquisitions tax” or an “accessions tax”.<sup>92</sup> Broadly speaking, the

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<sup>86</sup> SARS *Transfer Duty Handbook* (2007) 6.

<sup>87</sup> SARS *Transfer Duty Handbook* (2007) 6.

<sup>88</sup> Act 40 of 1949. See in general Franzsen LLD Thesis (1990) for a comprehensive and critical discussion on transfer duty in South Africa.

<sup>89</sup> Act 25 of 2007.

<sup>90</sup> For example, “death duty,” “probate duty,” “legacy duty,” “succession duty,” “estate duty,” “estate tax,” “capital transfer tax,” “inheritance tax” etc.

<sup>91</sup> Rudnick and Gordon in Thuronyi *ed* Vol 1 (1996) 293 n 5; Thuronyi (2003) 330.

<sup>92</sup> However, the “inheritance tax” currently levied in the UK is a transferor-based tax. See Ch 8 for further reading on the UK inheritance tax.

reference to an “accessions tax” refers to a tax where the aggregate value of all inheritances and gifts are taxed on an annual basis in the hands of the recipient, usually at progressive rates. On the other hand, a reference to an “inheritance tax” usually entails the taxation of the acquisition of individual gifts or inheritances (in the hands of the recipient), which is not measurable over a fixed period of time.<sup>93</sup>

Other countries levy a charge on the transferor, namely a deceased estate or a donor. Where the charge is levied on a deceased estate, the tax is commonly referred to as an “estate tax”. As pointed out earlier, South Africa levies currently transferor-based wealth transfer taxes on *inter vivos* transfers and transfers on death. The historical development of wealth transfer taxation will be more fully discussed in Chapter 3 below.

### ***2.2.3.3 Net Increase in Wealth Taxation***

The modern approach to subject a taxpayer’s net increase in wealth or “capital profit” to taxation has been established through net wealth taxation and capital gains taxation. A net wealth tax is a tax on unrealised capital gains, whereas a capital gains tax is usually imposed on a realisation basis.

#### ***2.2.3.3.1 Net Wealth Taxes***

The first modern net wealth tax, taking debts into account in the valuation of the property, was enacted in Prussia in 1893.<sup>94</sup> The tax is generally levied annually on the accrual in the value of a taxpayer’s assets, usually above a specified exemption limit.<sup>95</sup> Although a net wealth tax was very common in European countries,<sup>96</sup> many have recently abolished or

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<sup>93</sup> O’Brien Report (1982) 443; Rudnick and Gordon in Thuronyi *ed* Vol 1 (1996) 293; Dodge (2009) *Hastings Law J* 998.

<sup>94</sup> Lehner (2000) *Tax Law Rev* 672.

<sup>95</sup> Sandford (1971) 177; Thuronyi (2003) 329.

<sup>96</sup> Lehner (2000) *Tax Law Rev* 618. Joulfaian (2005) *Tax Notes* 951 refers to “the most draconian wealth tax ever envisaged”. In 1942 a wealth tax was imposed in Turkey in respect of which neither the tax rate nor Footnote continues on the next page

transformed such taxes.<sup>97</sup> It has been retained by only a few European countries.<sup>98</sup> Numerous countries have decided against its implementation, mainly because of the administrative difficulties and problems relating to cost efficiency, valuations and concerns over liquidity constraints.<sup>99</sup> The global trend is to move away from net wealth taxation.<sup>100</sup> The notion to tax the net increase in a taxpayer's capital by virtue of a realisation-based capital gains tax has probably contributed to the demise of net wealth taxation. It is arguable that a net wealth tax is not required if capital income already attracts tax under a comprehensive tax system which includes capital gains.<sup>101</sup>

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the taxable base was made public. Tax assessments were arrived at in secret. The tax was primarily envisaged to apply to assets and immovable property. The tax was payable within two weeks with no provision for appeal. Taxpayers were classified as Muslim and non-Muslim and the burden of the tax fell predominantly on the non-Muslims (Christians and Jews). If non-Muslims failed to pay their taxes within a month, their property was confiscated and they were deported to forced labour camps in Eastern Turkey. Apparently, the tax was implemented to control prices during the inflationary early years of World War II.

<sup>97</sup> E.g. in Denmark (abolished), Germany (abolished), The Netherlands (transformed), Austria (abolished), Ireland (abolished) and Luxembourg (abolished). See Messere, De Kam and Heady (2003) 174; Thuronyi (2003) 329 and [http://www.estv.admin.ch/e/dokumentation/zahlen\\_fakten/dok/inter/2007/vermoegennat.pdf](http://www.estv.admin.ch/e/dokumentation/zahlen_fakten/dok/inter/2007/vermoegennat.pdf) (accessed on 30 June 2008).

<sup>98</sup> E.g. Norway, Sweden, Switzerland, France and Spain. According to Kessler and Pestieau (1991) *Can Publ Pol* 309, the decline of net wealth taxes in the (then) EEC can be attributed to the fact that European governments have become increasingly more profit- and free market-orientated and sensitive about hurting capital formation.

<sup>99</sup> The possible introduction of net wealth taxation was considered and rejected by various official commissions and committees in various countries such as Canada (Carter Report Vol 3 (1966) 28); Australia (Asprey Report (1975) 510), UK (Tiley (2008) 1260 n 11 refers to the Committee on a Wealth Tax), Ireland (O'Brien Report (1982) 41–42, 58) and Zimbabwe (Chelliah Report (1986) 199). Although the Meade Committee proposed the implementation of an annual wealth tax for the UK (Meade Report (1978) 363, 514, 518), it was never implemented. Boadway, Chamberlain and Emmerson: *Mirrlees Review* (2008) 51 do not advocate the introduction of a regular wealth tax for the UK, although it is mentioned that an additional annual local government property tax targeted at very high value residential property (with no reduction for debt) may be an option that could be explored in the future.

<sup>100</sup> Sandford (2000) 103; Messere, De Kam and Heady (2003) 174.

<sup>101</sup> Third Interim Katz Report (1995) par 6.1.6.

Although the introduction of a net wealth tax into the South African tax system was considered by the Margo Commission, it was rejected on grounds of administrative difficulties.<sup>102</sup> This proposition was supported by the Katz Commission.<sup>103</sup>

#### 2.2.3.3.2 *Capital Gains Taxes*

With the development of the American notion to tax realised capital profits under the legal concept of income, capital gains have been taxed under the United States income tax system since 1913. On the other hand, continental Europe, England and the other common-law countries generally applied a legal concept of income in terms of which no provision was made for capital profits.<sup>104</sup> However, many of these countries imposed a net wealth tax on capital assets.<sup>105</sup> The taxation of capital gains therefore barely existed prior to 1950, but was introduced between 1958 and 2000 in most OECD<sup>106</sup> countries,<sup>107</sup> mainly to improve the equity, neutrality and redistributive justice of the tax systems.<sup>108</sup> Some

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<sup>102</sup> Margo Report (1986) par 20.42.

<sup>103</sup> Third Interim Katz Report (1995) par 7.1.11.

<sup>104</sup> See par 2.2.2.1.

<sup>105</sup> See par 2.2.3.3.1.

<sup>106</sup> The Organisation for Economic Co-operation and Development (OECD) is an international organisation of thirty countries committed to the principles of a free economy and a representative democracy. It originated in 1948 to assist with the reconstruction of Europe after World War II. The membership was later extended to non-European countries. The OECD provides a forum where governments and policy makers can compare policy experiences on various economic, social and environmental issues. See <http://www.oecd.org> (accessed on 3 September 2008). South Africa is currently not a member country of the OECD. However, the OECD's statistics and publications are a reliable source on comparable economic and social data, trends, analyses and forecasts.

<sup>107</sup> Messere, De Kam and Heady (2003) 23. It was introduced in the UK in 1965 (following the recommendations of a Royal Commission Report in 1955), Canada in 1971 (following a political process) and Australia in 1985 (following the recommendations of the Asprey Report). See Arnold and Edgar (1995) *Can Publ Pol* 60.

<sup>108</sup> Hepker (1973) 182; Margo Report (1986) par 12.34; Third Interim Katz Report (1995) pars 6.4.1–6.4.8.

countries provided for capital gains taxation within the existing income tax legislative framework,<sup>109</sup> whereas other countries have elected to introduce separate legislation.<sup>110</sup>

Unlike a net wealth tax, a capital gains tax is usually imposed on a realisation basis, whereby only the gains that have accrued to a taxpayer on the disposal (usually by way of a sale or exchange) of his or her capital assets during the year of assessment are taxed.<sup>111</sup>

A capital gain is generally assessed as the difference between the (1) original acquisition price (or value) plus value enhancement expenditures and (2) the consideration received for the asset on disposal.<sup>112</sup> It is therefore a tax levied on the “profit” made by the taxpayer on the disposal of his or her capital assets.<sup>113</sup>

A problematic event for purposes of capital gains tax is the death of a wealth holder, because such a person will have no future opportunity to realise a capital asset. The unrealised gains may be captured in the tax base in one of two ways. Firstly, the wealth holder’s assets may be deemed to have been realised on the date of death resulting in the deceased being taxed as if he or she had disposed of the assets to his or her deceased

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<sup>109</sup> Such as Australia, Canada, France, Japan, Sweden and Spain. See Arnold and Edgar (1995) *Can Publ Pol* 61 and Messere, De Kam and Heady (2003) 177. Although this has often been justified on the grounds that capital gains are actually akin to income (Asprey Report (1975) 18; Third Interim Katz Report (1995) pars 6.1.1, 6.1.5), it has been stated this has occurred instead because of administrative convenience (Messere, De Kam and Heady (2003) 179).

<sup>110</sup> Such as the UK, Italy and Ireland. See Arnold and Edgar (1995) *Can Publ Pol* 61 and Messere, De Kam and Heady (2003) 177.

<sup>111</sup> Arnold and Edgar (1995) *Can Publ Pol* 61. Most OECD countries apply capital gains tax on a realisation rather than an accrual basis. See Report of the OECD *Taxation of Capital Gains of Individuals* (2006) 104. The realisation approach has the advantages of the existence of liquidity and the avoidance of costly valuations. See Bittker (1967) *Harv Law Rev* 968–969; O’Brien Report (1982) 205–06; Margo Report (1986) par 5.25; Chelliah Report (1986) 200; Third Interim Katz Report (1995) pars 6.3.4, 6.3.10; Holmes PhD Thesis (2000) 381; Lang in Essers and Rijkers *eds* (2005) 30; Kavelaars in Essers and Rijkers *eds* (2005) 128–134 and Freedman in Essers and Rijkers *eds* (2005) 200. However, some commentators concede that the problems related to valuation and liquidity are not strong enough to reject the accrual method. See Shakow (1986) *Univ Pennsylvania Law Rev* 1111 *et seq* and Kavelaars in Essers and Rijkers *eds* (2005) 130–133.

<sup>112</sup> Third Interim Katz Report (1995) par 6.3.5; Arnold and Edgar (1995) *Can Publ Pol* 61.

<sup>113</sup> First Franzsen Report (1968) par 281; Riley (1991) 2; Steenekamp *Income Taxation* in Black, Calitz and Steenekamp *eds* (2008) 180.



estate.<sup>114</sup> This method will be referred to as the “deemed realisation” approach in this thesis. Secondly, the liability in respect of the unrealised gains may be deferred until the heir actually disposes of the asset. In these cases the heir takes over the acquisition cost, hereafter referred to as the “base cost”, from the deceased. The heir will be liable for capital gains tax on the total gain only upon the eventual disposal of the property.<sup>115</sup> This method will be referred to as the “carry-over” approach.

It is, however, possible that the unrealised gains may be excluded from capital gains tax altogether, where the system provides that the heir takes over the asset at base cost equal to market value on the date of death of the deceased. This method will be referred to as the “stepped-up” approach.

To extend the South African tax base to include capital profits, the Franzsen Commission recommended the introduction of a realisation-based capital gains tax.<sup>116</sup> Both the Margo Commission and the Katz Commission considered, but rejected, the proposition.<sup>117</sup> However, capital gains tax was introduced into the South African tax system by means of the inclusion of the Eighth Schedule to the Income Tax Act, which applied with effect from 1 October 2001.<sup>118</sup> It was decided that capital gains tax would be incorporated as an integral part of the income tax system, because a tax on capital gains “is regarded as a tax on income”.<sup>119</sup> On the practical side, it was stated that such an approach has

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<sup>114</sup> Maloney (1988) *Ottawa Law Rev* 606; Arnold and Edgar (1995) *Can Publ Pol* 68.

<sup>115</sup> Report of the OECD *Taxation of Capital Gains of Individuals* (2006) 111.

<sup>116</sup> First Franzsen Report (1968) par 312. A minority report by HS Mabin contended that a capital gains tax should not be introduced (at 65–67).

<sup>117</sup> Margo Report (1986) par 12.38 (only two of the commissioners supported the introduction of a capital gains tax on equitable grounds and requested that the majority report of the Franzsen Commission on this aspect be reaffirmed (par 12.39)); Third Interim Katz Report (1995) pars 6.6.1–6.7.1.

<sup>118</sup> The Minister of Finance announced in his budget speech of 23 February 2000 that a tax on capital gains was to be introduced into the South African tax system, thereby bringing the system more into line with the international position. The design of the Eighth Schedule was influenced by the tax legislation of especially Australia and the UK, and to a lesser extent, the US and Canada. See Williams (2005) 1.

<sup>119</sup> Explanatory Memorandum to the Taxation Laws Amendment Bill (2001) 7.



administrative advantages, as the existing procedures and provisions of the Income Tax Act relating to matters such as returns, assessments, payment and recovery of the tax and objection and appeals could be utilised for purposes of capital gains tax.<sup>120</sup>

Section 26 of the Income Tax Act includes the taxable capital gain of a person (in a year of assessment) in such person's taxable income and is therefore subject to normal tax at the normal tax rates published under the Act. A person's taxable gain is, however, separately determined in terms of the rules and provisions of the Eighth Schedule and basically consists of a certain percentage of a person's net capital gain (determined by multiplying the net capital gain with a certain inclusion rate). In the case of a natural person or special trust, the inclusion rate is 25 percent and in the case of most corporate entities and ordinary trusts the inclusion rate is 50 percent. Since a person's taxable gain is added to other taxable income and subject to normal tax, the effective maximum rate of tax payable on capital gains is less than in the case of other taxable income.<sup>121</sup>

The interaction between capital gains tax and wealth transfer taxation on the transfer of wealth will be highlighted in various chapters below (where pertinent).

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<sup>120</sup> Explanatory Memorandum to the Taxation Laws Amendment Bill (2001) 7.

<sup>121</sup> For the 2010 year of assessment, the maximum rates payable on capital gains are as follows: 25% x 40% = 10 % for natural persons and special trusts; 50% x 40% = 20% for ordinary trusts and 50% x 28% = 14% for corporate entities such as companies and close corporations.

## 2.2.4 The Taxation of Consumption

### 2.2.4.1 Taxes on Goods and Services

The earliest taxes on consumption were customs<sup>122</sup> and excise duties.<sup>123 124</sup> General sales taxes, where governments charge a tax at the point of purchase of goods and services on the total value of the exchange, were first introduced in France and Germany around the middle of World War I.<sup>125</sup> It became a popular method for governments to raise tax revenue between 1930 and 1965.<sup>126</sup> A modern development in the area of indirect consumption taxes is the value-added tax (VAT), which is levied on the added value which results from each taxable transaction.<sup>127</sup> VAT was invented by the French economist, Maurice Laure, in 1954, and has been adopted in the member states of the European Union, the Nordic countries, New Zealand, Australia, Canada and Japan. The only member of the OECD that continues to resist the introduction of VAT is the United States.<sup>128</sup> VAT has also been adopted by the majority of countries in Africa.<sup>129</sup>

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<sup>122</sup> Customs are levies charged on the importation or exportation of products. Smith (1776) book v ch ii pt ii art 4, available at <http://www.adamsmith.org> (accessed on 20 June 2008), explains that customs derived its name from “customary payments which had been in use from time immemorial”. See in general Thuronyi (2003) 335–337.

<sup>123</sup> Excise duties are levies charged on specific goods and services produced, sold or delivered within a country and on licences granted for certain activities. These duties are typically based on the physical characteristic of a product – for example, the weight of salt or tobacco, the strength of alcohol and the volume of fuel or oils. See Sandford (2000) 68 and Thuronyi (2003) 328–329.

<sup>124</sup> Smith (1776) book v ch ii pt ii art 4, available at <http://www.adamsmith.org> (accessed on 20 June 2008); Messere, De Kam and Heady (2003) 138.

<sup>125</sup> Messere, De Kam and Heady (2003) 138.

<sup>126</sup> Messere, De Kam and Heady (2003) 138.

<sup>127</sup> See Sandford (2000) 75–93 for a discussion on the various forms of general sales taxes and a comparison between a general sales taxes and VAT. Messere, De Kam and Heady (2003) 22 mention that VAT is probably the most important development in taxation during the last fifty years. See Thuronyi (2003) ch 8 for a brief comparative overview of VAT systems.

<sup>128</sup> Messere, De Kam and Heady (2003) 139; Thuronyi (2003) 303 n 5.

<sup>129</sup> See Krever *ed* (2008) 1–7.



The taxation of goods and services has represented a fundamental part of the South African tax system over the years. The earliest taxes, namely customs and excise duties, have remained part of the system. Currently excise duties are levied on, for example, wine, spirits, beer, tobacco, other fermented beverages, fuel, diesel, plastic bags, international air travel and various other products.<sup>130</sup> A diamond export levy is also levied.<sup>131</sup> In 1978 a general sales tax (GST) was introduced, following the international example. This tax, with its single-stage collection system, was replaced by a value-added tax in 1991, when the Value-Added Tax Act<sup>132</sup> was implemented. Besides the income tax, value-added tax is currently the second-largest revenue raiser in South Africa.<sup>133</sup>

#### ***2.2.4.2 Personal (Direct) Consumption Tax***

In 1651, long before the development of the income tax, Thomas Hobbes proposed that the criterion of equity demands that people should be taxed on what they consume.<sup>134</sup> Hobbes's idea of a direct consumption tax was taken up by some distinguished economists in the United States and the United Kingdom.<sup>135</sup> The tax base was formulated as a taxpayer's income minus savings plus spending out of capital.<sup>136</sup> Investments and

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<sup>130</sup> Customs and Excise Act 91 of 1964. See in general Cnossen (2006) for a comparative overview of excise taxation in Southern African countries.

<sup>131</sup> Diamond Export Levy Act 15 of 2007.

<sup>132</sup> Act 89 of 1991.

<sup>133</sup> For the 2007/2008 year of assessment, VAT contributed to approximately 26% of the total tax revenue. See National Treasury (Republic of South Africa) *2009 Estimate of National Revenue* 3, available at <http://www.treasury.gov.za/documents/national%20budget/2009/enr/enr.pdf> (accessed on 17 March 2009).

<sup>134</sup> See the reference to Hobbes's book, *Leviathan*, in O'Brien Report (1982) 259. Hobbes's proposition was restated by John Stuart Mill in his book *Principles of Political Economy* (1848). See O'Brien Report (1982) 259 and quotation by Musgrave (2000) 152.

<sup>135</sup> E.g. Alfred Marshall (*Principles of Economics* 1890), Arthur Cecil Pigou (*A Study in Public Finance* 1962) and Nicholas Kaldor (*An Expenditure Tax* 1958) in the UK, and Irving Fischer (*Constructive Income Taxation* 1942) in the US. See O'Brien Report (1982) 259.

<sup>136</sup> Sandford (2000) 38. See in general Bradford (2000) for a comprehensive discussion of the basic concepts and broad policy issues of a consumption tax, as well as a broad comparison with an income tax.

savings are therefore excluded from the tax base, which would arguably soften the economic distortions caused by taxation.

Tax policy-makers and economists have been exceptionally interested in the idea of a personal (direct) consumption tax.<sup>137</sup> While some official tax review commissions have indicated a willingness to accept such a tax base,<sup>138</sup> others have considered but rejected the proposal.<sup>139</sup> The consumption/income tax debate has attracted a lot of attention among United States commentators in particular.<sup>140</sup> This debate has arguably been intensified by the absence of value-added tax in that country.

Similar to the position under a comprehensive income tax,<sup>141</sup> there were three ways identified in theory to deal with inheritances and gifts in a direct consumption tax. In terms of the first approach, the making of a gift or bequest would be regarded as a form of consumption (and not savings) and the gift or bequest would be included in the tax base of the consumer, namely the transferor. For the recipient the tax would be postponed

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<sup>137</sup> See Steenekamp *Taxes on Goods and Services* in Black, Calitz and Steenekamp eds (2008) 205–206 for a discussion on the advantages and the disadvantages of a personal consumption tax.

<sup>138</sup> E.g. Blueprints for Basic Tax Reform, available at <http://www.ustreas.gov/offices/tax-policy/library/blueprints/full.pdf> (accessed on 30 June 2008); Meade Report (1978) 44, 502, 517; O'Brien Report (1982) 51, 277. See also Hettich and Winer (1985) *Natl Tax J* 425; Sandford (2000) 37.

<sup>139</sup> E.g. Carter Report Vol 1 (1966) 10 and Vol 3 (1966) 25–26; Asprey Report (1975) 15; Chelliah Report (1986) 144.

<sup>140</sup> See e.g. Andrews (1972) *Harv Law Rev* 309; Andrews (1974) *Harv Law Rev* 1113; Warren (1975) *Harv Law Rev* 931; Andrews (1975) *Harv Law Rev* 956–958; Graetz (1979) *Harv Law Rev* 1575; Kelman (1979) *Stanford Law Rev* 831; Warren (1980) *Yale Law J* 1081; Kelman (1983) *Stanford Law Rev* 649; Strnad (1985) *Stanford Law Rev* 1023; Strnad (1986) *Indiana Law J* 73; Epstein (1986) *Soc Philos Pol* 64–67; Zodrow in Cnossen and Bird eds (1990) 85; Halperin (1992) *Florida Tax Rev* 1; Fried (1992) *Stanford Law Rev* 961; McCaffery (1992) *Texas Law Rev* 1145; Knoll (1994) *UCLA Law Rev* 1791; Bankman and Fried (1998) *Georgia Law Rev* 539; Schenk (1999) *Chaplin Law Rev* 133; Musgrave (2000) 152–154; McNulty (2000) *Calif Law Rev* 2095; Graetz (2002) *Yale Law J* 261; Banks (2003) *Michigan Law Rev* 2238; Goldberg (2003) *Tax Lawyer* 1; Messere, De Kam and Heady (2003) 28–29; McCaffery (2005) *Michigan Law Rev* 807; Lang in Essers and Rijkers eds (2005) 31; Rose in Essers and Rijkers eds (2005) 53–76; McCaffery (2005) *Can J Law Jur* 153; Bankman and Weisbach (2006) *Stanford Law Rev* 1413; Avi-Yonah (2006) *Tax Law Rev* 1.

<sup>141</sup> See par 2.2.2.2.

until he or she consumes the gift or bequest.<sup>142</sup> Under the second approach, a gift or bequest would be omitted from the tax base of the transferor and only included in the tax base of the recipient when consumed.<sup>143</sup> In terms of the third approach, gifts and inheritances would be excluded from the tax base of the transferor and the recipient.<sup>144</sup>

Although numerous countries' tax systems contain consumption-type elements, no country has (as far as could be ascertained) adopted a pure direct consumption tax yet.<sup>145</sup> However, the choice between a traditional income tax and a consumption tax "would probably affect little more than the timing" of the taxes.<sup>146</sup> It is submitted that the twenty-first century would rather see the introduction of some consumption-type elements to the existing universally preferred income tax base model, for example the exemption of interest, the deductibility of mortgage interest payments, contributions to private pension schemes, premiums on life assurance policies, and the provision of tax incentives for the purchase of employee participation shares and the starting-up or expanding of a business.

In considering the proposition of a direct consumption tax for the South African tax system in 1986, the Margo Report concluded that "if South Africa were to take this step, it would be accepting a pioneering role that seems inappropriate to the present socio-political climate within the country and South Africa's standing in the international

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<sup>142</sup> Meade Report (1978) 41, 42 table 3.2 (approach no 2); O'Brien Report (1982) 275; Mintz (1991) *Can Publ Pol* 259; Zelenak (1996) *Tax Law Rev* 601; Dodge (1996) *Tax Law Rev* 558–559; Burke and McCouch (1998) *Virginia Tax Rev* 662; Musgrave (2000) 155.

<sup>143</sup> This was the approach preferred by the US report Blueprints for Basic Tax Reform. See Ch 3 par 3.2.3 n 50. See also Meade Report (1978) 41, 42 table 3.2 (approach no 1); O'Brien Report (1982) 275; Verbit (1980) *Boston Univ Law Rev* 39; Burke and McCouch (1998) *Virginia Tax Rev* 662, 705; Rakowski (2000) *Tax Law Rev* 374; Graetz (2002) *Yale Law J* 261 n 109.

<sup>144</sup> This was the approach preferred by the Meade Report. See Ch 3 par 3.2.3 n 40. See also Meade Report (1978) 41, 42 (approach no 3) and Burke and McCouch (1998) *Virginia Tax Rev* 705–708.

<sup>145</sup> Although Croatia imposed a business-based tax that was close to a consumption-type income tax, it was abolished in 2000. See Thuronyi (2003) 233 n 8 and accompanying text.

<sup>146</sup> Andrews (1974) *Harv Law Rev* 1124. See also Carter Report Vol 3 (1966) 26 and Musgrave (2000) 207.

community”.<sup>147</sup> The Katz Report did not even consider the possibility. However, the income tax contains many traces of consumption-based taxation, for example the provision for the deduction of retirement annuities and pension fund contributions. It seems likely that, instead of a total conversion to a direct consumption tax, the trend would instead be to increasingly provide for deductions in respect of savings and investments.

### 2.2.5 Miscellaneous Taxes

Stamp duties are often levied on documents such as lease agreements, bonds, sureties and wills. Social security levies are also commonly encountered. Although South Africa used to levy stamp duties on a plethora of different forms and documents, most of these duties were eliminated over the last 20 years. Stamp duty was abolished from the system altogether with the repeal of the Stamp Duty Act<sup>148</sup> with effect from 1 April 2009. Social security contributions such as a skills development levy<sup>149</sup> and an unemployment insurance contribution<sup>150</sup> have also been imposed.

### 2.2.6 Tax Systems: A Mix of Various Taxes

Although the income tax is the universally preferred tax base today, most countries have hybrid systems, typically comprising a combination of direct and indirect taxes on income, wealth and consumption.<sup>151</sup> From 1950 to 1980, there was an enormous world-wide shift from consumption taxes to income taxes, but since then there has been a

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<sup>147</sup> Margo Report (1986) par 5.39. See also pars 5.35–5.36 and 5.40–5.41.

<sup>148</sup> Act 77 of 1968.

<sup>149</sup> Levied in terms of the Skills Development Levy Act 9 of 1999.

<sup>150</sup> Levied in terms of the Unemployment Insurance Contributions Act 4 of 2002.

<sup>151</sup> Loeckx and Van Dionant (1980) 82; Margo Report (1986) par 6.1; Theron LLD Thesis (1994) 32; Sandford (2000) 36; Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 117, 118.

growing reliance on value-added tax and social security contributions.<sup>152</sup> It was realised that an income tax should be complemented with taxes on consumption and capital, so that tax systems can achieve optimal fairness.<sup>153</sup> In the words of Sandford, the tax bases “each tax a different facet of ability-to-pay and it can be argued that the fairest tax system will utilise them all”.<sup>154</sup>

## 2.3 OBJECTIVES OF TAXATION

The objectives of taxation can be categorised into two main parts. Firstly, taxation is an important fiscal tool to provide for the financing of public expenditures. Secondly, taxation can be utilised to accomplish numerous socio-economic and political objectives. Taxation is therefore a central component of state-building.<sup>155</sup>

### 2.3.1 Revenue

Almost all social policy efforts require expenditure, which can be financed through loan capital, user charges, administrative fees, government-induced inflation or taxation.<sup>156</sup> An important purpose of taxation is therefore to generate sufficient revenue to assist in the financing of government activities.<sup>157</sup>

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<sup>152</sup> See Messere, De Kam and Heady (2003) 9–12 and 20–29 for a summary of the trends in taxation and fiscal policy in the OECD countries over the period 1950–2000.

<sup>153</sup> Asprey Report (1975) 14; Gammie Report (1994) 7; Sandford (2000) 37.

<sup>154</sup> Sandford (1995) 49, as quoted by the Third Interim Katz Report (1995) par 7.1.6.

<sup>155</sup> See collection of essays in Brautigam, Fjelstad and Moore (eds) *Taxation and State-Building in Developing Countries* (2008) on this topic (with special reference to developing countries).

<sup>156</sup> See Steenekamp *Introduction* in Black, Calitz and Steenekamp eds (2008) 115–116 for further discussion.

<sup>157</sup> Adriani and Van Hoorn Vol 1 (1954) 102–103, 183; Wagner (1973) 3; Margo Report (1986) par 3.11; Stevens (1989) 5; Sandford, Pond and Walker (1980) 1; Gammie Report (1994) 6; Interim Katz Report (1994) par 1.5.4 (c); Third Interim Katz Report (1995) par 2.6.1; Rakowski (1996) *Tax Law Rev* 438; Paper by Bird and Zolt *Tax Policy Design and Development* (2003) 6; Graetz and Shapiro (2005) 266; Rose in Essers and Rijkers eds (2005) 53; Vivian (2006) *SA Journal of Economics* 83–84; Doyle (2008) par 1.4.1.

In South Africa, the actual total (gross) tax revenue collected for the 2007/2008 year of assessment was R572.81 billion. The non-tax revenue collected amounted to R11.67 billion.<sup>158</sup> Revenue collected through taxation has contributed a substantial 98 percent of total gross revenue for that year of assessment.

### 2.3.2 Socio-economic Objectives

Taxation can also be used as an instrument of social and economic policy.<sup>159</sup> Taxes can for instance assist socio-economic objectives such as the redistribution of resources, economic growth and reprising.

#### 2.3.2.1 Redistribution of Resources

According to liberal thought, a legal system should value political liberty, equality of opportunity and fairness in distribution so that all people may have an equal opportunity to pursue their economic dreams.<sup>160</sup> The redistribution of resources can assist these values by reducing the economic and political power that is concentrated in the hands of the wealthy and by raising the socio-economic standards of the poor.<sup>161</sup> It can also mitigate political tension, in view of the fact that the wide disparity of wealth in developing countries in particular has been a definite cause of racial and ethnic tension.<sup>162</sup> Redistribution can, for example, be effected through increased taxation on the more wealthy members of society, especially through progressive taxation and wealth taxes.<sup>163</sup>

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<sup>158</sup> National Treasury (Republic of South Africa) *2009 Estimate of National Revenue 2*, available at <http://www.treasury.gov.za/documents/national%20budget/2009/enr/enr.pdf> (accessed on 17 March 2009).

<sup>159</sup> Sandford, Pond and Walker (1980) 4; Chelliah Report (1986) 67; Brautigam in Brautigam, Fjelstad and Moore *eds* (2008) 1.

<sup>160</sup> See in general Rawls (1971) and the Meade Report (1978) 15.

<sup>161</sup> Meade Report (1978) 15; Duff (1993) *Can J Law Jur* 23–26; Kaplov in Gale, Hines and Slemrod *eds* (2001) 192; Paper by Zodrow and Diamond *The US Experience with the Estate Tax* (2006) 23.

<sup>162</sup> Rudnick and Gordon in Thuronyi *ed* Vol 1 (1996) 297.

<sup>163</sup> O'Brien Report (1982) 442; Terreblanche (2004) *TGW* 233; Doyle (2008) par 1.4.2.

It has therefore become an increasingly important, widely accepted objective of taxation in a democratic society.<sup>164</sup> Some theorists argue that it has even become the primary objective of taxation.<sup>165</sup>

Confiscatory taxation could, however, violate constitutionally protected property rights, increase tax avoidance and evasion, and have a negative impact on the economy. It could also encourage taxpayers to emigrate to other jurisdictions.<sup>166</sup> Capitalists concede that redistribution through taxation is an assault upon the capital system as such, because the system can lead to the concentration of wealth in the few, but by no means necessarily to the detriment of the many.<sup>167</sup>

The extent to which the redistribution of resources should be an objective of a jurisdiction's tax system is therefore likely to depend on political considerations. Nonetheless, in developing countries such as in South Africa,<sup>168</sup> where poverty and inequality are extreme problems, the redistribution of income is a common goal of tax policy.

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<sup>164</sup> Carter Report Vol 1 (1966) 6; O'Brien Report (1982) 101; Chelliah Report (1986) 68; Thuronyi (1990) *Tax Law Rev* 96; Ginsburg (1996) *Transformation* 89–99; Rakowski (1996) *Tax Law Rev* 438; Repetti (2001) *NY Univ Law Rev* 825; Bernstein (2004) *Cardozo J Int & Comp L* 187–188.

<sup>165</sup> Adriani and Van Hoorn Vol 1 (1954) 193; Loeckx and Van Dionant (1980) 84–85 refer to Wagner (1890–1944) and Neumark (1970).

<sup>166</sup> Carter Report Vol 3 (1966) 153; Duff (1993) *Can J Law Jur* 29; Lee (2007) *Legal Studies* 697 n 141 and accompanying text claims that this argument has been substantiated for the UK by a study conducted by Adam, Brewer and Shephard *The Poverty Trade-Off: Work Incentives and Income Redistribution in Britain* (London Institute for Fiscal Studies October 2006).

<sup>167</sup> See e.g. Editorial (1997) *Taxpayer* 67.

<sup>168</sup> According to a research paper on wealth inequality in South Africa, the poorest 40% of South African households, overwhelmingly black, earned only 4% of the total income earned by South Africans in 1991, while the richest 10%, predominantly white, earned more than 50% of the total income. About 17 million South Africans were living below the poverty line. See Ginsburg (1996) *Transformation* 89. A more recent study indicates that the situation has indeed worsened in recent years as approximately 22 million of the population, or 48.5%, were living below the poverty line in 2004. See Terreblanche (2004) *TGW* 213. Terreblanche's article provides a historical exposition of the development of poverty in South Africa. For commentaries on Terreblanche's article, see Brits (2004) *TGW* 241; Le Roux (2004) *TGW* 243 and Rossouw (2005) *TGW* 117.

The comment of the Katz Commission that the “actual and perceived redistributive effects” of the tax system are very significant<sup>169</sup> underlined the importance of redistributive justice for the South African context. Since the transition to a new political dispensation in 1994, tax reform in South Africa has especially been focused on the facilitation of the redistribution of resources.

### 2.3.2.2 *Economic Growth*

Adequate levels of investment and saving are essential for economic growth. Tax policy can be formulated to act as an incentive for economic growth and development,<sup>170</sup> the avoidance of inflation and unemployment<sup>171</sup> and the promotion of saving and investment.<sup>172</sup>

Both the Margo Report and the Katz Report considered the effect of tax incentives on the levels of saving and investment in the South African economy. Although taxation can serve as a fiscal tool to enhance a favourable climate for investment, the Margo Report concluded that fiscal incentives would not have a large positive effect on personal saving.<sup>173</sup> However, it was emphasised that no justification exists for maintaining fiscal disincentives to save.<sup>174</sup> Instead of specific tax incentives, the report favoured the international trend of a broad-based system with lower tax rates. This proposition was

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<sup>169</sup> Third Interim Katz Report (1995) par 7.1.4. See also Interim Katz Report (1994) pars 1.2.2–1.2.3, where it was noted that “[t]he disparities between the wealthy and the poor in South Africa rank amongst the greatest in the world ... This legacy of poverty and inequality constitutes a moral issue of the gravest dimension. Its continuation undermines the stability of South African society and thereby weakens the prospects for confident economic recovery. Unless these problems are urgently addressed, the prognosis for South Africa is bleak.”

<sup>170</sup> Carter Report Vol 1 (1966) 32; Interim Katz Report (1994) par 1.5.4 (c); Third Interim Katz Report (1995) 4; Stevens (1989) 6 refers for example to the function of import taxes to protect the local markets.

<sup>171</sup> Sandford (1970) 8.

<sup>172</sup> Chelliah Report (1986) 68.

<sup>173</sup> Margo Report (1986) par 4.24.

<sup>174</sup> Margo Report (1986) par 4.40.



supported in the Interim Katz Report with the statement that “[t]ax incentives aimed specifically at raising the aggregate level of investment and saving do not make much economic sense”.<sup>175</sup>

In respect of taxation’s relation to employment, the Margo Report stated that the short-term manipulation of taxes would be unlikely to successfully encourage employment. It suggested that efforts to encourage employment should rather be directed at the long term.<sup>176</sup>

### 2.3.2.3 Reprising

The encouragement or discouragement of certain types of activities (referred to as “reprising”) can be addressed by means of taxation.<sup>177</sup> The so-called “sin taxes”, levied on products such as alcohol and tobacco, were initially implemented to discourage people from consuming these products.<sup>178</sup> The criticism against reprising through taxation flows from the principle of non-discrimination, which requires the government to be neutral towards all kinds of activities.<sup>179</sup> However, the counter-argument is that these taxes can assist in the raising of revenue towards the social cost associated with the misuse or abuse of these products, which justifies discriminatory taxation. South Africa levies excise duties on a variety of products.<sup>180</sup>

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<sup>175</sup> Interim Katz Report (1994) par 15.6.1 (see also pars 15.6.2–15.6.16 for further discussion), endorsed by Third Interim Katz Report (1995) par 17.1.4.

<sup>176</sup> Margo Report (1986) par 4.6.

<sup>177</sup> Rakowski (1996) *Tax Law Rev* 438; Sandford (2000) 70; Bernstein (2004) *Cardozo J Int & Comp L* 189; Doyle (2008) par 1.4.3.

<sup>178</sup> Smith (1776) book v ch ii pt ii art iv, available at <http://www.adamsmith.org> (accessed on 20 June 2008), mentions that “[i]t has for some time past been the policy of Great Britain to discourage the consumption of spirituous liquors, on account of their supposed tendency to ruin the health and to corrupt the morals of the common people.”

<sup>179</sup> Wagner (1973) 44.

<sup>180</sup> See par 2.2.4.1.



## 2.4 TAX POLICY CONSIDERATIONS

### 2.4.1 General

The manner in which a tax jurisdiction imposes taxes to achieve its goals depends upon criteria such as the economic policy and level of development, the rate of inflation, the levels of employment, any budget deficit, history and culture, the tax structures of neighbouring countries, the administrative capacity to levy and administer taxes and political policy.<sup>181</sup> However, taxes should be coherent with the composition of the relevant tax system, which is largely the product of political decision-making. The importance of tax policy considerations is therefore to provide some non-political guidelines to policy-makers and legislators, founded on rational grounds.<sup>182</sup> The essential tax policy principles, referred to as the “canons of taxation”, are discussed in paragraph 2.4.2 below.

However, the essential policy principles of taxation cannot be considered in isolation. Over the past two centuries, the pursuit of a true democracy has resulted in the development of the concept of a constitution, setting out the structure and rules within which a government may operate within a jurisdiction and entrenching fundamental rights and values consistent with a true democracy to which the laws of the jurisdiction should adhere. The constitutional law and principles of a jurisdiction should therefore also be taken into account in the design and reform of its tax legislation and the interpretation thereof. Institutional processes are furthermore of extreme importance for the scrutiny of tax proposals and for the enactment of proper tax legislation in accordance with the constitutional principles and the general ideals of fair taxation. The South African constitutional considerations applicable to the realm of taxation are considered in paragraph 2.4.3 below.

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<sup>181</sup> Paper by Bird and Zolt *Tax Policy Design and Development* (2003) 4–5; Croome PhD Thesis (2008) 5.

<sup>182</sup> Gutmann in Essers and Rijkers *eds* (2005) 97.



## 2.4.2 The “Canons of Taxation”

In his 1776 treatise, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, the Scottish classical economist, Adam Smith, outlined four criteria of a good tax system, commonly referred to as the “canons of taxation”.<sup>183</sup> The principles of equity, certainty, convenience and cost efficiency were also accepted and restated by other classical economists<sup>184</sup> and have become the most enduring and widely acknowledged principles of taxation.<sup>185</sup>

### 2.4.2.1 *The First Canon: Equity*

Smith stated that the principle of equity demands that taxpayers ought to contribute towards the fiscal coffers in proportion to the revenue which they respectively enjoy under the protection of the state.<sup>186</sup> In order to apply equal treatment to taxpayers, it is firstly necessary to determine some method of measuring equity. This has been attempted by two different approaches, namely the benefit principle and the principle of ability-to-pay.<sup>187</sup>

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<sup>183</sup> Smith referred to the “maxims” of taxation, although these are commonly referred to by other commentators as the “canons” of taxation.

<sup>184</sup> Such as Jeremy Bentham (1748–1832), David Ricardo (1772–1823) and John Stuart Mill (1806–1873).

<sup>185</sup> See e.g. Buehler (1948) 321; Adriani and Van Hoorn Vol 1 (1954) 206–208; Hepker (1973) 7; Klein-Wassink in Jongsma and Verburg *eds* (1975) 99; Loeckx and Van Dionant (1980) 83; O’Brien Report (1982) 85; Gutman (1983) *Virginia Law Rev* 1216–1217; Holmes PhD Thesis (2000) viii; Musgrave (2000) 137 n 2 and accompanying text; Morse and Williams (2000) 5; Paper by Bird and Zolt *Tax Policy Design and Development* (2003) 5; Sabine (2006) 49; Doyle (2008) par 1.3. These principles have been supported in a South African context, see Margo Report (1986) pars 4.42–4.50, Interim Katz Report (1994) par 1.5.4 (a); Fourth Interim Katz Report (1997) pars 1.4–1.5 (equity and equality); Croome PhD Thesis (2008) 6 and Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 119–120.

<sup>186</sup> Smith (1776) book v ch ii pt ii, available at <http://www.adamsmith.org> (accessed on 20 June 2008).

<sup>187</sup> Buehler (1948) 318–324; Carter Report Vol 3 (1966) 3; Asprey Report (1975) 12; Margo Report (1986) par 4.43; Third Interim Katz Report (1995) par 6.1.4; Stevens (1989) 3–4; Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 120.

### 2.4.2.1.1 *The Benefit Principle*

According to the benefit principle, a person should pay taxes in accordance with the benefits that he or she receives from government-provided goods and services.<sup>188</sup> A major advantage of the benefit principle is that the expenditure side of the budget is linked to the revenue side.<sup>189</sup> The allocative procedures of market behaviour are furthermore approximated, thereby ensuring that resources are efficiently allocated.<sup>190</sup> Benefit taxes, also referred to as user charges, are commonly levied in the form of tolls for roads and bridges, admission charges to museums and parks, licence fees and certain tuition and school fees.<sup>191</sup>

However, the application of the benefit principle is rather restricted. Firstly, taxation based on benefits received cannot assist in the redistribution of resources, an important objective of taxation.<sup>192</sup> Secondly, there are many instances where benefits enjoyed from government services cannot be allocated to the users of such services in a generally acceptable manner.<sup>193</sup> The third issue is the difficulty of assigning indirect benefits amongst the taxpayers, because some of the indirect beneficiaries may even reside outside the tax jurisdiction.<sup>194</sup>

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<sup>188</sup> Carter Report Vol 3 (1966) 3; O'Brien Report (1982) 83; Stevens (1989) 3–4; Steenekamp *Introduction in Black, Calitz and Steenekamp eds* (2008) 120. This principle was developed by English philosophers Thomas Hobbes (1588–1679), John Locke (1632–1704) and by Dutch jurist Hugo Grotius (1583–1645). See <http://www.economyprofessor.com/economictheories/benefit-approach-principle.php> (accessed on 28 April 2008).

<sup>189</sup> Steenekamp *Introduction in Black, Calitz and Steenekamp eds* (2008) 120.

<sup>190</sup> Steenekamp *Introduction in Black, Calitz and Steenekamp eds* (2008) 120.

<sup>191</sup> Steenekamp *Introduction in Black, Calitz and Steenekamp eds* (2008) 121.

<sup>192</sup> Carter Report Vol 3 (1966) 4; Theron LLD Thesis (1994) 21; Steenekamp *Introduction in Black, Calitz and Steenekamp eds* (2008) 121. See par 2.3.2.1 for a discussion on the redistribution of resources as an objective of taxation.

<sup>193</sup> Buehler (1948) 319; Carter Report Vol 3 (1966) 4; Theron LLD Thesis (1994) 20; Steenekamp *Introduction in Black, Calitz and Steenekamp eds* (2008) 116, 121.

<sup>194</sup> Buehler (1948) 319; Carter Report Vol 3 (1966) 4.



#### 2.4.2.1.2 *The Ability-to-Pay Principle: Horizontal Equity and Vertical Equity*

The criterion of ability-to-pay, the underlying idea of which is that taxation is a sacrifice levied upon some kind of “personal economic well-being”, has been the more widely accepted approach, although it is a difficult concept to define.<sup>195</sup> It has become customary to define the two dimensions of ability-to-pay, namely horizontal equity, requiring taxpayers with equal capacity to contribute in equal proportions, and vertical equity, requiring taxpayers with greater capacity to pay more taxes.<sup>196</sup> Appropriate measures of taxable capacity include income, consumption, wealth and utility.<sup>197</sup> In the design of fiscal legislation, the principle of ability-to-pay requires the choice of the appropriate

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<sup>195</sup> Seligman (1921) 4; Buehler (1946) *Tax Law Rev* 243; Buehler (1948) 321; Carter Report Vol 1 (1966) 5, 9 Vol 3 (1966) 3 (the report refers to “economic power”); Van Nispen and Schuttevaer (1969) 45; Asprey Report (1975) 12, 13; Meade Report (1978) 14 (the report refers to “taxable capacity”); Dodge (1978) *Harv Law Rev* 1183 (Dodge refers to “economic well-being”); O’Brien Report (1982) 83–84; Chelliah Report (1986) 68; Margo Report (1986) par 4.43; Stevens (1989) 3 (Stevens refers to the “leer van het evenredige nutsoffer”); Gammie Report (1994) 7; Theron LLD Thesis (1994) 19; Holmes PhD Thesis (2000) 21; Morse and Williams (2000) 6; Authority cited by Lang in Essers and Rijkers *eds* (2005) 8 n 29; Vivian (2006) *SA Journal of Economics* 84; Kay: Mirrlees Review (2008) 8; Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 122. The modern principle was expounded by the Swiss philosopher Jean-Jacques Rousseau (1712–1778), the French political economist Jean-Baptiste Say (1767–1832) and the English economist John Stuart Mill (1806–1873). See Holmes PhD Thesis (2000) 22 n 40 and accompanying text and <http://www.Economyprofessor.com/economictheories/ability-to-pay-principle.php> (accessed on 28 April 2008). One of the first documentary references to the principle can be found in the French declaration of 1791, where it was demanded that the public financial requirements should be equally distributed among the citizens in proportion to their ability to pay. See Lang in Essers and Rijkers *eds* (2005) 9 n 30 and accompanying text and Vivian (2006) *SA Journal of Economics* 86.

<sup>196</sup> Carter Report Vol 1 (1966) 4–5; Asprey Report (1975) 12; Meade Report (1978) 12; O’Brien Report (1982) 83; Margo Report (1986) par 4.44; Franzsen LLD Thesis (1990) 20; Gammie Report (1994) 7; Theron LLD Thesis (1994) 19; Morse and Williams (2000) 6; Holmes PhD Thesis (2000) 19; Paper by Bird and Zolt *Tax Policy Design and Development* (2003) 11; Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 122.

<sup>197</sup> Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 122.

taxpayer<sup>198</sup> and the tax period<sup>199</sup> wherein the circumstances of the taxpayers should be compared.<sup>200</sup>

The criterion of vertical equity has undergone dramatic changes over the years. The idea was unknown to the natural law theorists such as John Locke.<sup>201</sup> Although some commentators have interpreted Adam Smith's first maxim as the foundation of progressive taxation,<sup>202</sup> it is submitted that Smith felt uneasy about progressive taxation and the redistribution of resources.<sup>203</sup> Smith instead supported proportional taxation, providing for fixed tax rates, as a fair way to distribute the burden.<sup>204</sup>

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<sup>198</sup> There are two fundamentally different approaches to the measurement of ability-to-pay. Firstly, an individual's resources can be measured over a lifetime, regardless of how they are used ("lifetime endowment"). This approach supports the individual as the appropriate taxpayer (sometimes referred to as "tax unit"). Secondly, resources can be measured in a multi-generational (family) context ("dynastic equity"). See Paper by Zodrow and Diamond *The US Experience with the Estate Tax* (2006) 16. Consequently, the main taxpayers are (a) the individual, (b) the married (or cohabitating) couple and (3) the married (or cohabitating) couple with dependants. See Bittker (1967) *Harv Law Rev* 925, 973; Asprey Report (1975) 131; Meade Report (1978) 15, 377; Gutman (1983) *Virginia Law Rev* 1218; Musgrave (2000) 207. Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 122 n 2 refers to the debate in a South African context (Margo Report (1986) 106–154 and Interim Katz Report (1994) 67–84).

<sup>199</sup> Ideally, the notion of horizontal equity dictates that taxpayers should as far as practically possible be compared on the basis of a lifetime of circumstances. See Carter Report Vol 3 (1966) 241; Asprey Report (1975) 14; Blueprints for Basic Tax Reform (1977) 25; Zodrow in Cnossen and Bird *eds* (1990) 93; Riley (1991) 25; Lang in Essers and Rijkers *eds* (2005) 17; Rose in Essers and Rijkers *eds* (2005) 63–66.

<sup>200</sup> Margo Report (1986) par 4.43; Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 122.

<sup>201</sup> Adriani and Van Hoorn Vol 1 (1954) 219; Musgrave (2000) 182.

<sup>202</sup> See e.g. Adriani and Van Hoorn Vol 1 (1954) 222; Dobris (1984) *Syracuse Law Rev* 1219.

<sup>203</sup> Musgrave (2000) 138–139 explains that "[i]n the *Wealth of Nations*, he [Smith] argues that economic progress created by the market system greatly advances the welfare not only of the rich but also of the poor. Their position, while below the extravagance of the rich, 'exceeds that of many an African King.' Moreover, as argued in *The Theory of Moral Sentiments*, the gain from riches is largely a fiction. The wealthy landlord, in imagination, may consume his whole harvest, but 'the capacity of his stomach bears no proportion to the immensity of his desires, and will receive no more than that of the meanest peasant'". See also Vivian (2006) *SA Journal of Economics* 88.

<sup>204</sup> Buehler (1948) 325; Hepker (1973) 3; Musgrave (2000) 139, 183; Lang in Essers and Rijkers *eds* (2005) 9.

The principle of vertical equity has, nonetheless, evolved to encompass the value of distributive justice through taxation. The initial idea developed in the utilitarian school of thought. Jeremy Bentham (1748–1832) defended the idea of distribution by proposing that the primary goal of a government is the maximum aggregate welfare of the society and that total happiness increases with equality of wealth.<sup>205</sup> The first phase of development was the granting of an exemption of a specific amount of income, justified by John Stuart Mill (1806–1873) in view of the fact that there is a minimum amount which is essential to provide for the necessities of life. Modern commentators and policy-makers generally concede that, in the measurement of a taxpayer's ability-to-pay, basic necessities should be taken into account.<sup>206</sup>

Bentham's proposition was restated almost a century later by the economic theorists Edgeworth (1897) and Pigou (1928).<sup>207</sup> Edgeworth took the idea one step further and developed the idea of progressive tax rates, namely the idea that higher levels of income, property, wealth or whatever the tax is applied to should be charged at higher marginal rates, compared to a flat proportional rate that is applicable to all taxpayers.<sup>208</sup>

A third practice of progressive taxation developed in the differentiation between various kinds of income, for example earned income (labour income) and unearned or investment

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<sup>205</sup> Adriani and Van Hoorn Vol 1 (1954) 219; Musgrave (2000) 140, 184.

<sup>206</sup> Shehab (1953) 2; Seligman (1921) 25–29; Buehler (1948) 323. Rose in Essers and Rijkers *eds* (2005) 57 refers to a reduced form of ability-to-pay, a concept which he names “social or humane ability-to-pay”. The Carter Report Vol 1 (1966) 5, 9 and Vol 3 (1966) 5, 32 refers to “discretionary economic power”. Vivian (2006) *SA Journal of Economics* 85–88 points to the fact that people who fall below the tax threshold will contribute to the state coffers through indirect taxes.

<sup>207</sup> Edgeworth and Pigou developed the theory of “equal marginal sacrifice”. See Goode in Cnossen and Bird *eds* (1990) 75 and Musgrave (2000) 142.

<sup>208</sup> When the rates increase with the amount of income, we refer to progressive taxation. When the rate decreases when the income decreases, we have regressive taxation. There may also be progression up to a certain level, with proportional (fixed) rates thereafter. This is referred to as degressive taxation. See Seligman (1921) 30; Hepker (1973) 2–3; Loeckx and Van Dionant (1980) 74; Franzsen LLD Thesis (1990) 25–26; Theron LLD Thesis (1994) 84; Bernstein (2004) *Cardozo J Int & Comp L* 189 n 13 and Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 117, 118.

income.<sup>209</sup> This developed from the idea that recipients of earned income have greater needs to satisfy at a higher cost than recipients of more permanent investment income.<sup>210</sup> While earned income used to be taxed at the same or lower rates than unearned income, the reverse has become the modern trend, namely that unearned income is subject to lower rates for reasons based on efficiency.<sup>211</sup>

Although it has commonly been accepted that the rich should pay more taxes, the controversial question is: how much more should the rich pay? Is the criterion of vertical equity sufficiently satisfied by proportional taxation, or does it require some level of progressive taxation? Furthermore, if progressive taxation is desirable, what is the desired level of progressivity? It has often been observed that these questions are some of the most contentious issues in taxation.<sup>212</sup> Progressive taxation has been challenged and criticised on the one hand,<sup>213</sup> and justified on the other.<sup>214</sup> Proponents of proportional taxation argue that it constitutes a fairer approach to vertical equity than progressive taxation, and that it results in better work effort, less complexity and better compliance.<sup>215</sup> Nonetheless, and although it has been submitted that political support for progressive taxation has diminished,<sup>216</sup> theorists and tax policy-makers generally prefer some level of progressive taxation within the tax system, especially to achieve the goal of redistribution

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<sup>209</sup> Seligman (1921) 22–25; Shehab (1953) 5; Sandford (2000) 54.

<sup>210</sup> Shehab (1953) 5–6.

<sup>211</sup> Sandford (2000) 54; Thuronyi (2003) 15; Lang in Essers and Rijkers *eds* (2005) 3.

<sup>212</sup> Carter Report Vol 1 (1966) 19; Asprey Report (1975) 23; O'Brien Report (1982) 101; Interim Katz Report (1994) par 1.8.1; Coetzee (1998) *Tax Planning* 90.

<sup>213</sup> See Blum and Kalven (1952) *Univ Chicago Law Rev* 417; Von Hayek (1960) 306–323; Blum (1982) *Taxes* 16; Epstein (1986) *Soc Philos Pol* 69–70; Brennan and Buchanan (2006) 196–198 (advocating constitutional restrictions on rate structures).

<sup>214</sup> Modern theorists such as John Rawls explains the desire for progressive taxation from the perspective of fairness, which calls for each person to do to others as he would have others do to him (Musgrave (2000) 144). See also Graetz (1983) *Yale Law J* 274–278 and Maloney (1988) *Ottawa Law Rev* 611–622.

<sup>215</sup> Buehler (1948) 325–326; Bankman and Griffith (1987) *Calif Law Rev* 1966.

<sup>216</sup> Goode in Clossen and Bird *eds* (1990) 75.



of resources in a democratic society.<sup>217</sup> The appropriate approach to vertical equity is essentially political and involves basic value judgments about the nature of a good society.<sup>218</sup> As a consequence, it would influence tax policy on aspects such as rate structures, choice of tax bases and special provisions.<sup>219</sup> This study will not attempt to address this debate, but will merely accept that vertical equity through some level of progressive taxation is of special importance in South Africa to assist in the redistribution of resources.<sup>220</sup>

#### 2.4.2.1.3 *Equity through Objectives: A Better Approach?*

The criterion of ability-to-pay has been criticised as having no independent normative content.<sup>221</sup> Some commentators therefore advocate its abandonment in favour of distributive justice, so that the choice of taxation depends upon its primary purpose<sup>222</sup> or the optimal utility for the society.<sup>223</sup> Others have cautioned that the notion of using taxation to achieve socio-economic goals, by providing for exemptions and special tax treatment for certain taxpayers, thereby treating “equal taxpayers differently”, is in conflict with the basic principle of equity and argue that tax laws should ideally be protected against political motives and abuse.<sup>224</sup>

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<sup>217</sup> Buehler (1948) 328; Carter Report Vol 3 (1966) 153; Bankman and Griffith (1987) *Calif Law Rev* 1905; Report of the Joint Standing Committee on Finance on the Interim Katz Report (1995) 4.

<sup>218</sup> Third Interim Katz Report (1995) par 7.1.4.

<sup>219</sup> See Hettich and Winer (1985) *Natl Tax J* 426–432. The society’s view of the extent to which distribution should be effected through taxation would e.g. determine whether taxes should be proportional, progressive or regressive. See Musgrave (1967) *Harv Law Rev* 45 n 2 and Sandford (2000) 37.

<sup>220</sup> Coetzee (1998) *Tax Planning* 89.

<sup>221</sup> See e.g. Kaplov (1989) *Natl Tax J* 139; McDaniel and Repetti (1993) *Florida Tax Rev* 607; Banks and Diamond: Mirrlees Review (2008) 2, 8, 102.

<sup>222</sup> Davies (1984) *Rutgers Law J* 869; Lang in Essers and Rijkers eds (2005) 11 n 38, n 39 and accompanying text; Gassner in Essers and Rijkers eds (2005) 40–42.

<sup>223</sup> Banks and Diamond: Mirrlees Review (2008) 2.

<sup>224</sup> Essers and Rijkers in Essers and Rijkers eds (2005) xxiii–iv.

Lang's statement that "the ability-to-pay principle is the most adequate guide to optimise the tax equity and equality, because each branch of the law needs basic principles",<sup>225</sup> deserves support. Ability-to-pay will always be susceptible to social change and is a dynamic concept, which can be shaped to fit into any tax system. It connotes the objectives of fairness and equality, values that are unmistakably part of a democratic society that abides by the "rule of law".<sup>226</sup>

#### 2.4.2.2 *The Second Canon: Certainty and Simplicity*

Smith's second maxim dictates that the tax which a person is bound to pay ought to be certain, and not arbitrary, which implies that the time, manner and amount of payment should be clear and ascertainable to the taxpayer.<sup>227</sup> Furthermore, the enforcement thereof should be consistent and universal.<sup>228</sup> Certainty of law is closely linked to legality, both principles of adherence to the rule of law,<sup>229</sup> and is an essential quality of a true democracy where the taxing authorities are accountable to the electorate.<sup>230</sup> Reliance on, for example, selective enforcements might leave too much power to the discretion of the

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<sup>225</sup> Lang in Essers and Rijkers *eds* (2005) 13.

<sup>226</sup> The "rule of law" is fundamentally the principle that no one is above the law. Foldvary in Racheter and Wagner *eds* (2002) 191–192 explains as follows: "The supreme law of an organized society makes up its constitution, such that all other laws must adhere to that highest-level framework. In any society, there is always a constitution, whether explicit in writing or implicit in custom and authority. The stability and constraints implied by the rule of law imply a constitution that is itself more stable than operating laws, and thus that the requirements for changing constitutional law are broader, such as requiring supermajorities and wider ratification requirements such as consent also by the voters or by other levels of government. The rule of law is not an end in itself, but a means to something greater."

<sup>227</sup> Smith (1776) book v ch ii pt ii, available at <http://www.adamsmith.org> (accessed on 20 June 2008). See also Meade Report (1978) 18–19; Chelliah Report (1986) 72; Gammie Report (1994) 7; Margo Report (1986) par 4.47; Morse and Williams (2000) 7.

<sup>228</sup> Morse and Williams (2000) 7.

<sup>229</sup> Lang in Essers and Rijkers *eds* (2005) 4.

<sup>230</sup> O'Brien Report (1982) 85.

taxing authorities.<sup>231</sup> Certainty is also required for economic purposes, because a lack thereof would undermine confidence in markets, which can impede economic growth.<sup>232</sup>

Certainty also involves simplicity, requiring that taxes should be simple in concept, collection and administration.<sup>233</sup> It is for example desirable that the taxpayer should ascertain his or her tax liability according to operations and records that he or she needs to perform and preserve anyway.<sup>234</sup> Another aspect is the number of taxpayers: the fewer taxpayers per revenue raised, the simpler the tax system.<sup>235</sup> The problem is, the simpler the rules, the less fair they are, but the fairer they are, the more complex they are.

#### ***2.4.2.3 The Third Canon: Convenience***

Smith's third maxim provides that every tax ought to be levied at a time, or in a way, most convenient to the taxpayer.<sup>236</sup> This principle touches upon the proposition that taxes should preferably be levied in cash rather than in kind.<sup>237</sup> Furthermore, taxes should ideally be levied in a way that takes cognisance of a taxpayer's liquidity. If a tax is levied on the value of unrealised assets, the assets need to be valued, which opens the door for inconsistencies and tax avoidance through discretionary valuations.

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<sup>231</sup> Banks and Diamond: Mirrlees Review (2008) 76.

<sup>232</sup> O'Brien Report (1982) 85.

<sup>233</sup> Meade Report (1978) 18–20; O'Brien Report (1982) 85; Chelliah Report (1986) 72–73; Margo Report (1986) par 4.47.

<sup>234</sup> Asprey Report (1975) 15; O'Brien Report (1982) 85.

<sup>235</sup> As stated by the Asprey Report (1975) 15: "The sheikdom that can raise all the revenue it requires (and maybe much more) from a single tax on a single oil company has what is unquestionably the simplest tax system of all". See also O'Brien Report (1982) 85.

<sup>236</sup> Smith (1776) book v ch ii pt ii, available at <http://www.adamsmith.org> (accessed on 20 June 2008). See also Chelliah Report (1986) 72 and Stevens (1989) 5, where the author refers to "het beginsel van de minste pijn".

<sup>237</sup> Epstein (1986) *Soc Philos Pol* 58.

#### 2.4.2.4 *The Fourth Canon: Cost Effectiveness and Efficiency*

The economic function of a tax in a market economy is to transfer resources from the private sector to the public sector. Smith's fourth maxim requires that the costs of a tax should not be a disproportionately high percentage of the revenue yield.<sup>238</sup> There are three major components of costs, namely collection costs, "dead-weight" market costs and unproductive costs.

##### 2.4.2.4.1 *Collection Costs*

The first component is the collection costs of the system, which consists of (1) administrative costs, namely the cost of establishing and maintaining a tax collection system, and (2) compliance costs, namely the cost for taxpayers to comply with their tax liabilities (in terms of time, money and effort).<sup>239</sup> An efficient collection system requires that "the resources available for public use be as nearly as possible equal to the resources withdrawn from the private sector: that is, that the process by which resources are transferred involve minimal 'waste.'"<sup>240</sup> Both costs will be less if the taxpayers' tax liability can be easily established. Efficiency will therefore be enhanced by a certain and simple tax system.<sup>241</sup>

##### 2.4.2.4.2 *Dead-Weight Market Costs and Neutrality*

A tax has an efficiency cost in that it influences the economic decisions of taxpayers. Taxation perceived as being unfair and a penalty to the economically active may

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<sup>238</sup> Smith (1776) book v ch ii pt ii, available at <http://www.adamsmith.org> (accessed on 20 June 2008). See also Margo Report (1986) par 4.49; Epstein (1986) *Soc Philos Pol* 56; Stevens (1989) 5.

<sup>239</sup> Meade Report (1978) 20; Margo Report (1986) par 4.48; Morse and Williams (2000) 8; Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 142.

<sup>240</sup> Asprey Report (1975) 16. See also Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 142. As stated by Jean-Baptiste Colbert: "[t]he art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing" (quoted by Theron LLD Thesis (1994) 18).

<sup>241</sup> Asprey Report (1975) 15; Meade Report (1978) 20.

discourage work effort and savings<sup>242</sup> and may encourage tax avoidance.<sup>243</sup> This involves the cost to the society of the misallocation of resources (referred to as “dead-weight losses”), resulting in the underlying economic activity being distorted or even destroyed.<sup>244</sup>

Although it is inevitable that taxation distorts economic decision-making to some extent and discourages certain economic behaviour,<sup>245</sup> the criterion of efficiency requires that taxes should ideally be designed to redistribute purchasing power with the least distortion to the market economy.<sup>246</sup> This underlines the criterion that the tax system should be neutral: a taxpayer should therefore not be influenced by the tax system to choose one course of action above another predominantly because its tax position is better.<sup>247</sup> The objective presupposes the fact that, before a system of taxation is imposed, individuals order their preferences in a discrete and particular way. It cannot be presumed, however, that taxpayers will consume wisely. Government intervention is sometimes required to influence consumer behaviour, and efficiency may even be improved by a departure from neutrality.<sup>248</sup> It can have important effects on, for example, incentives to save or work and the allocation of resources to uses that best serve the needs of society.<sup>249</sup> As a

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<sup>242</sup> Coetzee (1998) *Tax Planning* 91.

<sup>243</sup> Banks and Diamond: *Mirrlees Review* (2008) 76.

<sup>244</sup> A classic example of a tax that destroyed economic activity is the French “gabelle”, an excise duty on salt that destroyed the salt trade and yielded no income. See Margo Report (1986) par 4.49.

<sup>245</sup> Schmalbeck (2000) *Cleve State Law Rev* 754; Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 137.

<sup>246</sup> Carter Report Vol 1 (1966) 24–26; O’Brien Report (1982) 84; Chelliah Report (1986) 71; Gammie Report (1994) 6; Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 137. This principle is sometimes referred to as the principle of “least price distortion”. See Sandford (1970) 8; Sandford (1971) 24 and Rose in Essers and Rijkers eds (2005) 55.

<sup>247</sup> Asprey Report (1975) 16; O’Brien Report (1982) 84; Margo Report (1986) pars 4.41–4.42; Epstein (1986) *Soc Philos Pol* 55; Gammie Report (1994) 6–7; Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 137.

<sup>248</sup> Asprey Report (1975) 16; O’Brien Report (1982) 84; Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 137.

<sup>249</sup> Meade Report (1986) 7–11.

consequence, economic theory has developed some rules to maximise social welfare, collectively referred to as the principles of “optimal taxation”.<sup>250</sup>

#### 2.4.2.4.3 Unproductive Costs

A third component is the costs of tax planning and tax advisors, resulting in resources being employed in the unproductive activity of finding loopholes and tax-free alternatives, which may even further distort the allocation of resources.<sup>251</sup> An efficient tax system therefore dictates that tax avoidance and evasion be kept to a minimum, which requires simple tax laws.<sup>252</sup>

#### 2.4.2.5 Other Considerations

The Meade Report mentions that a good tax structure should be flexible for economic and political reasons, especially in a democratic society where one government succeeds another.<sup>253</sup>

The Margo Report refers to the criterion of invisibility, relating to the view that the best taxes are those paid by other people. The Report, however, remarked that “[s]trictly speaking, invisibility is an approach to rather than a canon of taxation”.<sup>254</sup>

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<sup>250</sup> See in general Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 137–142 for a comprehensive discussion, which involves rules derived in relation to the magnitude of the excess burden, price elasticities and tax rates.

<sup>251</sup> Margo Report (1986) par 4.50; Morse and Williams (2000) 8; Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 142.

<sup>252</sup> Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 143.

<sup>253</sup> Meade Report (1978) 21. See also Steenekamp *Tax Efficiency* in Black, Calitz and Steenekamp eds (2008) 144.

<sup>254</sup> Margo Report (1986) par 4.46. See Franzsen LLD Thesis (1990) 22 for criticism on this statement.

Morse and Williams add that the rules of the system should be workable in the international arena.<sup>255</sup>

#### *2.4.2.6 Principles in Conflict*

The criteria are frequently in conflict with one another. In endeavouring to achieve one criterion more fully, another is less adequately realised.<sup>256</sup> Musgrave correctly states that “[t]ax equity, as with all good things in life, carries its costs”.<sup>257</sup> Compromises are therefore inescapable and the relative importance that should be allocated to each of these principles will have to be established by virtue of political processes.<sup>258</sup>

History illustrates that the criterion of equity (“equitable taxation”) dominated tax policy during the 1950s and 1960s,<sup>259</sup> whereas the criterion of efficiency gained importance only during the 1970s and 1980s with the development of the theory of “optimal taxation”, which uses simple econometric models to draw inferences about how taxes should be set in order to strike a balance between equity and efficiency concerns.<sup>260</sup> Distributive justice, as a function of vertical equity, is currently gaining relative importance in developing countries, including South Africa.

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<sup>255</sup> Morse and Williams (2000) 9.

<sup>256</sup> Carter Report Vol 1 (1966) 3; O’Brien Report (1982) 86.

<sup>257</sup> Musgrave (2000) 209.

<sup>258</sup> Meade Report (1978) 23.

<sup>259</sup> Hettich and Winer (1985) *Natl Tax J* 424–426. The Carter Report Vol 1 (1966) 4 concluded that “[w]e are convinced that scrupulous fairness in taxation must override all other objectives where there is a conflict among objectives”. See also Bird (1991) *Can Publ Pol* 330.

<sup>260</sup> Holmes PhD Thesis (2000) viii.

### 2.4.3 Constitutional Considerations: A South African Perspective

#### 2.4.3.1 *The Constitutional Transformation*

In a South African context, coercive taxation has certainly evolved to a level of accountable taxation, especially with the constitutional transformation and democratisation since 1994. From 1910, when the Union of South Africa was established, to 1994, the South African parliament was mainly elected by South Africa's white minority. The parliamentary system was based on the English Westminster system of parliamentary supremacy.<sup>261</sup> In the absence of a bill of rights, taxpayers could not challenge fiscal legislation or the revenue authorities' powers in a court of law.<sup>262</sup> Although members of the coloured races were generally not permitted to participate in elections, they were still required to pay taxes in the era prior to 1994.<sup>263</sup> This situation has caused several rebellions, such as the Bambatha rebellion in 1906.<sup>264</sup>

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<sup>261</sup> Croome PhD Thesis (2008) 7 n 12 refers to s 34(3) of the Republic of South Africa Constitution Act 110 of 1983: "No Court of Law shall be competent to enquire into or pronounce upon the validity of an Act of Parliament." Legislation could only be invalidated if it did not comply with the legal procedures set out in the Act.

<sup>262</sup> Croome PhD Thesis (2008) 8 (except for some narrow common-law grounds based on administrative justice).

<sup>263</sup> Various poll and "hut taxes" were levied on natives in the colonial era by the colonial governments. To consolidate and amend the law relating to the taxation of natives, the Natives Taxation and Development Act 41 of 1925 was enacted. It provided for the levying of an annual general poll tax on every adult male native domiciled in the Union of South Africa (s 2(1)). An additional local tax was payable by the native occupier of every hut or dwelling in a native location within the Union (s 2(2)). This Act was repealed by the Bantu Taxation Act 92 of 1969, which provided for the levying of an annual graduated income tax on the taxable income of any Black as well as a fixed poll tax, payable by any Black male who has attained the age of 18 years in the year of assessment. This Act also imposed a local ("hut") tax on the occupier of every hut or dwelling. The Act was repealed in 1984. See in general Trevor (1936) *Rev of Econ Studies* 217 *et seq* and Redding (2006) for an extensive historic discussion on the taxation of non-white South Africans for the period 1880–1963.

<sup>264</sup> During this revolt, which resulted from the imposition of a new poll tax, between 3 000 and 4 000 Zulus were reportedly killed and more than 7 000 imprisoned in the former Natal Colony. See Redding (2006) Ch 4 for a comprehensive discussion.



In 1994 the first democratic elections were held. The unbearable situation of “taxation without representation” was rectified with the institution of the first democratically elected government on 27 April 1994. On this date the first Interim Constitution came into force by virtue of Act 200 of 1993 (hereafter “Interim Constitution”).<sup>265</sup> One of its main purposes was to redefine the public values in the light of newly defined common interests by guaranteeing certain fundamental rights in the Bill of Rights (chapter 3), such as a person’s right to equality, privacy and property, and access to information and justice. The Interim Katz Report, published later in the year, noted that “[w]hereas millions of citizens have in the past regarded the tax system to a lesser or greater degree as a mechanism to fund their oppression, South Africa now enters an era in which taxation becomes a legitimate instrument of achieving national, democratic objectives”.<sup>266</sup> The commission declared its intention to bring about equality of taxation in the South African tax system.

Following the enactment of the Interim Constitution and the subsequent recommendations by the Katz Commission,<sup>267</sup> some of the discriminatory provisions in fiscal statutes were deleted or amended.<sup>268</sup> On 4 February 1997, the Constitution of the Republic of South Africa 1996 (hereafter “the Constitution”) replaced the Interim Constitution.<sup>269</sup> Chapter 2 of the Constitution contains the Bill of Rights similar to the Bill of Rights contained in chapter 3 of the Interim Constitution.

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<sup>265</sup> South Africa became a constitutional state, i.e. a state where the Constitution is the supreme law of the land. Legislation breaching the constitutional principles may not remain in force. See Croome PhD Thesis (2008) 8.

<sup>266</sup> Interim Katz Report (1994) par 1.4.2 (b).

<sup>267</sup> See Interim Katz Report (1994) Ch 6 entitled “Implications of the Constitution of the Republic of South Africa”.

<sup>268</sup> See summary and discussion by Croome (2002) *Acta Juridica* 3–6 and Croome PhD Thesis (2008) 11–14.

<sup>269</sup> The Constitution was adopted on 8 May 1996, amended on 11 October 1996, promulgated on 18 December 1996 and implemented on 4 February 1997. See Croome PhD Thesis (2008) 15 n 52.

The founding provisions of the Constitution states that the Republic of South Africa is one, sovereign, democratic state founded on fundamental values such as human dignity, the achievement of equality, the advancement of human rights and freedoms, non-racialism, non-sexism, the supremacy of the constitution, the rule of law, universal adult suffrage, a national voters' roll, regular elections and a multi-party system of democratic government.<sup>270</sup> The principle of "supremacy of the constitution" indicates that legislation should primarily abide by the principles set out in the Constitution. Any legislative provision in conflict with the Constitution may be declared unconstitutional, in which case such provision will be of no force and effect.

#### ***2.4.3.2 The Power to Impose Taxes***

The government's power to impose a tax should be inferred from the general grant of legislative and executive authority and the limitations on that authority imposed by the provisions of the Constitution.<sup>271</sup> The Constitution distinguishes between three spheres of government, namely national, provincial and local spheres of government.<sup>272</sup> The legislative authority of the national sphere vests in Parliament, which consists of the National Assembly and the National Council of Provinces.<sup>273</sup> The legislative authority of the provincial sphere vests in the different provincial legislatures<sup>274</sup> and the local sphere

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<sup>270</sup> Constitution Ch 1 s 1(a)–(d). See Michelman in Woolman, Roux and Bishop *eds* Vol 1 (2007) Ch 11 and Roederer in Woolman, Roux and Bishop *eds* Vol 1 (2007) Ch 13 for a discussion of the founding provisions.

<sup>271</sup> Croome PhD Thesis (2008) 15. Sections 228 and 229 explicitly limit the rights to tax of the provincial and local spheres of government respectively. See Swart (1996) *SA Public Law* 446 *et seq* for a discussion on the delegation of the power to tax under the Interim Constitution. See Budlender in Woolman, Roux and Bishop *eds* Vol 1 (2007) Ch 17 and Madlingozi in Woolman, Roux and Bishop *eds* Vol 1 (2007) Ch 18 for a discussion of the national and provincial legislative authority and processes.

<sup>272</sup> Constitution Ch 3 s 40(1).

<sup>273</sup> Constitution Ch 4 s 42 and 43(a).

<sup>274</sup> Constitution Ch 4 s 43(b) and Ch 6 s 104. The Republic has the following nine provinces: Eastern Cape, Free State, Gauteng, KwaZulu-Natal, Limpopo, Mpumalanga, Northern Cape, North West and Western Cape.

of government vests in the municipal councils.<sup>275</sup> The national legislative authority, as vested in Parliament, confers on the National Assembly the power to amend the Constitution and to pass legislation in respect of any matter, including a matter listed within the functional areas of concurrent national and provincial legislative competence listed in schedule 4, but excluding any matter within the functional areas of exclusive provincial competence listed in schedule 5.<sup>276</sup> However, the National Assembly has the power to assign any of its general legislative powers, except the power to amend the Constitution, to any legislative body in another sphere of government.<sup>277</sup>

The area of taxation is not listed in either schedule 4 or 5, which means that the National Assembly primarily has the exclusive authority to pass tax legislation, unless such authority has been assigned to a sub-national sphere of government, or unless the Constitution expressly confers some power on another sphere of government. Section 228 provides that a provincial legislature may impose (a) taxes, levies and duties other than income tax, value-added tax, general sales tax, rates on property or customs duties and (b) flat-rate surcharges on any tax, levy or duty that is imposed by national legislation, other than corporate income tax, value-added tax, rates on property or customs duties. However, no province in South Africa has yet exercised the right to introduce a new provincial tax.<sup>278</sup> Section 229 confers on a municipality the right to impose (a) rates on property and surcharges on fees for services provided by or on behalf of the municipality, and (b) other taxes, levies and duties appropriate to local government, but only if sanctioned by national legislation and excluding income tax, value-added tax, general sales tax or customs duty.

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<sup>275</sup> Constitution Ch 4 s 43(c) and Ch 7 s 156.

<sup>276</sup> Constitution Ch 4 s 44(1)(a)(i) and (ii).

<sup>277</sup> Constitution Ch 4 s 44(1)(a)(iii).

<sup>278</sup> Croome PhD Thesis (2008) 15–16. The Western Cape has mentioned the possible introduction of a provincial fuel levy.



### 2.4.3.3 Substantive Limitations

#### 2.4.3.3.1 The Bill of Rights

The most important substantive limitations to the government's taxing power is the Bill of Rights contained in chapter 2 of the Constitution, which is applicable to all law and binds the legislature, the executive, the judiciary and all organs of state.<sup>279</sup> It is, however, important to note that the fundamental rights are not absolute and may be restricted. Section 36 provides that a right may only be limited in terms of:

“law of general application to the extent that the limitation is reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom, taking into account all relevant factors, including (a) the nature of the right, (b) the importance of the purpose of the limitation, (c) the nature and extent of the limitation, (d) the relation between the limitation and its purpose and (e) less restrictive means to achieve such purpose.”<sup>280</sup>

In the realm of taxation, and especially the imposition of a tax, the fundamental rights enshrined in section 9 (equality) and section 25 (property) deserve consideration.

#### 2.4.3.3.2 Right to Property

Section 25(1) provides that “[n]o one may be deprived of property except in terms of law of general application, and no law may permit arbitrary deprivation of property”. Although a comprehensive description of “property” is difficult to achieve for purposes of section 25, the term has a wide meaning.<sup>281</sup> The levying of a tax on a taxpayer's

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<sup>279</sup> Constitution Ch 2 s 8(1).

<sup>280</sup> A number of articles have been written on the limitation clause, e.g. De Ville (1994) *SA Public Law* 287; Woolman (1997) *SA J for Human Rights* 102; Devenish (1998) *Obiter* 256; Rautenbach (2001) *THRHR* 617.

<sup>281</sup> In *First National Bank of SA Ltd t/a Wesbank v CSARS* (2002 (7) BCLR 702 (CC), 64 SATC 471) the court stated (at par 51) that “at this stage of our constitutional jurisprudence it is ... practically impossible to furnish – and judicially unwise to attempt – a comprehensive definition of property for purposes of s 25. Such difficulties do not, however, arise in the present case. Here it is sufficient to hold that ownership of

Footnote continues on the next page

“entitlement to certain benefits or rights” would generally constitute a deprivation of property as envisaged in section 25 of the Constitution.<sup>282</sup>

In *First National Bank of SA Ltd t/a Wesbank v CSARS*<sup>283</sup> Conradie J (at 449) commented that:

“[T]axation does not amount [in principle] to a deprivation of property. Nor is there anything which is expropriated. No one would think of claiming compensation for having been taxed. Freedom from taxation is not a fundamental right. Nothing protects the subject against taxation. Not even death ... It may be different where the impugned tax is oppressive or partial and unequal in its operations ... If its reach seems broader than it need be, that is no ground for a constitutional challenge.”

This line of thinking is also in accordance with the internationally accepted viewpoint.<sup>284</sup> Croome therefore concludes that where a taxing measure applies equally to all citizens of South Africa, a taxpayer will generally fail to challenge its constitutionality merely because it constitutes a violation of the right to property.<sup>285</sup>

#### 2.4.3.3.3 Right to Equality

Section 9 provides that “[e]veryone is equal before the law and has the right to equal protection and benefit of the law”.<sup>286</sup> It furthermore directs that the state may not unfairly discriminate against anyone on grounds such as race, gender, sex, pregnancy, marital

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corporeal movable property must – as must ownership of land – lie at the heart of our constitutional concept of property”.

<sup>282</sup> Croome PhD Thesis (2008) 28.

<sup>283</sup> 2001 (7) BCLR 715 (C), 63 SATC 432.

<sup>284</sup> Croome PhD Thesis (2008) 32–36 discusses the approaches of the European Convention on Human Rights and the constitutional law of Australia, Switzerland, Trinidad and Tobago, India, the US, Ireland and Canada.

<sup>285</sup> Croome PhD Thesis (2008) 36.

<sup>286</sup> Constitution Ch 2 s 9(1).

status, ethnic or social origin, colour, sexual orientation, age, disability, religion, conscience, belief, culture, language or birth,<sup>287</sup> unless it is established that the discrimination is fair.<sup>288</sup> It is therefore not lawful, for example, to impose a tax that applies exclusively to a section of the community.<sup>289</sup> Croome argues that the fiscal statutes that levy taxes in South Africa constitute laws of general application and do not currently discriminate unfairly on the grounds set out in section 9 of the Constitution.<sup>290</sup>

#### 2.4.3.4 *Procedural Limitations*

The Constitution provides that a national bill that imposes a tax is defined as a “money bill”.<sup>291</sup> Money bills must be considered in accordance with a special detailed procedure, which enhances the level of parliamentary scrutiny.<sup>292</sup>

The power of a provincial legislature or a municipality to impose a tax or levy may not be exercised in a way that materially and unreasonably prejudices national economic policies, economic activities across provincial borders and the mobility of services, goods, capital or labour.<sup>293</sup> Any provincial tax must comply with the provisions of the Provincial Tax Regulation Process Act<sup>294</sup> and any municipal tax with the Municipal Fiscal Powers and Functions Act.<sup>295</sup>

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<sup>287</sup> Constitution Ch 2 s 9(3).

<sup>288</sup> Constitution Ch 2 s 9(5).

<sup>289</sup> Croome PhD Thesis (2008) 17.

<sup>290</sup> Croome PhD Thesis (2008) 31.

<sup>291</sup> Constitution Ch 4 s 77(1). See also Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 116.

<sup>292</sup> Constitution Ch 4 s 77(3). The special procedure is set out in s 75. See also Steenekamp *Introduction* in Black, Calitz and Steenekamp *eds* (2008) 116.

<sup>293</sup> Constitution Ch 13 ss 228(2)(a), 229(2)(a).

<sup>294</sup> Act 53 of 2001. See Croome PhD Thesis (2008) 15 n 53 and accompanying text.

<sup>295</sup> Act 12 of 2007 (to be read with Constitution Ch 13 s 229(2)(b)).

### 2.4.3.5 *The Power to Collect Taxes*

In 1997, the South African Revenue Service Act<sup>296</sup> (“SARS Act”) established the South African Revenue Service (“SARS”) as an organ of state within the public administration, but as an institution outside the public service.<sup>297</sup> The Commissioner of SARS is primarily responsible for the administration of fiscal legislation, as well as the efficient and effective collection of revenue, customs and excises at the national sphere of government.<sup>298</sup> Under fiscal legislation the Commissioner has extensive powers to collect taxes effectively and efficiently.<sup>299</sup> These powers should comply with constitutional standards, as they could violate the taxpayer’s fundamental rights, such as the right to property, privacy, access to information, administrative justice and access to the courts.<sup>300</sup>

## 2.5 CONCLUSIONS

- (a) This chapter provided a brief historic overview of taxation in general.<sup>301</sup> It was shown that modern tax systems typically comprise a variety of taxes on income, consumption and wealth, which is also the position in South Africa.<sup>302</sup> The discussion illustrated that the taxation of wealth transfers

<sup>296</sup> Act 34 of 1997.

<sup>297</sup> SARS Act s 2 (the Act became effective on 1 October 1997).

<sup>298</sup> SARS Act ss 3, 4. Previously, revenue was primarily collected and administered by the Commissioner for Inland Revenue (CIR) and the Controller of Customs and Excise. See Croome PhD Thesis (2008) 17.

<sup>299</sup> These powers have been the subject of constitutional attack. See *Metcash Trading Limited v CSARS and the Minister of Finance* 2001 (1) BCLR (1) CC, 63 SATC 13 (the case dealt with some powers of SARS in terms of the Value-Added Tax Act 89 of 1991).

<sup>300</sup> For further reading on the constitutionality of the Commissioner’s powers, see Solomon (1995) *Annual Survey of SA Law* 690; Silke (1997) *Tax Planning* 17; Croome (1999) *Tax Planning* 80; Erasmus (2001) *Without Prejudice* 16; Silke (2001) *Tax Planning* 50; Olivier (2001) *TSAR* 193; Williams (2001) *SALJ* 418; Williams (2001) *SALJ* 242; Croome (2002) *Acta Juridica* 1; Silke (2002) *Acta Juridica* 282; Silke (2003) *Tax Planning* (I) 44; Silke (2003) *Tax Planning* (II) 50; Louw (2003) *THRHR* 292; Olivier (2004) *TSAR* 273; Croome (2005) *Without Prejudice* 7. See also Croome PhD Thesis (2008) for a comprehensive discussion of the extent to which the powers of SARS comply with the taxpayer’s constitutional rights to property, privacy, administrative justice, access to information and access to courts.

<sup>301</sup> See par 2.2.1.

<sup>302</sup> See pars 2.2.2, 2.2.3 and 2.2.4.

may conceptually be accommodated under a comprehensive income tax,<sup>303</sup> a direct consumption tax<sup>304</sup> or a wealth transfer tax.<sup>305</sup>

- (b) In the realm of capital gains tax, it was shown that there are a variety of ways to deal with the unrealised gains on the death of a wealth holder. The gains may either be subjected to taxation by treating death as a taxable event (referred to as the “deemed-realisation” approach) or by deferring the tax liability to the moment when the heir realises the asset (referred to as the “carry-over” approach). On the other hand, unrealised gains may escape taxation where the system provides that the base cost is stepped up in the hands of the heir (referred to as the “stepped-up” approach).<sup>306</sup>
- (c) This chapter also outlined the objectives and essential policy considerations of taxation in general. Taxes are levied by tax jurisdictions to achieve various goals, the most prominent of which are the collection of revenue to fund government activities.<sup>307</sup> Taxes can also assist the accomplishment of certain socio-economic objectives such as the redistribution of resources.<sup>308</sup> In drafting the legislation to levy taxation, legislatures should not restrict their policy considerations to these socio-economic and political goals, but should ideally adhere to the “canons of taxation”, which are rational policy considerations based on principles of

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<sup>303</sup> See par 2.2.2.2.

<sup>304</sup> See par 2.2.4.2.

<sup>305</sup> See par 2.2.3.2.2.

<sup>306</sup> See par 2.2.3.3.2.

<sup>307</sup> See par 2.3.1.

<sup>308</sup> See par 2.3.2.



equity, certainty, convenience, efficiency and neutrality. These principles reflect general ideals of justice in taxation.<sup>309</sup>

- (d) Although a government has a fundamental right to levy taxation, it was pointed out that such a right should be exercised within the constitutional framework of the relevant jurisdiction, the principles of which may require accountability on the part of such government and taxing authorities.<sup>310</sup>
- (e) In a South African context, taxes of national application should generally be levied on the national sphere of government in accordance with certain procedures. Although the general ideals of taxation (“canons of taxation”) are not enshrined in the Constitution, tax laws should adhere to the general constitutional values and should not violate the bill of rights. Although the administrative powers of SARS have been under constitutional attack, the levying of taxation as an infringement on property rights has received little attention in the South African courts. It was, however, explained that a taxpayer would generally not be able to challenge fiscal legislation in South Africa merely because it constitutes a violation of the right to property, unless it can be shown that the tax is confiscatory. Because fiscal statutes in South Africa constitute laws of general application, they do not currently discriminate unfairly.<sup>311</sup>

The next chapter will provide a brief overview of the historical development of the taxation of wealth transfers.

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<sup>309</sup> See par 2.4.2.

<sup>310</sup> See par 2.2.1.1.

<sup>311</sup> See par 2.4.3.

## CHAPTER 3

### THE HISTORICAL DEVELOPMENT OF THE TAXATION OF WEALTH TRANSFERS

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#### 3.1 INTRODUCTION

This chapter briefly explores the historical development of the taxation of wealth transfers from its earliest inception in the ancient civilisations and the Roman Empire, to the contemporary position in the South African law. To provide the reader with a general



understanding of the international position, the discussion explores aspects of the historical development in the United Kingdom, the Netherlands, United States, Ireland, Canada and Australia.

### 3.2 THE INTERNATIONAL HISTORICAL DEVELOPMENT OF WEALTH TRANSFER TAXATION IN SELECTED COUNTRIES: A BRIEF OVERVIEW

#### 3.2.1 The Ancient Civilisations and the Roman Empire

The origin of the taxation of inheritances has historically been attributed to the Emperor Augustus, who is known to have established a tax called the *vicesima hereditatium* on Roman citizens in 6 CE.<sup>1</sup> Apparently, the Romans borrowed the idea from the Egyptians, who had taxed the transfer of property as early as the seventh century BCE.<sup>2</sup> Unlike the Egyptians, the Romans taxed the property received.<sup>3</sup> It is unknown when the *vicesima* was finally repealed, but it definitely occurred before the time of the Code of Justinian, somewhere between the third century and the middle of the sixth century CE.<sup>4</sup>

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<sup>1</sup> West (first published in 1893 and reprinted in 2004) 11–14; Buehler (1948) 388; Coffield (1970) 24–26; Schuttevaer and Zwemmer (1998) v3; Zwemmer (2001) *Mededelingen* 9. These regulations were codified in the *Lex Iulia de Vicesima Hereditatium*. The main characteristics of this tax codification can still be found in the works of the historian Cassius Dio *Dio's Roman History* (Vol vi), with an English translation by E Cary, London, New York 1917. See Beckham LLM Thesis (1993) 15.

<sup>2</sup> A papyrus roll (of *circa* 117 BCE) was found which records that a certain Hermias was sentenced to pay a heavy penalty for failing to pay the tax on the house he inherited from his father. See West (2004) 11; Kartiganer and Sedlaczek in Atherton *ed* (2003) 117 n 7 and Adriani and Van Hoorn Vol 1 (1954) 317; Van Nispen and Shuttevaer (1969) 124 n 3 and accompanying text; Schuttevaer and Zwemmer (1998) v3; Gale and Slemrod in Gale, Hines and Slemrod *eds* (2001) 12 n 19 and accompanying text.

<sup>3</sup> West (2004) 12.

<sup>4</sup> West (2004) 13, 15; Beckham LLM Thesis (1993) 15.



### 3.2.2 The Middle Ages

In the Middle Ages the taxation of inheritances was governed by the principles of the *relief* and *heriot* of feudal origin. The *relief* was payable on the death of a tenant by the heir to the landlord, due to the principle that the property escheated to the landlord, for which he requested a contribution in permitting the heir to take possession of the property. The *heriot*, established in England by the Danes, was a contribution of the best beast or chattel by the estate of a deceased tenant to the lord on the death of a tenant. The *heriot*, unlike the *relief*, did not extend to land. An important difference is that the *heriot* was considered to be a payment by the deceased tenant's estate, whereas the *relief* was imposed on the tenant's heir.<sup>5</sup>

### 3.2.3 The Modern Era (from 1500 CE)

The recipient-based *relief* formed the basis of the first inheritance taxation that was introduced in France in 1553.<sup>6</sup> To finance the wars with Spain, the different provinces of the Netherlands started to levy succession duties at the end of the sixteenth century. Holland, for example, introduced a recipient-based duty (the *Collaterale Impost*) on immovable property in 1598, which was extended to movables in 1653.<sup>7</sup> A stamp tax on wills was also introduced in 1624.<sup>8</sup> These taxes were of a feudal nature and were therefore charged on individual assets.<sup>9</sup> The Dutch taxes formed the basis of numerous other European inheritance taxes initiated in the sixteenth and seventeenth centuries, such as the German *erbkauf*. It was also common for countries to introduce accompanying

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<sup>5</sup> West (2004) 14–15.

<sup>6</sup> West (2004) 16; Adriani and Van Hoorn Vol 1 (1954) 318.

<sup>7</sup> West (2004) 20; Adriani (1925) 4; Shuttevaer and Zwemmer (1998) v5; Zwemmer (2001) *Mededelingen* 9.

<sup>8</sup> West (2004) 20.

<sup>9</sup> Adriani (1925) 5.



taxes on gifts. These European taxes continued to develop mainly as a charge on the recipients.<sup>10</sup>

England borrowed the idea of a stamp tax from Holland, by introducing a probate duty in 1694. This duty was essentially a stamp duty on probates and letters of administration. The publication of Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* in 1776 made the Dutch inheritance taxes better known and led England to introduce some additional taxes on inherited wealth. In the two hundred years thereafter, four other duties were developed and simultaneously imposed. Legacy duty (introduced in 1780) and succession duty (introduced in 1853) were duties imposed on the heirs of personal property and real estate respectively. To counter the avoidance of probate duty by gifting property in the period shortly before death, account duty was introduced in 1881. A short-lived temporary estate duty was implemented in 1889 to act as a supplement to the other co-existing duties. Probate duty, account duty and temporary estate duty were levied on the transferor, whereas legacy duty and succession duty were imposed on the beneficiaries.<sup>11</sup> This complicated system of five collateral death duties needed reform. In 1894, a modern transferor-based estate duty replaced the old probate, account and temporary estate duties, but the recipient-based legacy and succession duties were initially retained.<sup>12</sup> For purposes of estate duty, gifts were only included if they were made in a certain period before death (the "gifts period").<sup>13</sup> The introduction of the direct income tax in the United Kingdom in 1799 did not disturb the existence of the well-

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<sup>10</sup> See West (2004) 20–36 for a comprehensive discussion of the historical development of these taxes in Europe. See also Hauser (1999) *Real Prop Prob & Tr J* 371–374 and Sonneveldt (2004) *WPNR* 314. The levying of *Schenkingsrecht* (gift tax) was introduced into the Dutch wealth transfer tax system only in 1917. See Adriani (1925) 32; Zwemmer (2001) *Mededelingen* 10.

<sup>11</sup> For further reading on the early English duties, see West (2004) 37–41; Sandford (1971) 64–65; Coombes (1977) 2–3; Tiley (2007) *Br Tax Rev* 306–317 and Wallington (2002) div A1.

<sup>12</sup> Coombes (1977) 2–3. The introduction of estate duty came at a time when the focus of tax policy moved away from consumption to income and wealth. The Victorian Era witnessed a growth in "new money". Those who worked hard for their income welcomed the taxation of "old money" in the hands of heirs who enjoyed a life of leisure. See discussion by Lee (2007) *Legal Studies* 681–682.

<sup>13</sup> The "gifts period" was initially set at one year, but increased to three years in 1909, to five years in 1946 and eventually to seven years in 1946. See Coombes (1977) 5.



rooted death duties, because the English concept of income conceptually excluded inheritances and gifts.<sup>14</sup>

The early development of wealth transfer taxation in England had a significant influence on the development of this type of taxation in a number of international jurisdictions. The expansion of the British Empire in the eighteenth and nineteenth centuries resulted in the adoption of the English death duties in most of the former colonies.<sup>15</sup>

For example, in the United States a recipient-based duty, similar to the English legacy duty, was introduced on federal level in 1797.<sup>16</sup> The tax was initiated to finance the undeclared naval war with France and was repealed in 1802.<sup>17</sup> Since 1826, numerous states introduced death duties on a state level, most of which were charged on a recipient basis.<sup>18</sup> Wealth transfer taxation was briefly reintroduced on federal level in 1862, but was repealed by *circa* 1872.<sup>19</sup> Because the 1894 United States income tax legislation (which included inheritances and gifts in the tax base)<sup>20</sup> was declared unconstitutional in

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<sup>14</sup> See Ch 2 par 2.2.2.1.

<sup>15</sup> See West (2004) 37–56 for a comprehensive discussion. In Australia, New South Wales introduced the first death duty in 1851. Tasmania followed in 1865, Victoria in 1870, South Australia in 1876, Queensland in 1886 and Western Australia in 1895. In New Zealand, an estate tax was first introduced in 1866. See Duff (2005) *Pittsburgh Tax Rev* 85 n 70. In Canada, the first succession duties were enacted in 1892 in Ontario, Nova Scotia and Quebec. See West (2004) 52–55. See also par 3.3.2.1 for a discussion on the first South African colonial succession duties.

<sup>16</sup> West (2004) 57; Eisenstein (1956) *Tax Law Rev* 225; Morgan (1981) *Tax Notes* 340; Gale and Slemrod in Gale, Hines and Slemrod eds (2001) 14; Thistle (2007) *Ga J Int & Comp L* 710.

<sup>17</sup> West (2004) 57; Gale and Slemrod in Gale, Hines and Slemrod eds (2001) 14; Thistle (2007) *Ga J Int & Comp L* 710.

<sup>18</sup> Pennsylvania was the first state to impose a recipient-based inheritance tax in 1826. Numerous other states followed the example, such as Louisiana (in 1828), Virginia (in 1843), Maryland (in 1845), North Carolina (in 1847), Alabama (in 1848), Delaware (in 1869), Wisconsin (1868), Minnesota (in 1875), New Hampshire (in 1878), Illinois (in 1887), New York (in 1885), Connecticut (in 1889), Massachusetts (in 1889), Tennessee (in 1891), New Jersey (in 1892), Ohio (in 1893), Maine (in 1893) and California (in 1893). See West (2004) 62–94 for a comprehensive discussion.

<sup>19</sup> West (2004) 57, 62; Eisenstein (1956) *Tax Law Rev* 225; Gale and Slemrod in Gale, Hines and Slemrod eds (2001) 14; Thistle (2007) *Ga J Int & Comp L* 710.

<sup>20</sup> See Ch 2 par 2.2.2.1.



1895,<sup>21</sup> the need for some form of taxation on wealth transfers arose. As a consequence, a transferor-based estate tax was introduced on federal level in 1898. Because the estate tax was repealed in 1902<sup>22</sup> and because the income tax legislation of 1913 expressly excluded wealth transfers from the concept of income,<sup>23</sup> the platform was set for the introduction of a modern federal transferor-based estate tax in 1916,<sup>24</sup> which continued to be levied collaterally with the succession duties at state level. In 1924 the estate tax was complemented by the introduction of a separate gift tax.<sup>25</sup>

Unlike the United Kingdom, the levying of transferor-based taxation and recipient-based taxation operated on various levels of government in the United States. The notion of levying transferor-based wealth transfer taxation at federal level together with collateral succession duties at state level was also encountered in other federal countries, such as

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<sup>21</sup> The Act was declared unconstitutional in *Pollock v Farmers' Loan and Trust Company* 158 US 429 (1895) due to the fact that the gains from real property constituted a direct tax, which had to be apportioned amongst the states according to the census. This set the stage for the introduction of the sixteenth amendment to the United States Constitution, which expressly allows the federal government to impose an income tax without census apportionment. See Gale and Slemrod in Gale, Hines and Slemrod eds (2001) 14.

<sup>22</sup> Eisenstein (1956) *Tax Law Rev* 227 n 23; Morgan (1981) *Tax Notes* 340; Rudnick (1945) *Tax Law Rev* 27; Gale and Slemrod in Gale, Hines and Slemrod eds (2001) 14; Thistle (2007) *Ga J Int & Comp L* 711.

<sup>23</sup> See Ch 2 par 2.2.2.1.

<sup>24</sup> The tax was originally enacted to fund the US' entry into World War I. See Dobris (1984) *Syracuse Law Rev* 1217; Bernstein (2004) *Cardozo J Int & Comp L* 189 n 16; Thistle (2007) *Ga J Int & Comp L* 711. For further reading on the historical development of the US federal estate tax, see Rudnick (1945) *Tax Law Rev* 27–30; Morgan (1981) *Tax Notes* 340; McCaffery (1999) *Tax Notes* 1429–1430; Gale and Slemrod in Gale, Hines and Slemrod eds (2001) 14; Graetz and Shapiro (2005) 8; Paper by Zodrow and Diamond *The US Experience with the Estate Tax* (2006) 11.

<sup>25</sup> After a brief period of repeal from 1926–1932, the tax was reintroduced to increase revenues that were decreasing as a result of the Depression. See McCaffery (1999) *Tax Notes* 1430; Gale and Slemrod in Gale, Hines and Slemrod eds (2001) 14; Paper by Zodrow and Diamond *The US Experience with the Estate Tax* (2006) 11; Thistle (2007) *Ga J Int & Comp L* 712.



Canada<sup>26</sup> and Australia.<sup>27</sup> In other countries, the multiple-duty system was adopted and operated on the same level of government, such as in Ireland upon its foundation of a state in 1922<sup>28</sup> and in the Union of South Africa upon the introduction of its first national wealth transfer tax legislation in the same year.<sup>29</sup> The complicated multiple-duty system (whether levied on the same or on different levels of government) became a focal point for tax reform in these countries in the latter part of the twentieth century. Several government-appointed law reform commissions considered the taxation of wealth transfers, but the recommendations were far from being uniform. The proposals put forward should be seen against the background of the evolution of the income tax (and the idea of a comprehensive income tax), the development of a model for a direct consumption tax and the modern trend to impose a tax on realised capital gains.<sup>30</sup>

In the United Kingdom, the Colwyn Committee suggested in 1927 that it might be plausible to develop the recipient-based legacy and succession duties, so that a recipient-based tax would occupy a more prominent position in the death duty system. This committee's recommendations were not acted upon and the abolition of these duties in 1949 precluded any such development.<sup>31</sup> The abolition was a means of simplification, leaving the transferor-based estate duty as the sole death duty.<sup>32</sup> What is noteworthy is that the respective merits of a transferor-based tax and a recipient-based tax were

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<sup>26</sup> The federal government introduced a federal estate tax in 1935 and a federal succession duty in 1941. At that point in time, provincial succession duties were levied in most of the provinces. Although some provinces abolished their succession duties in consequence of the introduction of the federal taxes, British Columbia, Ontario and Quebec continued to levy and collect their own duties. See Maloney (1988) *Ottawa Law Rev* 605; McKie (1991) *European Taxation* 243 and Duff in Tiley *ed* (2007) 316 n 50.

<sup>27</sup> Duff (2005) *Pittsburgh Tax Rev* 88.

<sup>28</sup> O'Brien Report (1982) 68–69, 424; Doyle (2008) pars 1.2.2 and 1.2.4. See also Bohan and McCarthy (2008) 3–4 for a general discussion on the old English duties that applied in Ireland.

<sup>29</sup> See par 3.3.2.2.1 for further reading.

<sup>30</sup> See Ch 2 pars 2.2.2, 2.2.3.3.2 and 2.2.4.2.

<sup>31</sup> Report by Chancellor of the Exchequer *Cmnd 4930* (1972) 2.

<sup>32</sup> Report by Chancellor of the Exchequer *Cmnd 4930* (1972) 2.





apparently not properly considered.<sup>33</sup> According to the literature, the estate duty concept was chosen above the legacy and succession duties in view of its administrative simplicity and the fact that estate duty was paid within a few months after death, whereas the other duties were collected only on the finalisation of the estate administration.<sup>34</sup> Another explanation offered for the preference for a transferor-based charge was the difficulty of fitting trusts into a recipient-based tax, in view of the fact that a trust is a mechanism whereby the acquisition of vested rights in the trust property by the beneficiaries could be deferred until some future date or event.<sup>35</sup> A third theory is rooted in the difference of the estate administration approaches. Anglo-American law provides for a process of probate, where an executor finalises the administration of an estate before it is distributed among the heirs. The executor (as the representative of the deceased) is burdened with the payment of all the outstanding liabilities and taxes. Conversely, the civil-law jurisdictions generally follow a process where the liabilities and outstanding tax charges are carried over to the heirs.<sup>36</sup>

The introduction in 1965 of capital gains tax into the United Kingdom tax system, providing for death as an occasion of charge, led to a public perception of double taxation because estate duty was charged on the value of a deceased estate.<sup>37</sup> This culminated in the replacement of the deemed-realisation approach with a stepped-up base-cost approach in 1971 (which is still in force today).<sup>38</sup> In 1975, estate duty was replaced with an

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<sup>33</sup> Sandford, Willis and Ironside (1973) 1.

<sup>34</sup> Tiley (2007) *Br Tax Rev* 305.

<sup>35</sup> Jones in Jones, Harris and Oliver *eds* (2008) 220.

<sup>36</sup> Rudnick and Gordon in Thuronyi *ed* Vol 1 (1996) 320; Sonneveldt (2004) *WPNR* 314; Boadway, Chamberlain and Emmerson: *Mirrlees Review* (2008) 6.

<sup>37</sup> Sandford, Willis and Ironside (1973) 96; Lee (2007) *Legal Studies* 703.

<sup>38</sup> Sandford, Willis and Ironside (1973) 96; Kerridge (1990) *Br Tax Rev* 75; Lee (2007) *Legal Studies* 703. In view of the absence of a general gift tax at that time, a gift remained as an occasion of charge. See Ch 2 par 2.2.3.3.2 for the meaning of “stepped-up” approach and “deemed-realisation” approach.



improved transferor-based tax on gifts and donations, namely “capital transfer tax”.<sup>39</sup> In 1978, reform of the current tax system was once again on the table when the Meade Committee released a comprehensive report on the existing tax system, dealing *inter alia* with wealth taxation. The report favoured a direct consumption tax (without gifts and inheritances) together with a recipient-based progressive annual wealth accessions tax (PAWAT).<sup>40</sup> However, the recommendations were never implemented. In 1979 a Treasury inquiry was set up to examine the system of capital taxes, and, in 1986, the capital transfer tax was replaced by yet another transferor-based tax on wealth transfers, referred to as “inheritance tax”.<sup>41</sup> In 1988 the Capital Taxes Group of the Institute for Fiscal Studies produced two commentaries on capital tax reform. The second report, entitled “Death: the Unfinished Business”, recommended the reintroduction of the CGT charge at death. According to the report, the main reason for the restriction of CGT at the moment of death seemed to be the fact that the taxpayer was also responsible for the payment of inheritance tax, the heavier of the two taxes.<sup>42</sup> Nonetheless, the report’s recommendation fell on death ears. In 1994 the Gammie Report reviewed the existing system and concluded that the combination of transferor-based wealth transfer taxation and capital gains tax lacked a rational basis and could barely be described as fair.<sup>43</sup> As a consequence, the report favoured the implementation of an accessions tax and the

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<sup>39</sup> A reform of the existing structure was called for in 1972. For further reading on the political process, see Lee (2007) *Legal Studies* 683 n 34 and Chapman (1980) 2. Coombes (1977) 10 discusses the lack of public discussion and consultation with interested parties, which lead to a lot of criticism against the legislation. See also Thistle (2007) *Ga J Int & Comp L* 716–717.

<sup>40</sup> Meade Report (1978) 318, 320–330, 513, 518. As an alternative, the committee (at 330–336) suggested a linear annual wealth accessions tax (LAWAT). See Verbit (1980) *Boston Univ Law Rev* 30–35 and Jones in Jones, Harris and Oliver *eds* (2008) 221–225 for a comprehensive discussion and explanation of the Meade Committee’s proposals. See also Tiley (2008) 1261.

<sup>41</sup> Thistle (2007) *Ga J Int & Comp L* 717; Chapman (1980) 2–3. The term “inheritance tax” has been criticised as being a misnomer in view of the fact that the term has acquired a more precise meaning in tax literature – referring to a recipient-based tax (as opposed to a transferor-based estate tax). See Sandford (1986) *Br Tax Rev* 141, who suggests that the term was used to “camouflage a return to the old estate duty of 1974”. See also Lee (2007) *Legal Studies* 681; Boadway, Chamberlain and Emmerson: *Mirrlees Review* (2008) 24. See Ch 8 for further reading on the UK inheritance tax.

<sup>42</sup> Kerridge (1990) *Br Tax Rev* 77.

<sup>43</sup> Gammie Report (1994) 52.



application of the capital gains tax regime on the death of a wealth holder.<sup>44</sup> These proposals were never legislated.

In the United States, the US Law Institute proposed in the 1960s that the existing federal estate tax be replaced by a recipient-based tax.<sup>45</sup> This proposal was largely ignored.<sup>46</sup> In 1976, the federal estate and gift tax system was replaced by a unified transfer tax and a new tax on generation-skipping transfers was introduced to curb tax avoidance through the use of trusts.<sup>47</sup> This year also saw the replacement of the stepped-up base-cost approach for purposes of capital gains tax (which had been applied since the introduction of the 1913 income tax legislation) with a carry-over approach.<sup>48</sup> In 1977, a Department of the Treasury report entitled *Blueprints for Basic Tax Reform* endorsed the taxation of wealth transfers in principle. However, the report favoured a comprehensive (direct) cash-flow consumptions tax to the Carter Report's comprehensive income tax<sup>49</sup> within the United States tax system. In respect of gifts and inheritances, the report favoured their inclusion in the tax base of the recipient (once consumed), but proposed a deduction from the tax base of the transferor.<sup>50</sup> These recommendations were never implemented. In fact, although significant changes were effected to the estate tax, the gift tax and the generation-skipping transfer tax in 1981,<sup>51</sup> the basic framework of the legislation has

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<sup>44</sup> Gammie Report (1994) 52–53.

<sup>45</sup> Graetz (2002) *Yale Law J* 267 and n 30.

<sup>46</sup> Graetz (2002) *Yale Law J* 267.

<sup>47</sup> Graetz (1983) *Yale Law J* 260; Schmalbeck (2000) *Cleve State Law Rev* 751; Thistle (2007) *Ga J Int & Comp L* 712.

<sup>48</sup> Schmalbeck (2000) *Cleve State Law Rev* 753 n 27; Graetz (1983) *Yale Law J* 262 n 22 and accompanying text.

<sup>49</sup> See Ch 2 par 2.2.2.2.

<sup>50</sup> *Blueprints for Basic Tax Reform* (1977) 12, 113, 137, available at <http://www.ustreas.gov/offices/taxpolicy/library/blueprints/full.pdf> (accessed on 30 June 2008).

<sup>51</sup> The changes were introduced in terms of the Economic Recovery Tax Act of 1981 (ERTA). See Graetz (1983) *Yale Law J* 262 n 26 and n 28; Gale and Slemrod in Gale, Hines and Slemrod *eds* (2001) 15. For a detailed discussion on the introduction and impact of ERTA, see Gutman (1983) *Virginia Law Rev* 1197–1216.



essentially remained unchanged. It is significant, however, that a stepped-up base-cost approach was re-introduced for purposes of capital gains tax in 1980 because of the difficulties involved in establishing base-cost valuations and the perception of double taxation.<sup>52</sup>

In Canada the Carter Report (1966), which was inspired by the broad economic definition of income,<sup>53</sup> recommended that the existing federal estate tax and provincial recipient-based duties should be repealed in favour of a comprehensive income tax in terms of which gifts and bequests should be included as income in the hands of the recipient (and not be deductible in the hands of the transferor).<sup>54</sup> In addition, the report proposed that all capital gains and losses, of which there was no provision at that time, should be included on a realisation basis, irrespective of whether it accrued by way of sale, gift or inheritance.<sup>55</sup> Although the report was praised by numerous Canadian commentators,<sup>56</sup> the reaction of the public and business spokesmen was overwhelmingly negative.<sup>57</sup> Following a period of governmental press releases and public responses, the government finally repealed the federal estate tax in 1972. This was in essence a trade-off to gain acceptance by the public and organised interest groups for the introduction of a capital gains tax, which included the taxation of unrealised capital gains at death.<sup>58</sup> This trade-off meant that the repeal of the estate tax was not followed by an inclusion of wealth transfers in the

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<sup>52</sup> Schmalbeck (2000) *Cleve State Law Rev* 753 n 27; Graetz (1983) *Yale Law J* 262 n 22 and accompanying text.

<sup>53</sup> See Ch 2 par 2.2.2.2.

<sup>54</sup> Carter Report Vol 3 (1966) 147, 465–466.

<sup>55</sup> Carter Report Vol 3 (1966) 369–370, 477.

<sup>56</sup> Duff in Tiley *ed* (2007) 318 n 59 refers to e.g. AC Harberger and JG Head.

<sup>57</sup> Sandford (1987) *Br Tax Rev* 148 156 stated that “[t]he recommendation that legacies and gifts should be treated as income was foreign, not to say repugnant, to many Canadians”. See also Duff in Tiley *ed* (2007) 318 n 59.

<sup>58</sup> McKie (1991) *European Taxation* 244; Richardson and Moore (1995) *Can Publ Pol* 85–87; Duff in Tiley *ed* (2007) 319–329 (see 324 n 112, n 113 and n 114 for a discussion of the parliamentary debates that preceded the enactment).



income tax base, as recommended by the Carter Commission. Furthermore, the government's decision to repeal the estate tax snowballed into the gradual abolition of all the provincial succession duties and, by the end of 1985, all these duties had been repealed.<sup>59</sup>

In Australia (where a transferor-based federal wealth transfer tax was levied together with recipient-based provincial duties in much the same manner as the United States), a political campaign to abolish death taxes was launched in the 1970s.<sup>60</sup> The Asprey Committee Report, released in 1975, stated that death taxes had an essential role to play in the tax structure as a whole.<sup>61</sup> The report expressed a preference for an estate tax and recommended substantial changes to the existing system.<sup>62</sup> Apparently, the recommendations were too late to stop the gathering momentum of the repeal movement, especially among farming communities and small businesses.<sup>63</sup> In 1976, Queensland was the first state to abolish its succession duty.<sup>64</sup> The threat of the flight of capital was a concern for the five other states and this gave impetus to the repeal movement, which gained significant momentum.<sup>65</sup> During this time Australia experienced a constitutional crisis, resulting in the repeal movement being absorbed as a strategic weapon in a

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<sup>59</sup> In view of the fact that British Columbia, Ontario and Nova Scotia were the only provinces that collected succession duties at the time when the federal estate tax was repealed, the government assisted the other provinces in the drafting of a model act for the uniform levying of succession duties. At the beginning of 1972, newly adopted succession duties were levied in Manitoba, Saskatchewan, Newfoundland, New Brunswick, Prince Edward Island and Nova Scotia. However, Alberta, did not levy any duties at all. The provinces gradually started to abolish the duties, starting with Prince Edward Island in 1972. Quebec was the last province to abolish its succession duty (it did so in 1985). See Duff in Tiley *ed* (2007) 326–330.

<sup>60</sup> The campaign was spearheaded by a skilled carpenter and building contractor from Western Australia, Sydney Negus, who then ran for public office and was elected to the federal senate. A senate committee was elected to examine the subject of wealth transfer taxation. Five of the eight senators on the committee recommended that the federal estate and gift duties be repealed. See Pedrick (1981) *Tax Lawyer* 114–118.

<sup>61</sup> Asprey Report (1975) 440.

<sup>62</sup> Asprey Report (1975) 441–477. See also Green and McKay (1980) *Victoria Univ Wellington Law Rev* 235 n 39.

<sup>63</sup> Duff (2005) *Pittsburgh Tax Rev* 112.

<sup>64</sup> Pedrick (1981) *Tax Lawyer* 115.

<sup>65</sup> Pedrick (1981) *Tax Lawyer* 115.



political war, as a consequence of which the federal estate tax was repealed in 1979.<sup>66</sup> Between 1980 and 1982, the other states followed the example of Queensland and the Commonwealth by abolishing their succession duties.<sup>67</sup>

Although the Carter Commission's proposal for the inclusion of wealth transfers in the concept of income was not followed in Canada or in any other country, the reasoning that wealth transfers should primarily be taxable in the recipient's hands stimulated at least the law reform movement in Ireland, where the British transferor-based estate duty was replaced by a recipient-based tax, referred to as "capital acquisitions tax", in 1976.<sup>68</sup> At that time there was no example of a country with a common-law legal system that imposed a recipient-based tax.<sup>69</sup> Although a carry-over base-cost approach was initially applied on the death of a wealth holder when capital gains tax was introduced in 1975, a stepped-up base-cost approach was adopted in 1978 in imitation of the position in the United Kingdom.<sup>70</sup> When the Irish tax system was extensively reviewed by the O'Brien Commission in 1982, the comprehensive income tax base, as proposed in the Carter Report, was commended.<sup>71</sup> However, the report contended that the existing capital acquisitions tax provided an adequate framework for wealth transfer taxation<sup>72</sup> and the tax is still in force today.<sup>73</sup> Also, the Commission recommended that unrealised capital gains

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<sup>66</sup> See discussion of the events by Pedrick (1981) *Tax Lawyer* 116–117 and Duff (2005) *Pittsburgh Tax Rev* 112.

<sup>67</sup> See Duff (2005) *Pittsburgh Tax Rev* 111 n 269–n 270.

<sup>68</sup> O'Brien Report (1982) 424; Doyle (2008) par 1.2.4.

<sup>69</sup> Doyle (2008) par 1.2.4.

<sup>70</sup> Taxes Consolidation Act 39 of 1997 Pt 19 Ch 3 s 573.

<sup>71</sup> O'Brien Report (1982) 31, 117.

<sup>72</sup> O'Brien Report (1982) 425.

<sup>73</sup> See Ch 10 for a discussion on wealth transfer taxation in Ireland.



should not escape taxation on death and that bequests should be treated as a disposal for purposes of the tax.<sup>74</sup> However, to date this recommendation has not been acted on.

### 3.2.4 Recent International Developments: A Tendency of Decline?

Wealth transfer taxation has, broadly speaking, experienced an increased unpopularity in the last few decades. In some countries, the unpopularity has culminated in the total or partial abolition of these taxes from the tax systems, such as in Canada and Australia. Commentators were in general taken by surprise.<sup>75</sup> The abolition of wealth transfer taxes in Australia caused shock waves in the Western industrialised nations, especially in view of the fact that Australia, at that stage, did not levy any form of a tax on capital in terms of an annual wealth tax or a capital gains tax.<sup>76</sup> Although wealth transfer taxes were in the process of being abolished in Canada, a capital gains tax was in place in that country. The abolition of all capital taxes certainly did not follow any trend in the United Kingdom, the United States, or any other member country of the OECD.<sup>77</sup> In fact, while the repeal movements were blooming in Canada and Australia, the taxation of wealth transfers were endorsed and modernised in other countries. The forecast is, nonetheless, that the current absence of wealth transfer taxation is likely to persist in Canada.<sup>78</sup> Although some

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<sup>74</sup> O'Brien Report (1982) 49, 210.

<sup>75</sup> Duff (2005) *Pittsburgh Tax Rev* 114 n 291–n 293 and accompanying text refers to the Canadian economist Bird, who experienced the repeal in Canada as “strange”, the Australian economist John Head, who described the events in Australia as “totally incomprehensible” and the English economist Cedric Sanford, who noted that the disappearance “had an accidental element about it”. In Canada the general view was that the abolition was detrimental to the equity of the tax system and that a useful redistributive tool was lost. See e.g. Bucovetsky and Bird (1972) *Natl Tax J* 37; Carter (1973) *Can Tax J* 239; Bird (1978) *Osgoode Hall Law J* 144; Bird (1991) *Can Publ Pol* 325; Maloney (1991) *Can Publ Admin* 244; Mintz (1991) *Can Publ Pol* 260; Duff (2005) *Pittsburgh Tax Rev* 116–120.

<sup>76</sup> Pedrick (1981) *Tax Lawyer* 113, 117.

<sup>77</sup> At that stage, capital was taxed in all the 21 member countries, except for Australia. See Pedrick (1981) *Tax Lawyer* 119.

<sup>78</sup> Bird (1991) *Can Publ Pol* 331; Brown (1991) *Can Publ Pol* 349.



commentators have predicted its return to the Australian tax base,<sup>79</sup> this appears to be unlikely at present.

Wealth transfer taxation has not only been abolished in the Australian and the Canadian tax systems, but has also disappeared in Argentina, China, Columbia, Cyprus, the Czech Republic, Estonia, Hong Kong, India, Indonesia, Israel, Latvia, Lithuania, Malaysia, Malta, Mexico, Portugal, Russia, the Slovak Republic, Slovenia, Sweden, Switzerland, Thailand and New Zealand.<sup>80</sup> Although Italy's wealth transfer taxes were repealed in 2001, they were reinstated in 2007, but in a much weaker form.<sup>81</sup> Furthermore, these taxes have come under increased pressure in the United States and the United Kingdom over the last twenty years.

In the United States, President George W Bush signed the Economic Growth and Tax Relief Reconciliation Act in 2001, providing for a decade-long phase-out of the estate and generation-skipping taxes, but not the gift tax.<sup>82</sup> This process culminated in repeal scheduled for 1 January 2010.<sup>83</sup> Under the Act's "sunset provision" the entire Act expires on December 31, 2010. If the sunset provision is not repealed by then, the estate and generation-skipping taxes will be reinstated on 1 January 2011, in their pre-2001 form (at rates ranging from 41 percent to 60 percent).<sup>84</sup> The Act imposes a carry-over capital gains tax approach for the year 2010, instead of the present stepped-up cost of base system.<sup>85</sup> In

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<sup>79</sup> E.g. Pedrick (1981) *Tax Lawyer* 141.

<sup>80</sup> See Special Report ACCF *New International Survey* (2007), available at <http://www.accf.org/pdf/sr-death-tax-survey.pdf> (accessed on 9 August 2008). See Duff (2005) *Pittsburgh Tax Rev* 113 for a comprehensive discussion on the abolition of wealth transfer taxes in New Zealand.

<sup>81</sup> Sonneveldt and De Kroon (2008) *WFR* 595 n 22 and accompanying text.

<sup>82</sup> Dodge (2001) *Tax Law Rev* 423 n 2 explains that the gift tax would be retained in view of the opportunities of possible income shifting.

<sup>83</sup> Graetz and Shapiro (2005) 4-5; Thistle (2007) *Ga J Int & Comp L* 713.

<sup>84</sup> Graetz and Shapiro (2005) 5; Thistle (2007) *Ga J Int & Comp L* 713.

<sup>85</sup> If the stepped-up approach were left intact for 2010, inherited wealth transfers as well as unrealised capital gains at death would have escaped taxation altogether.





2004, Bush's budget again called for permanent repeal, but it was also stated that estate tax was not the top priority.<sup>86</sup> In light of the fact that the forecasted budget surpluses had since 2001 fallen into large deficits, due to, for example, the unpredictable massive stock market decline that had begun in March 2000 and the increase in government spending that followed the attacks of 11 September 2001, the prospects of permanent repeal might be unlikely.<sup>87</sup> However, the future existence of the current wealth transfer tax system is highly uncertain and a popular subject for speculation. Some commentators favour the repeal movement,<sup>88</sup> whilst others argue for the restructuring of the current system,<sup>89</sup> the introduction of an accessions tax<sup>90</sup> or the accommodation of wealth transfers within the income tax base.<sup>91</sup> Apparently, public opinion polls have shown little political support for the retention of the estate and generation-skipping taxes.<sup>92</sup>

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<sup>86</sup> Graetz and Shapiro (2005) 204.

<sup>87</sup> Graetz and Shapiro (2005) 144.

<sup>88</sup> E.g. Morgan (1981) *Tax Notes* 343; Dobris (1984) *Syracuse Law Rev* 1226–1227, 1233–1234; Galvin (1991) *Tax Notes* 1419; Donaldson (1993) *W&L Law Rev* 553; McCaffery (1999) *Tax Notes* 1443; McCaffery (1994) *Yale Law J* 364; Report of the Joint Committee on Taxation *The Economics of the Estate Tax* (1988) 35; Paper by Robbins and Robbins *The Case for Burying the Estate Tax* (1999); Schlachter (2000) *Virginia Tax Rev* 824; Youdan in Atherton *ed* (2003) 134.

<sup>89</sup> E.g. Eisenstein (1956) *Tax Law Rev* 258–259; Gutman (1983) *Virginia Law Rev* 1185, 1271; Graetz (1983) *Yale Law J* 286; Stephan (1986) *Virginia Law Rev* 1484; Ascher (1990) *Michigan Law Rev* 150; Davenport and Soled (1999) *Tax Notes* 630; Ventry (2000) *Tax Notes* 1168–1169; Repetti (2000) *Tax Notes* 1510; Schmalbeck (2000) *Cleve State Law Rev* 769; Wampler (2001) *Seton Hall Legis J* 547; Gale and Slemrod in Gale, Hines and Slemrod *eds* (2001) 57; Graetz (2002) *Yale Law J* 267–268; Klooster (2003) *Drake Law Rev* 665; Waldeck (2005) *Virginia Tax Rev* 731; Mombrum (2006) *Taxes – The Tax Magazine* 29.

<sup>90</sup> E.g. Rudnick (1945) *Tax Law Rev* 25; Andrews (1967) *Tax Law Rev* 589, 589–591; Halbach (1988) *Real Prop Prob & Tr J* 211; Dodge (2009) *Hastings Law J* 1005.

<sup>91</sup> E.g. McNulty (1976) *Tax Notes* 24; Dodge (1978) *Harv Law Rev* 1211; Kornhauser (1992) *Conn Law Rev* 1; Galvin (1993) *Vanderbilt Law Rev* 1528–1529; Darnell (2004) *Seton Hall Law Rev* 709; Dodge (2009) *Hastings Law J* 998.

<sup>92</sup> Ventry (2000) *Tax Notes* 1159–1160.



Although the United Kingdom's last conservative government promised the repeal of the inheritance tax in 1996,<sup>93</sup> the historic political victory of the Labour Party in 1997 precluded any such possibility. However, after 20 years of relative stability, the inheritance tax has recently become a subject of intense political debate.<sup>94</sup> In 2006 the Forsyth Report of the Conservative Tax Reform Commission issued a controversial proposal for the government to repeal the inheritance tax, which the government refused to endorse.<sup>95</sup> The current campaign is directed instead at increasing the basic exemption to £1 million.<sup>96</sup> The continued existence of the tax is currently under tremendous public pressure. Some commentators have favoured repeal of the inheritance tax altogether,<sup>97</sup> whereas others have proposed that the current system should instead be reformed<sup>98</sup> or be replaced by a recipient-based accessions tax<sup>99</sup> or a comprehensive income tax.<sup>100</sup> However, commentators generally agree that the inheritance tax will in all probability remain a part of the tax system for many years to come.<sup>101</sup> The recent Mirrlees Review (published in 2008) recommended that, although abolition seemed a possibility, the tax should rather be retained and reformed.<sup>102</sup> The report highlighted the benefits of a

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<sup>93</sup> See Lee (2007) *Legal Studies* 678 n 1 and Boadway, Chamberlain and Emmerson: Mirrlees Review (2008) 14 n 12 and accompanying text.

<sup>94</sup> Boadway, Chamberlain and Emmerson: Mirrlees Review (2008) 6 n 2 and accompanying text.

<sup>95</sup> Thistle (2007) *Ga J Int & Comp L* 706; Boadway, Chamberlain and Emmerson: Mirrlees Review (2008) 14.

<sup>96</sup> See e.g. Editorial "Tories Would Abolish Inheritance Tax under 1 Million Pounds" *Sky News* (27/02/2008).

<sup>97</sup> E.g. Bracewell-Milnes (2002) 15; Lee (2007) *Legal Studies* 708.

<sup>98</sup> One suggestion is to effectively restore the capital transfer tax regime by bringing lifetime gifts within the ambit of the system. See Goodhart (1988) *Br Tax Rev* 473–481.

<sup>99</sup> Riley (1991) 33.

<sup>100</sup> Goodhart (1988) *Br Tax Rev* 473–481. Lee (2007) *Legal Studies* 694 n 125 refers to the Commission on Taxation and Citizenship *Paying for Progress: A New Politics of Tax for Public Spending* (London Fabian Society 2000) and R Patrick and M Jacobs *Wealth's Fair Measure: The Reform of Inheritance Tax* (London Fabian Society 2003).

<sup>101</sup> Thistle (2007) *Ga J Int & Comp L* 720.

<sup>102</sup> Boadway, Chamberlain and Emmerson: Mirrlees Review (2008) 23.



recipient-based tax.<sup>103</sup> As a consequence, the report favoured a radical change-over to a recipient-based tax combined with some reform of relief and rates, and the reintroduction of a capital gains tax on death.<sup>104</sup> As an alternative, the imposition of a capital gains tax on death together with the abolition of the inheritance tax was proposed.<sup>105</sup>

Although there has been a remarkable decline of wealth transfer taxation in numerous countries, it would be incorrect to conclude that the tendency resembles an international trend. In numerous countries, wealth transfer taxes play a vital role in the tax system, such as in most member-countries of the European Union.<sup>106</sup> The law reforms in these countries tend to focus instead on the improvement of the current legal structures. In the Netherlands, for example, the existing inheritance and gift tax has recently been subjected to a reform process.<sup>107</sup> Although a few Dutch scholars have briefly touched on (some) of the basic arguments for and/or against wealth transfer taxation in principle,<sup>108</sup> one senses that, in the words of Sonneveld and De Kroon, the time is not ripe for the abolition of wealth transfer taxation from the Dutch fiscal system yet.<sup>109</sup> It is evident from the Dutch literature that the attention of scholars is directed instead at improvements to the current regime.<sup>110</sup> It is noteworthy, however, that the Council of States has, in reaction to the

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<sup>103</sup> Boadway, Chamberlain and Emmerson: *Mirrlees Review* (2008) 2–3.

<sup>104</sup> Boadway, Chamberlain and Emmerson: *Mirrlees Review* (2008) 78.

<sup>105</sup> Boadway, Chamberlain and Emmerson: *Mirrlees Review* (2008) 78 stated that, although it is considered that a capital gains tax is conceptually different to a wealth transfer tax, any improvements to the existing inheritance tax would probably increase its inefficiency.

<sup>106</sup> See Paper by Sonneveldt and Zwemmer *Avoidance of Multiple Inheritance Taxation in Europe* (2001) for a comparative discussion on the legal structure of wealth transfer taxation in 15 European countries. See also the national reports delivered at the conference available at <http://www.eatlp.org/index.html> (accessed on 1 March 2009).

<sup>107</sup> See Ch 9 for further reading on the development of wealth transfer taxation in the Netherlands.

<sup>108</sup> See e.g. Sonneveldt and De Kroon (2008) *WFR* 593; Van Vijfeijken (2008) *WPNR* 425 and Juch (2008) *WFR* 655.

<sup>109</sup> Sonneveldt and De Kroon (2008) *WFR* 593.

<sup>110</sup> See reference to textbooks and journal articles throughout Ch 9 below. The majority of Dutch scholars support recipient-based taxation. See Van Vijfeijken (2006) *Int Tax Rev* 152, 154; Van Vijfeijken (2004) Footnote continues on the next page



proposal for the amendment of the current legislation, remarked that more attention should be afforded to the justification of the tax.<sup>111</sup>

### 3.3 THE HISTORICAL DEVELOPMENT OF WEALTH TRANSFER TAXATION IN SOUTH AFRICA: A BRIEF OVERVIEW

The following paragraphs will focus on the development of wealth transfer taxation in the South African law. This must be seen against the background of the development of the South African income tax and the introduction of capital gains tax in 2001.

#### 3.3.1 Income Taxation

The South African income tax was largely premised on the English example, as a consequence of which inheritances and donations, being of a capital nature, were excluded from the ambit and scope of the income tax base.<sup>112</sup> This was the position for a *donatio non mera* or “donation properly so called” (a donation prompted by sheer liberality and benevolence)<sup>113</sup> as well as a *donatio mera*, or so-called “remuneratory donation”, which is a donation made in recognition of benefits received or services rendered (and therefore “akin to an exchange or discharge of a moral obligation”).<sup>114</sup>

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WPNR 322; Van Vijfeijken (2008) WPNR 425; Van Rijn (2008) WPNR 436; Van Bommel and Pagter (2008) WFR 501. However, some scholars have claimed that an estate tax may be a commendable alternative. See Oliemans and Stevens (2008) WFR 577.

<sup>111</sup> Advies W06.09.0081/III (3 April 2009) par 1, available at <https://www.raadvanstate.nl> (accessed on 5 July 2009).

<sup>112</sup> See Ch 2 par 2.2.2.1. See *SIR v Watermeyer* 1965 (4) SA 431 (A), 27 SATC 117, where the court (at 438) referred to the English cases *Stedeford v Beloe* [1932] AC 388 and *Blakiston v Cooper* [1909] AC 104.

<sup>113</sup> See Ch 7 par 7.4.2 for further reading on the common-law meaning of a donation properly so called.

<sup>114</sup> See *Avis v Verseput* 1943 AD 331 353; *CIR v Lunnon* 1924 AD 94, 1 SATC 7. In the *Lunnon* case Innes CJ held (at 97–98) that even a remuneratory donation does not possess the quality of income because it is not made in pursuance of a *legal obligation*. This viewpoint was also followed and affirmed in *Stander v CIR* 1997 (3) SA 617 (C), 59 SATC 212. In the words of Williams (1998) SALJ 770 “[t]his ... is the first manifestation of the lamentable development in South African income tax whereby judges cut our tax law adrift from the wisdom of the kindred disciplines of economics and accountancy and tried to develop

Footnote continues on the next page



Nevertheless, the legislature had included provisions to deem certain voluntary awards relating to services rendered in the definition of gross income, thereby attempting to bring remuneratory donations within the income tax base.<sup>115</sup>

### 3.3.2 Wealth Transfer Taxation

#### 3.3.2.1 Pre-Union Legislation

The first appearance of a wealth transfer tax in South Africa was the introduction of a recipient-based succession duty in the Cape of Good Hope Colony in 1864, precedent for which came from England.<sup>116</sup> Natal and the Orange Free State followed suit by introducing a similar succession duty by virtue of colonial legislation in 1905.<sup>117</sup> By contrast, the former Zuid-Afrikaanse Republiek (ZAR) introduced a transferor-based estate duty in 1899.<sup>118</sup>

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idiosyncratic ‘legal’ concepts as the basis of income tax law. These legal concepts often (as in *Lunnon*) share the nomenclature of economics but deviate in their meaning. Decades later we see the result – income tax lacks a secure foundation of concept and principle.”

<sup>115</sup> The current provisions are contained in paragraphs (c), (d) and (i) to the definition of gross income in section 1 of the Income Tax Act 58 of 1962 and s 8A-8C of the Act. These accruals are therefore currently exempt from donations tax. See Ch 5 par 5.5.3.

<sup>116</sup> The Act imposed a duty on legatees and heirs on the value of their legacies and inheritances. See Chaplin (1989) *SA Banker* 132 and West (2004) 52. The wording, however, differed so widely from that of the English legislation that the English case law was not of any use for reference purposes. See Howard (1924) vii.

<sup>117</sup> Chaplin (1989) *SA Banker* 132.

<sup>118</sup> Chaplin (1989) *SA Banker* 132.



### 3.3.2.2 National Legislation

#### 3.3.2.2.1 Death Duties (1922-1955)

The first national wealth transfer tax was enacted with the promulgation of the Death Duties Act in 1922, repealing all the provincial laws.<sup>119</sup> Due to the fact that the Cape of Good Hope Colony, Natal and the Orange Free State previously provided for succession-based duties, whereas the ZAR provided for a transferor-based estate duty, the unified 1922 Act levied both estate duty and succession duty on a parallel basis country-wide. The dual-duty approach that applied in England at that time<sup>120</sup> provided a foundation for the design of the legislation.

Estate duty, which was modelled on the provisions of the English estate duty, was chargeable upon the deceased estate of every person dying on or after the first day of July 1922.<sup>121</sup> An estate consisted of all property of the deceased which passed on his or her death, and all property that was deemed to pass on his or her death,<sup>122</sup> such as a *donatio*

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<sup>119</sup> Act 29 of 1922. See Howard (1924) for a comprehensive discussion on the provisions of this Act.

<sup>120</sup> In 1922, when the South African Death Duties Act was introduced, England levied a transferor-based estate duty in terms of the Finance Act of 1894 as well as a recipient-based legacy duty on personal estate and a recipient-based succession duty on real estate and settled property on the heirs or legatees. The recipient-based duties were abolished in 1949. See par 3.2.3.

<sup>121</sup> Death Duties Act s 1.

<sup>122</sup> Death Duties Act s 3(1).



*mortis causa*.<sup>123 124</sup> Any property passing under a *donatio inter vivos*,<sup>125</sup> exceeding £100 in value, made by the deceased after the first day of July 1922, and which took effect within a period of two years immediately prior to his or her death, was also included as property deemed to be property of the deceased.<sup>126</sup> The period was extended to five years in 1951.<sup>127</sup> In the assessment of the dutiable estate, certain deductions were allowed,<sup>128</sup> as well as a rebate.<sup>129</sup>

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<sup>123</sup> Death Duties Act s 3(4)(d). This donation is made in contemplation of the death of the donor. The motive for this donation must be pure benevolence. The mere fact that the donation will only be implemented after the death of the donor does not necessarily characterise the donation as a *donatio mortis causa*. The expectation of the donor's death must be the motivating factor. Sometimes the property is delivered, subject to it being returned in case death should not actually occur, or sometimes the gift is made without delivery, on condition that the property shall not pass to the donee until the donor's death. However, the donor always retains the right to revoke the donation unilaterally. A valid *donatio mortis causa* should comply with all the formalities required for a will, which include signature by the donor and attestation by two witnesses. In addition, the donee should accept the donation before the death of the donor. Furthermore, the donation is only valid if the donee survives the donor. See Owens in *LAWSA* (2005) pars 316–320 (and the authority cited there); Stein (2004) 49; Meyerowitz (2007) par 27.43; Davis, Beneke and Jooste (2009) par 2.4.4.1; De Waal and Schoeman-Malan (2008) 218 (and the authority cited there) and Corbett *et al* (2001) 33, 35, 36.

<sup>124</sup> Death Duties Act s 3(4)(a)–(c) furthermore provides that the following are included as deemed property in the estate: life insurance policies effected by the deceased to the extent that the deceased paid the premiums, limited interests that were held immediately prior to death and annuities to which the deceased had an interest to the extent of any advantage accruing by “survivorship” on his or her death.

<sup>125</sup> A *donatio inter vivos* is “a donation made with the intention of granting the donee the benefit of the gift during the life of the donor (unlike a donation *mortis causa* which normally contemplates the donor retaining ownership until his death) and which, subject to a few exceptions, is irrevocable”. See Owens in *LAWSA* (2005) par 304.

<sup>126</sup> Death Duties Act s 3(4)(e). Donations that were made two years prior to death were not liable to duty.

<sup>127</sup> Editorial (1997) *Taxpayer* 66.

<sup>128</sup> Death Duties Act s 4(a)(i)–(x). Provision was made for the deduction of death and funeral expenses, debts due to persons ordinarily resident in the Union, administration and liquidation costs, foreign death duties, the balance of debts due to persons ordinarily resident outside the union that cannot be discharged from foreign property, the value of any limited interest that ceased upon the death of the deceased (where such interest was created under the terms of a bona fide transaction of purchase and sale entered into before 1 July 1922), the value of any usufruct over property which formed part of the estate of the predeceased spouse, the value of dispositions to public institutions, the value of dispositions to the union and the proceeds of certain life insurance policies.

<sup>129</sup> Death Duties Act s 4(b) (which amounted to £1 000 when the Act was first introduced).



Succession duty, which was modelled on the provisions of the English legacy and succession duties, was levied on the accrual of every succession by a person.<sup>130</sup> A succession was deemed to have been accrued whenever any person became entitled to, or to any interest in, any property,<sup>131</sup> (a) by virtue of any disposition made by any predecessor, who died on or after the first day of July 1922, on his or her death, whereby property passed on the death of the predecessor, or (b) by reason of a cessation of an interest held by a predecessor, or (c) by reason of any advantage that accrued by “survivorship”, or (d) by devolution in accordance with the law on the death of such predecessor, or (e) by virtue of any disposition made by such predecessor whereby such property was deemed to have been passed on the death of the predecessor.<sup>132</sup> The dutiable amount was calculated by allowing for a sliding abatement.<sup>133</sup> The rate upon which the duty was levied was determined according to the blood relationship between the predecessor and the successor.<sup>134</sup> Any accrual in respect of a surviving spouse was exempt from duty,<sup>135</sup> as well as any succession accruing to any public institution of a charitable, educational or ecclesiastical nature<sup>136</sup> or a provincial administration.<sup>137</sup> Although the successor was liable and ultimately responsible for the duty,<sup>138</sup> it was payable and recoverable from the executor of the estate of the predecessor,<sup>139</sup> who was entitled to

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<sup>130</sup> Death Duties Act s 8.

<sup>131</sup> Which property referred to “property” and “deemed property” as provided for in chapter 1 s 3(1) of the Death Duties Act that dealt with estate duty.

<sup>132</sup> Death Duties Act s 10. A fideicommissary interest created by such disposition was expressly excluded.

<sup>133</sup> Death Duties Act s 14 (which amounted to £100 when the Act was first introduced).

<sup>134</sup> Death Duties Act s 8. See Howard (1924) 103.

<sup>135</sup> Death Duties Act s 15(a).

<sup>136</sup> Death Duties Act s 15(b).

<sup>137</sup> Death Duties Act s 15(c).

<sup>138</sup> Death Duties Act s 23(c).

<sup>139</sup> Death Duties Act s 24.





deduct the succession duty so paid from the amount of the succession paid over to the successor or to recover such duty in any other way.<sup>140</sup>

#### 3.3.2.2.2 *Donations Tax and Estate Duty (1955-)*

Donations tax, which was introduced in South Africa in 1955 by means of an amendment to the then existing income tax legislation, was aimed at inhibiting the avoidance of income tax and estate duty, and was never intended to raise revenue.<sup>141</sup> The tax was made payable on the cumulative value of donations made by a taxpayer after 23 March 1955. The grafting of donations tax onto income tax legislation was presumably a convenient way to make many of the definitions and administrative provisions applicable to the new tax.<sup>142</sup>

On 1 April 1955, the Death Duties Act was replaced by the Estate Duty Act (hereafter “the Act”).<sup>143</sup> Its structure is generally based on the part of the Death Duties Act that levied estate duty on the deceased estate. The provisions relating to succession duty were not re-enacted, although some of its characteristics were retained in the form of relief in respect of the surviving spouse and children as well as progressive tax rates. As a consequence, the Act levies a transferor-based estate tax on the decedent’s estate, not on the inheritance acquired by the heir. The introduction of the Act was therefore “a move

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<sup>140</sup> Death Duties Act s 26.

<sup>141</sup> See Hansard (Volksraad Debatte) 89 (1955) 7185; *Ogus v SIR* 1978 (3) SA 67 (T) 74 and Margo Report (1986) par 20.22.

<sup>142</sup> Currently, the following provisions of the Income Tax Act 58 of 1962 are applicable to donations tax: the secrecy provisions contained in s 4, the provisions relating to the exercise of the Commissioner’s discretion contained in s 3, the provisions relating to representative taxpayers (as adapted by s 61), the provisions relating to the refund of excess payments contained in s 102, the provisions relating to non-disclosure of relevant information and penalties (as adapted by s 61), the general anti-avoidance provision contained in s 80A–L. See Meyerowitz (2007) par 1–4.

<sup>143</sup> Act 45 of 1955.

away from the succession duty dispensation introduced by the Death Duties Act 29 of 1922”.<sup>144</sup>

This approach was motivated by administrative reasons. When the bill was read in parliament, the Minister of Finance said that:

“[d]ie belangrikste aspek van hierdie boedelwetsontwerp is die afskaffing van suksessieregte ... Dit is omrede die baie moeilike en ingewikkelde probleme wat gepaard gaan met die aanslaan, en die invordering van suksessieregte. Daar is ’n ernstige tekort aan personeel in die Meesterskantoor, waardeur ernstige vertraging plaasgevind het met die afhandeling van boedels, wat groot ongerief veroorsaak het, nie alleen vir die eksekuteurs nie, maar ook vir die erfgename.”<sup>145</sup>

Without supplying any substantive reasons, the Minister remarked that he would personally have favoured the retention of the succession duty, rather than the estate duty. Apparently, numerous difficulties were experienced in the area of limited interests and bare *dominium* property.<sup>146</sup> Although objections were raised in respect of the implementation of the proposed legislation,<sup>147</sup> the bill was passed (effective for persons dying on or after 1 April 1955).<sup>148</sup>

The move towards transferor-based taxation was arguably motivated by the abolition of the legacy and succession duties in the United Kingdom in 1949, leaving transferor-based estate duty as the sole death duty in that country.<sup>149</sup>

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<sup>144</sup> Van der Linde and Franzsen (2001) *TSAR* 827.

<sup>145</sup> Hansard (Volksraad Debatte) 89 (1955) 7236.

<sup>146</sup> This was informally mentioned by Gert van der Berg, an attorney specialising in deceased estates and estate planning, in a symposium on estate duty arranged by National Treasury on 18 November 2009.

<sup>147</sup> The arguments raised were that the tax erodes capital, provides a low revenue yield and has a destructive effect on small businesses and farmers. See Hansard (Volksraad Debatte) 89 (1955) 7239–7249, 7253.

<sup>148</sup> Estate Duty Act s 32.

<sup>149</sup> See par 3.2.3.



Both estate duty and donations tax were initially charged at progressive rates.<sup>150</sup> When estate duty was first introduced, donations made by the deceased after 23 March 1955 were included in the dutiable estate, providing for a set-off against estate duty of any donations tax that was payable by the deceased during his or her lifetime.<sup>151</sup>

When the income tax legislation was consolidated in 1962, the provisions dealing with the levying of donations tax were consolidated in sections 54–64, part V of chapter 2 of the Income Tax Act 58 of 1962, which is still in force today. Except for minor changes, the material provisions of the Estate Duty Act and Part V of the Income Tax Act have been kept intact over the years, notwithstanding the fact that they have been subjected to the examination of three official tax law reform commissions.

### ***3.3.2.3 The Tax Law Reform Commissions***

In its second report released in 1970, the Franzsen Commission recommended that estate duty should not be abolished, in view of the fact that it contributed to the overall fairness and balance of the South African tax system.<sup>152</sup> Although it was stated that a recipient-based inheritance tax would be “a more equitable system in so far as the assessment could be made in accordance with the individual’s ability to pay”, the commission favoured a transferor-based estate tax for pure practical and administrative reasons and consequently endorsed the existing structure of estate duty as levied in terms of the Estate Duty Act.<sup>153</sup> The Commission proposed minor amendments, mostly in respect of the rate structure and rebates.<sup>154</sup>

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<sup>150</sup> The highest rate being 25% on the amount exceeding £45 000. See Editorial (1997) *Taxpayer* 66.

<sup>151</sup> Editorial (1997) *Taxpayer* 66.

<sup>152</sup> Second Franzsen Report (1970) par 364.

<sup>153</sup> Second Franzsen Report (1970) 371.

<sup>154</sup> Second Franzsen Report (1970) pars 372–376, 384–396.



As pointed out in Chapter 1, the Margo Commission recommended the implementation of a “capital transfer tax”, a combined death and gift tax which is imposed on dispositions of property for no or for inadequate consideration, a recommendation that was in principle supported by the government.<sup>155</sup> The name of the tax was probably derived from the corresponding United Kingdom legislation which was in force at that time. Although the commission noted that a recipient-based tax would better support the principle of ability-to-pay,<sup>156</sup> it nevertheless recommended a transferor-based tax for practical and administrative reasons.<sup>157</sup> In order to provide for interim relief in anticipation of the new legislation, the Commission provided some recommendations in respect of rebates, the rate schedule, spousal relief, tax-avoidance, instalment-payments and valuation.<sup>158</sup> Most of these recommendations were accepted and introduced by the Taxation Laws Amendment Act of 1988, which provided for amendments to the Estate Duty Act (in respect of estate duty) and the Income Tax Act (in respect of donations tax).<sup>159</sup> The progressive rate structure was replaced by a flat rate. Another significant amendment was the exclusion of donations (except for donations *mortis causa*) from the estate duty tax base.<sup>160</sup> Donations tax, which was previously charged on the cumulative value of non-exempt donations, was amended to be charged on each individual non-exempt donation (made after 16 March 1988).<sup>161</sup>

Critics commented that “this ‘interim relief’ [brought] the existing legislation so close to what the Commission recommended should be contained in a capital transfer tax that one

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<sup>155</sup> See Ch 1 par 1.1.

<sup>156</sup> Margo Report (1986) pars 20.44–20.45.

<sup>157</sup> Margo Report (1986) pars 20.44 and 20.50.

<sup>158</sup> See Margo Report (1986) par 20.68 for a summary of the recommendations. See also Eskinazi (1988) *Ins & Tax* 26 *et seq.*

<sup>159</sup> See RDJ (1987) *Income Tax Reporter* 260–265 and Editorial (1988) *Taxpayer* 120(d) for a summary of the amendments affected in consequence of the recommendations.

<sup>160</sup> Editorial (1997) *Taxpayer* 66.

<sup>161</sup> King and Victor (2008/2009) par 12.2.



wonders whether there is any need for entirely new legislation, other than a desire to change names”.<sup>162</sup> This forecast proved to be true. The proposal for the new integrated Act never culminated in legislation.

Nearly a decade later, the Katz Commission supported the Margo Commission’s proposal for a capital transfer tax,<sup>163</sup> also favouring a transferor-based tax.<sup>164</sup> Although the commission conceded that a recipient-based tax would better adhere to the principle of ability-to-pay, it was maintained that an estate tax would be easier to administer than a recipient-based tax, which involved a greater number of taxpayers. In addition, it was noted that an estate-type tax has for many years been in place in South Africa. As a consequence, the principles are well-documented and have been the subject of numerous court decisions. The Commission furthermore stated that the administrative systems in place in the Master’s Office and revenue collectors had the competence to administer such a tax.<sup>165</sup> The Commission addressed aspects such as rates, rebates, the problem of interest-free loans and preference shares, generation-skipping trusts, anti-avoidance measures, spousal relief, charitable dispositions and the possible expansion to a residence-basis of charge.<sup>166</sup> Regrettably, the recommendations were ignored to a large extent. To date, the proposal for the combined estate and donations tax has not been taken any further by the government.

### 3.3.3 Comprehensive Income Tax and Comprehensive Consumption Tax

As pointed out earlier, the Margo Commission did not consider the introduction of a comprehensive income tax or a direct consumption tax (both of which could conceptually

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<sup>162</sup> Editorial (1988) *Taxpayer* 120(d).

<sup>163</sup> See Ch 1 par 1.1.

<sup>164</sup> Fourth Interim Katz Report (1997) par 5.8.

<sup>165</sup> Third Interim Katz Report (1995) par 7.3.3.

<sup>166</sup> See Fourth Interim Katz Report (1997) Ch 14 for a summary of the main recommendations.



include the taxation of wealth transfers) to be appropriate for the South African tax system. The Katz Commission did not even consider the possibilities.<sup>167</sup>

### 3.3.4 Capital Gains Taxation

As pointed out earlier, capital gains tax was introduced into the South African tax system in 2001 despite the fact that the Margo Commission and the Katz Commission rejected the proposal for the introduction of such a tax.<sup>168</sup> For the purposes of the capital gains tax regime, a donation of an asset constitutes a disposal.<sup>169</sup> Also, a deceased person is deemed to dispose of all his or her assets (except for those transferred to a spouse and for assets consisting of domestic life insurance policies or retirement savings) to the deceased estate for an amount received or accrued to equal to the market value of the assets on the date of death.<sup>170</sup> A deemed-realisation approach is therefore applied on the death of a wealth holder.

Unlike the Canadian experience, the introduction of a deemed realisation-approach on death did not uproot the estate duty and donations tax regimes. However, in view of the fact that the imposition of both capital gains tax and estate duty may have had a negative impact on the liquidity of an estate, the estate duty rate was reduced with effect from 1 October 2001, the date on which capital gains tax became operative.<sup>171</sup>

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<sup>167</sup> See Ch 2 par 2.2.2.2 and Ch 2 par 2.2.4.2.

<sup>168</sup> See Ch 1 par 1.1 and Ch 2 par 2.2.3.3.2.

<sup>169</sup> See Ch 5 par 5.8.

<sup>170</sup> See Ch 6 par 6.8.

<sup>171</sup> See Ch 5 par 5.1.



### 3.4 CONCLUSIONS

- (a) Wealth transfer taxes have been imposed in fiscal jurisdictions since the earliest civilisations. An interesting phenomenon that occurred over the centuries is that civil-code countries have traditionally developed and imposed recipient-based taxation on wealth transfers, whereas Anglo-American common-law countries have indicated a preference for transferor-based taxation. Although the earliest taxes were imposed on inheritances only, gift taxes were introduced in the course of time.<sup>172</sup>
- (b) Although inheritances and gifts are conceptually included in the economic concept of income, the rise of the modern income tax did not disturb the well-rooted wealth transfer taxes in view of the fact that the popular English source-based concept of income excluded fortuitous gains. In addition, these gains had been statutorily removed from the American accretion concept of income since 1913. Nonetheless, the academically acclaimed Carter Report, published in 1966, urged the introduction of a comprehensive income tax for the Canadian tax system, the adoption of which would have rendered wealth transfers taxable in terms of ordinary broad-based income taxation. Although the Carter Report's recommendations were not adopted in Canada or any other country, they at least stimulated an academic debate on the possible accommodation of wealth transfers in an income tax base. Also, the report influenced the wealth transfer tax reform in countries such as Ireland, which constitutes the first (and only) common-law jurisdiction that successfully replaced its transferor-based estate duty with a recipient-based acquisitions tax.<sup>173</sup>

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<sup>172</sup> See pars 3.2.1, 3.2.2 and 3.2.4.

<sup>173</sup> See par 3.2.3.



- (c) When thoughts on the possible implementation of a direct consumption tax surfaced in the international arena in the 1970s, an alternative structure for the taxation of wealth transfers was once again on the table. The *Blueprints for Basic Tax Reform* Report, published in the United States in 1977, and the Meade Report, published in the United Kingdom in 1978, recommended that inheritances and gifts be taxed under a direct consumption tax. These proposals never culminated in law reform. Although the idea of a direct consumption has received much academic support over the years, it has not (as far as could be ascertained) been implemented in any country in the world.<sup>174</sup>
- (d) In view of the fact that income taxation and consumption taxation have not developed to successfully account for the taxation of inheritances and gifts, wealth transfer taxes are still commonly encountered in modern tax systems. However, these taxes have experienced a decline in some leading international jurisdictions over the past four decades. They have been abolished in Canada, Australia, New Zealand and a number of other countries. Furthermore, the United States estate tax is currently being phased out over a decade-long period with a reinstatement scheduled for 2011. The United Kingdom inheritance tax is also under tremendous public pressure.<sup>175</sup> Seligman's prediction (in 1969) that "[w]ith all the variations in detail, it is clear that the democratic trend is in one general direction; and it is more than probable that progressive inheritance taxes will play by no means an insignificant role in the fiscal systems of the future"<sup>176</sup> turned out to be partly incorrect.

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<sup>174</sup> See par 3.2.3.

<sup>175</sup> See pars 3.2.3 and 3.2.4.

<sup>176</sup> Seligman (1969) 141.





- (e) The abolition of wealth transfer taxes from significant tax systems and the current pressure experienced in the United States and United Kingdom in particular have stimulated a debate on the conceptual justification of these taxes in modern tax systems. It is of special significance that the decline of wealth transfer taxes in OECD countries has in fact been much greater among countries with transferor-based taxation than in countries which levy recipient-based taxes.<sup>177</sup>
- (f) It is noteworthy that numerous official tax reform commissions have recommended a transition to recipient-based taxation for common-law countries that levy transferor-based wealth transfer taxes.<sup>178</sup> However, these recommendations fell on death ears.
- (g) It is evident that the interaction between wealth transfer taxation and capital gains taxation has played a significant role in the development of wealth transfer taxes. The United States and the United Kingdom introduced a stepped-up approach for purposes of capital gains tax (on the death of a wealth holder) because of the fact that a combination of transferor-based taxation and capital gains taxation produces double taxation in the hands of the transferor. The experience in Canada, where wealth transfer taxation was actually replaced by the introduction of capital gains tax (and more specifically a deemed-realisation approach) contributes to the realisation that the interaction between these two forms

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<sup>177</sup> Duff (2005) *Pittsburgh Tax Rev* 120; Duff in Tiley *ed* (2007) 334.

<sup>178</sup> E.g. in the US the Special Committee of the US Law Institute (1960) and in the UK the Colwyn Committee (1927), the Meade Report (1978), the Gammie Report (1994) and the Mirrlees Review (2008). See pars 3.2.3 and 3.2.4.



of taxation is significant in a tax system.<sup>179</sup> This aspect will be explored more fully in the next chapter.<sup>180</sup>

- (h) Since the initial inception of provincial succession duties *circa* 1864 in South Africa, wealth transfer taxation has remained a part of the South African tax system. The adoption of the English source-based concept of income, which excludes inheritances and donations from a taxpayer's gross income because of their capital nature, precluded the taxation of wealth transfers under ordinary income taxation in South Africa. This was the position not only for inheritances and donations properly so called, but also for remuneratory donations. The income tax legislation has since been adapted to include most remuneratory donations in the gross income of the recipient (allowing a corresponding exemption from wealth transfer taxation).<sup>181</sup> A comprehensive income tax and a comprehensive (direct) consumption tax have never been officially considered for the South African tax system.<sup>182</sup>
- (i) It is clear that, with the introduction of estate duty and donations tax in 1955, South Africa moved away from recipient-based taxation. Although all three of the official tax reform commissions supported the transferor-based approach, it would seem that the merits of recipient-based taxation were not properly considered. What is also noteworthy is that the commissions were not confronted with the double taxation produced by transferor-based wealth transfer taxation and capital gains taxation, because capital gains tax was introduced into the South African tax system

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<sup>179</sup> See par 3.2.3.

<sup>180</sup> See Ch 4 par 4.4.1.2.

<sup>181</sup> See par 3.3.1.

<sup>182</sup> See par 3.3.3.



only in 2001. Both the Margo Report and the Katz Report rejected the idea of a capital gains tax for the South African tax system.<sup>183</sup>

- (j) Since the introduction of capital gains tax in 2001, South Africa has applied a deemed-realisation approach for the purposes of the unrealised gains on a wealth holder's death. With reference to the Canadian experience, the question may be posed whether the simultaneous imposition of capital gains taxation and wealth transfer taxation on a transferor is justifiable in a tax system. This issue is bolstered if one considers the disappearance or imminent disappearance of these taxes in some countries.

The conceptual justification for wealth transfer taxation in the context of the South African tax system will be considered in the next chapter.

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<sup>183</sup> See pars 3.3.2 and 3.3.4.