



## CHAPTER 10

### WEALTH TRANSFER TAXATION IN IRELAND

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## 10.1 HISTORICAL ORIENTATION AND INTRODUCTION

### 10.1.1 Historical Development

The British estate duty, which was adopted in Ireland upon its foundation as a state in 1922, was replaced by a recipient-based capital acquisition tax (hereafter “CAT”) in 1975. When CAT was enacted, Ireland became the first common-law legal system to



impose a recipient-based wealth transfer tax.<sup>1</sup> As already pointed out earlier, when the O'Brien Committee reviewed the direct tax system of Ireland in 1982, the existing framework for CAT was endorsed.<sup>2</sup>

The provisions of the Capital Acquisitions Tax Act of 1976 and the amending provisions of the subsequent annual Finance Acts were consolidated with the enactment of the Capital Acquisitions Consolidation Act of 2003 (hereafter “CATCA” or “the Act”),<sup>3</sup> which is (as amended by the annual Finance Acts) currently still in force. A short-lived probate tax, which levied a duty of 2 percent on a deceased estate and which was introduced in 1993, was abolished in respect of deaths occurring on or after 6 December 2000.<sup>4</sup>

### 10.1.2 Broad Overview of CAT

CAT comprises three taxes, namely an inheritance tax, a gift tax and a discretionary trust tax. The two principal taxes, namely inheritance tax and gift tax, are imposed on the taxable value of all taxable gifts and taxable inheritances acquired by individuals. In general, the taxable value is determined by deducting from the “incumbrance-free value”<sup>5</sup> costs and expenses allowable by the Act and any *bona fide* consideration (in money or money’s worth) paid for the benefit by the beneficiary.

The Act provides for a broad spectrum of relief and exemptions, some of which depend on the relationship between the transferor and the beneficiary. To calculate the amount of CAT due on a taxable acquisition (an inheritance or a gift), one also needs to take the

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<sup>1</sup> See Ch 3 par 3.2.3. See also Bohan and McCarthy (2008) par 1.05.

<sup>2</sup> See Ch 3 par 3.2.3.

<sup>3</sup> Act 1 of 2003.

<sup>4</sup> Doyle (2008) par 1.2.4.

<sup>5</sup> The “incumbrance-free value” of property is the market value of property less relevant liabilities.

relevant group threshold into account. Each beneficiary is entitled to three exempt lifetime thresholds, depending on the relationship between the disponent<sup>6</sup> and the beneficiary.<sup>7</sup> All lifetime gifts and inheritances taken by a beneficiary, which fall within the same group threshold, are aggregated for the purposes of ascertaining whether or not a tax-free threshold has been exceeded. The thresholds are indexed every year on 1 January by an indexation factor calculated by reference to the Consumer Price Index.<sup>8</sup> Inheritance tax and gift tax are then charged at a current flat rate of 25 percent<sup>9</sup> on the amount of the taxable gift or taxable inheritance that exceeds the relevant tax-free group threshold. Other Irish taxes, which arise in respect of the same property on the same event, such as capital gains tax or stamp duty, as well as foreign inheritance taxes, may in certain instances be allowed as a credit against any CAT payable.<sup>10</sup>

The three group (lifetime) thresholds are:

- (a) Group A (currently determined at €434 000), which applies:
- in respect of a gift or an inheritance, where the beneficiary is the child of the disponent;
  - in respect of a gift or an inheritance, where the beneficiary is a nephew or niece of the disponent and has worked substantially on a full-time basis for a period of five years, in general, in the business or profession of the disponent and the gift or inheritance consists of property which was used in connection with such business or profession;<sup>11</sup>

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<sup>6</sup> A “disponent” is a term used in Irish law to describe the transferor.

<sup>7</sup> Where a beneficiary is, at the date of the gift or inheritance, the surviving spouse of a deceased person who was, at the time of his or her death, of nearer relationship to the disponent than the beneficiary, then the beneficiary is deemed to bear the same relationship to the disponent that his or her deceased spouse had. See sch 2 prt 1 par 6. See in general Bohan and McCarthy (2008) par 8.13 and Doyle (2008) 837 example 34.6.

<sup>8</sup> Bohan and McCarthy (2008) par 12.36.

<sup>9</sup> The rate has been increased from 22% with effect from 8 April 2009.

<sup>10</sup> Ss 104–107. See in general Bohan and McCarthy (2008) par 5.26.

<sup>11</sup> Sch 2 prt 1 par 7 (the nephew or niece will be regarded as a child of the disponent). See in general Bohan and McCarthy (2008) pars 8.02–8.12 and Doyle (2008) 837 example 34.5.



- in respect of a gift or an inheritance, where the beneficiary is a minor child<sup>12</sup> of a predeceased child of the disponent;<sup>13</sup>
  - in respect of an inheritance, where the successor is the parent of the disponent and the interest taken does not constitute a limited interest;<sup>14</sup>
  - in respect of a gift or an inheritance, where the beneficiary is a foster-child of the disponent, subject to certain conditions;<sup>15</sup>
- (b) Group B (currently determined at €43 400), which applies:
- In respect of a gift or an inheritance, where the beneficiary is a lineal ancestor, lineal descendant (other than a child), brother, sister or brother's or sister's child of the disponent; and
- (c) Group C (currently determined at €21 700), which applies to all other cases.<sup>16</sup>

In view of the different exemptions applicable to the various group thresholds, a disponent may arrange for a gift to reach a person through the use of two or more connected gifts, by taking advantage of the other higher group thresholds.<sup>17</sup> This avoidance technique (the so-called “gift-splitting”) is countered by the Act, which provides that where a donee takes a gift under a disposition made by a disponent (the “original disponent”) and, within the period commencing three years before and ending three years after the date of that gift, the donee makes a disposition under which a second donee takes a gift and whether or not the second donee makes a disposition within the same period under which a third

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<sup>12</sup> In terms of the Age of Majority Act 1985, a minor child is a child who is under 18 years of age. See Bohan and McCarthy (2008) par 8.14.

<sup>13</sup> Sch 2 prt par 1. See in general Bohan and McCarthy (2008) par 8.14.

<sup>14</sup> Sch 2 prt 1 par 1(a)(ii). See in general Bohan and McCarthy (2008) par 8.16.

<sup>15</sup> Sch 2 prt 1 par 9. See in general Bohan and McCarthy (2008) par 8.17.

<sup>16</sup> Sch 2. See Bohan and McCarthy (2008) Ch 12 and Doyle (2008) 836–837 for a comprehensive discussion on the computation of CAT.

<sup>17</sup> For example, if a father (A) intends to donate an amount of €200 000 to his daughter-in-law (C), the gift would be subject to the exemption applicable to Group C (for strangers). However, if A donates the amount to his son (B), whereafter B donates the sum to his wife (the daughter-in-law of A), then the gift between the father (A) and his son (B) would be subject to the Group A threshold, and the subsequent gift between the son (B) and his wife (C), would be exempt from CAT. See Bohan and McCarthy (2008) par 20.1.

donee takes a gift, and so on, each donee is deemed to have taken a gift from the original donor.<sup>18</sup> However, this provision will not apply if the first gift was not made with a view to enabling or facilitating the second gift.<sup>19</sup>

Because a beneficiary is not deemed to become beneficially entitled to assets held in trust by the trustees of a discretionary trust until a disposal is made from the trust, a discretionary trust tax, which was introduced in 1984, is imposed on certain discretionary trusts. Discretionary trust tax, which will be discussed more fully in paragraph 10.6 below, comprises an initial charge on the transfer of property to a discretionary trust, as well as an annual levy until all the property has been appointed to the beneficiaries. The DTT regime was therefore introduced to discourage persons from transferring assets to a discretionary trust to postpone CAT.<sup>20</sup>

## 10.2 TAX BASE

### 10.2.1 Taxable Transfers

A beneficiary (the “successor”<sup>21</sup> or “donee”<sup>22</sup>) is deemed to take an inheritance or a gift where, under or in consequence of any disposition, he or she becomes beneficially entitled in possession to any benefit, otherwise than for full consideration in money or money’s worth.<sup>23 24</sup> An inheritance is taken “on a death”, namely where benefits are taken

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<sup>18</sup> S 8(1). See Bohan and McCarthy (2008) pars 20.01–20.02 for some examples.

<sup>19</sup> S 8(2); Bohan and McCarthy (2008) par 20.03.

<sup>20</sup> Bohan and McCarthy (2008) par 10.03.

<sup>21</sup> The person taking the inheritance is referred to as the successor (s 2(1) “successor”).

<sup>22</sup> The person taking the gift is referred to as the donee (s 2(1) “donee”).

<sup>23</sup> See in general Bohan and McCarthy (2008) pars 4.07–4.11 for a discussion on the meaning of “full consideration in money or money’s worth”.

<sup>24</sup> Ss 5 (gift) and 10 (inheritance).

under dispositions ascertainable by reference to the death of a person, for example a benefit taken under a testamentary disposition or a *donatio mortis causa*.<sup>25</sup> The term does not involve only the death of the donor. For example, where A donates property to B, subject to the proviso that the property should devolve upon C on the death of B (a *fideicommissum*), then C takes an inheritance from A on the death of B. This is the case even where A may still be living when C becomes entitled to the property on the death of B.<sup>26</sup> A gift, on the other hand, is taken “otherwise than on a death”,<sup>27</sup> except where the gift was made within two years prior to the death of the donor, in which case the benefit taken would be regarded as an inheritance.<sup>28</sup> Although it was quite relevant to distinguish between an inheritance and a gift prior to December 1999, when gifts were taxed at 75 percent of the primary tax rate, the distinction has become less significant. However, it is still relevant for the purposes of the application of certain exemptions, the jurisdictional basis and the determination of the date of liability and date of valuation, as will appear more fully from the discussion below.

A beneficiary becomes beneficially “entitled in possession” to property only on acquiring a present right to the enjoyment of the property, as opposed to acquiring a future right in respect thereof.<sup>29</sup> If A, for example, bequeaths his property to his son C, subject to a life interest in favour of his spouse B, then B will take an inheritance from A on his death (valued as a limited interest),<sup>30</sup> whereas C will take an inheritance (of the full value of the property) from A only on the death of the life tenant B. C’s interest is referred to as a “reversionary interest”.

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<sup>25</sup> S 10. See ss 3(1)(a)–(d) and 3(2)(a)–(d) for the meaning of the term “on a death”. See in general Bohan and McCarthy (2008) pars 2.71–2.73 for a comprehensive discussion.

<sup>26</sup> Doyle (2008) 833 example 34.1.

<sup>27</sup> S 5.

<sup>28</sup> S 3(1)(c). Accordingly, where an individual dies within two years of making a gift, the property transferred constitutes an inheritance. See Bohan and McCarthy (2008) par 2.72 for a general discussion.

<sup>29</sup> S 2(1) “entitled in possession”. See in general Bohan and McCarthy (2008) par 4.01.

<sup>30</sup> See par 10.3.5.



The term “disposition” includes a long list of specific matters listed from paragraph (a) to (n).<sup>31</sup> Paragraph (a) includes any act or omission by a person as a result of which the value of that person’s estate immediately after the act or omission is less than would be but for the act or omission. Although this paragraph requires only a loss to the disponent,<sup>32</sup> it should be noted that it is the value of the increase in the recipient’s estate that is subject to CAT. A disposition in terms of this paragraph therefore presupposes the impoverishment of the disponent as well as the enrichment of the recipient. It is, however, not necessary that the decrease in the disponent’s estate be equal to the increase in the recipient’s estate.<sup>33</sup> For the purposes of this paragraph, an example of an “omission” would be the failure to defend an action.<sup>34</sup> Although the failure to take up a valuable right would not be included in this paragraph (because it does not diminish an estate, but merely prevents an increase), paragraph (h) specifically deems the failure to exercise a right, as well as the release, forfeiture, surrender or abandonment of any debt or benefit, to be a disposition (without requiring impoverishment).<sup>35</sup> A typical example of a failure taxable within the ambit of this paragraph is the failure to demand payment of an outstanding debt or the failure to exercise an option.<sup>36</sup> According to Bohan and McCarthy, the failure to sue for damages could apparently also be covered by this paragraph.<sup>37</sup> In addition, the following events are included as dispositions for the purposes of the Act, namely:

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<sup>31</sup> S 2(1) “disposition”.

<sup>32</sup> Bohan and McCarthy (2008) par 2.32.

<sup>33</sup> Bohan and McCarthy (2008) par 2.32.

<sup>34</sup> Bohan and McCarthy (2008) par 2.32.

<sup>35</sup> Apparently, the failure to exercise a right would be a disposition even if it arises inadvertently. An example of this would be the failure to take up a rights issue in a company (which would confer a benefit on the other shareholders). See Bohan and McCarthy (2008) par 2.44.

<sup>36</sup> Bohan and McCarthy (2008) par 2.44.

<sup>37</sup> Bohan and McCarthy (2008) par 2.44.



- any trust, covenant,<sup>38</sup> agreement<sup>39</sup> or arrangement,<sup>40</sup> whether made by a single operation<sup>41</sup> or by associated operations<sup>42</sup> (paragraph b);<sup>43</sup>
- the creation of a debt or other right enforceable against the disponent personally or against any estate or interest that the disponent may have in property (paragraph c);<sup>44</sup>
- the payment of money (paragraph d);<sup>45</sup>
- the allotment of shares in a company (paragraph e);<sup>46</sup>
- the grant or creation of any benefit (paragraph f);<sup>47</sup>

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<sup>38</sup> A covenant is an undertaking to transfer money or money's worth in terms of a deed of covenant. See Bohan and McCarthy (2008) par 2.33.

<sup>39</sup> An agreement is simply the coming together of two or more minds. See Bohan and McCarthy (2008) par 2.34.

<sup>40</sup> An arrangement is apparently something less than an agreement and can be the result of one person's unilateral actions. It is a form of an unenforceable right, which is unenforceable due to a technical or legal deficiency, e.g. a lack of compliance to formalities. See Bohan and McCarthy (2008) par 2.34.

<sup>41</sup> An operation includes virtually any act that an individual can carry out. However, it does not include (a) an omission, (b) a death, (c) a birth, (d) the vesting of an interest and (e) the happening of a contingency, unless the contingency is dependent on a positive action by the beneficiary, e.g. a marriage. See Bohan and McCarthy (2008) par 2.35.

<sup>42</sup> The reference to "associated operations" was adopted from the UK wealth transfer tax legislation to act as a mechanism to counter tax avoidance schemes. See Ch 8 par 8.2.1 and Bohan and McCarthy (2008) 2.36–2.38 for further discussion on the position in the UK law. Unlike the position in the UK, the term is not defined in the Act.

<sup>43</sup> See in general Bohan and McCarthy (2008) pars 2.33–2.38.

<sup>44</sup> This includes any agreement to pay a sum of money. See in general Bohan and McCarthy (2008) par 2.39.

<sup>45</sup> See in general Bohan and McCarthy (2008) par 2.40.

<sup>46</sup> The existing shareholders would be the disponents and the new shareholders would be the donees or successors. The formal issue of the shares (subsequent to the allotment thereof) would not qualify as a disposition. See in general Bohan and McCarthy (2008) par 2.41.

<sup>47</sup> This description is very wide and would cover almost all other matters in relation to property which have not been covered by the definition of a disposition. See in general Bohan and McCarthy (2008) par 2.42.



- the grant or the creation of any lease, mortgage, charge, licence, option, power, partnership or joint tenancy or other estate or interest in or over any property (paragraph g);<sup>48</sup>
- the exercise of a “general power of appointment”<sup>49</sup> in favour of any person other than the holder of the power (paragraph i);<sup>50</sup>
- a *donatio mortis causa* (paragraph j);<sup>51</sup>
- a will or other testamentary disposition (paragraph k);<sup>52</sup>
- an intestacy, whether total or partial (paragraph i);<sup>53</sup>
- the payment of a share as a legal right under pt IX of the Succession Act 1965 (paragraph m);<sup>54</sup> and
- a resolution passed by a company (paragraph n).<sup>55</sup>

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<sup>48</sup> See in general Bohan and McCarthy (2008) par 2.43.

<sup>49</sup> A “general power of appointment includes every power, right, or authority whether exercisable only by will or otherwise which would enable the holder of such power, right, or authority to appoint or dispose of property to whoever the holder thinks fit or to obtain such power, right or authority, but exclusive of any power exercisable solely in a fiduciary capacity under a disposition made by the holder, or exercisable by a tenant for life under the Settled Land Act 1882, or as mortgagee” (s 2(1) “general power of appointment”).

<sup>50</sup> See in general Bohan and McCarthy (2008) pars 4.46–4.52.

<sup>51</sup> A *donatio mortis causa* is a gift made in contemplation of death. The gift is reversible and cannot be taken until death. It is therefore an inheritance under the Act (not a gift). The following conditions must be satisfied: (a) the gift must be made in expectation of death, (b) the property must comprise personal movable property (it must be capable of passing by delivery), (c) there must be a delivery (either actual or constructive) of the property to the donee and possession must be transferred at the time of the gift. If the property is too difficult to deliver, a symbol of dominion may be an effective delivery (for example a key to a box), (d) the gift must be conditional on the disponent’s death and must be returned if the disponent recovers. See in general Bohan and McCarthy (2008) par 2.50.

<sup>52</sup> See in general Bohan and McCarthy (2008) par 2.51.

<sup>53</sup> See in general Bohan and McCarthy (2008) par 2.52.

<sup>54</sup> See in general Bohan and McCarthy (2008) par 2.53.

<sup>55</sup> Bohan and McCarthy (2008) par 2.54 point out that this is an anti-avoidance provision. If a resolution is passed by a company whereby the value of one shareholder’s shares is increased at the expense of another shareholder, the resolution will qualify as a disposition if the last-mentioned shareholder could have prevented it by voting against it or exercising any right to block the resolution.



It is specifically provided that a disclaimer (a repudiation) of a benefit under a will or intestacy is not a disposition for the purposes of the Act.<sup>56</sup> The exclusion does, however, not extend to a post-death redistribution agreement and there could therefore be a charge to CAT.<sup>57</sup>

In the case of a disposition by virtue of a gift, the intention to donate need not be present.<sup>58</sup> A bad bargain in a commercial context could therefore be subject to CAT. Bohan and McCarthy mention that it is unfortunate that CATCA does not contain a provision exempting transactions entered into at arm's length from the scope of the tax, such as is provided for under the United Kingdom inheritance tax legislation.<sup>59</sup>

Where a person is allowed to have the use, occupation or enjoyment of any property (to which that person is not beneficially entitled in possession) otherwise than for full consideration in money or money's worth, then that person is deemed to take an annual gift or inheritance of such free use in the property.<sup>60</sup> The annual value that will be subject to CAT is "the best price obtainable in the open market for such [annual] use, occupation or enjoyment".<sup>61</sup> This provision would apply to, for example, interest-free loans and the use of a dwelling free of rent (or at a rent less than the market value).<sup>62</sup>

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<sup>56</sup> S 12(2). See Hourican (2002) *Conv Prop Law J 17 et seq*; Bohan and McCarthy (2008) pars 4.19–4.34 and Gallagher (2007) *Irish Tax Rev 78 et seq* for a discussion of the various disclaimers and their legal and tax effects.

<sup>57</sup> See O'Hanlon (2004) *Irish Tax Rev 311 et seq*.

<sup>58</sup> Bohan and McCarthy (2008) pars 4.01 and 4.10.

<sup>59</sup> Bohan and McCarthy (2008) par 4.10. See Ch 8 par 8.2.1 for a reference to the exclusion of commercial transactions from the UK inheritance tax.

<sup>60</sup> S 40(2).

<sup>61</sup> S 40(3).

<sup>62</sup> Bohan and McCarthy (2008) par 7.03.



Life insurance policies<sup>63</sup> payable to a deceased estate will devolve upon an heir under a testamentary (or intestate) disposition (because it will form part of the “free estate”).<sup>64</sup> If, however, a beneficiary was nominated under an insurance policy, the proceeds will not form part of the free estate, but the beneficiary will be liable for CAT under the nomination, which also constitutes a disposition.<sup>65</sup> If the benefits were acquired for inadequate consideration, the policy benefits will be subject to CAT in the hands of the beneficiary.<sup>66</sup> The Act contains a special provision that an interest in a policy of assurance on human life is only deemed to become an interest in possession when the policy either matures or is surrendered to the insurer for consideration in money or money’s worth.<sup>67</sup> If, during the currency of the policy, the insurer makes a payment of money or money’s worth, in full or partial discharge of the policy, the interest is deemed to have come into possession to the extent of such payment.<sup>68</sup> The purpose of the section is to postpone a charge to CAT, which could otherwise arise, until such time as a value is derived from the policy.<sup>69</sup> However, Bohan and McCarthy point out that the Act does not deal with the instance where value is derived prior to maturity or where a policy has been sold to a third party, which can give rise to anomalies. Suppose, for example, that A gives a lump sum life insurance product valued at €1 million to his son B, who immediately sells his right to C for €900 000. B has therefore become entitled to a benefit of €900 000 provided to him by his father without having an immediate liability to CAT.<sup>70</sup>

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<sup>63</sup> See Bohan and McCarthy (2008) pars 18.70–18.74 for a discussion on the various contracts of assurance. The section refers to both Irish and foreign contracts of assurance (par 18.72).

<sup>64</sup> See par 10.2.4 for the meaning of “free estate”.

<sup>65</sup> Bohan and McCarthy (2008) par 4.35.

<sup>66</sup> See par 10.5.2 for an explanation on the effect of any consideration paid in respect of life policy benefits.

<sup>67</sup> S 41(a) and (b).

<sup>68</sup> S 41(b).

<sup>69</sup> Bohan and McCarthy (2008) par 18.56.

<sup>70</sup> Bohan and McCarthy (2008) par 18.57.

In view of the fact that the application of inheritance tax and gift tax is restricted to individuals only, the Act provides that any consideration paid by, or disposition made by, a private company is deemed to be consideration, or a disposition, paid or made by the beneficial owners of the shares in the company and the beneficial owners of the entitlements under any liability incurred by the company (hereafter referred to as the “beneficial owners”), otherwise than wholly and exclusively for the business of the company,<sup>71</sup> in the same proportions that the value of their beneficial interests in the shares and entitlements bear to each other.<sup>72</sup> It is furthermore provided that any consideration, or a gift, or an inheritance taken by a private company is deemed to be consideration, or a gift, or an inheritance taken by the beneficial owners of the company, proportionally in relation to the value of their interests or entitlements in the company.<sup>73</sup>

To cater for value-shifting arrangements, it is provided that where a person (the disponer) has an absolute interest in possession in shares in a private company and any arrangement results in a decrease in the market value of those shares, the beneficial owners of the “related shares”, namely the shares the market value of which had been increased as a result of the arrangement,<sup>74</sup> would be taking a gift or inheritance from the disponer in proportion to their shareholdings.<sup>75</sup> A charge to CAT arises in respect of the difference between the market value of the disponer’s shares immediately before and after the arrangement was made.<sup>76</sup>

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<sup>71</sup> Bohan and McCarthy (2008) par 20.11 mention that business creditors would therefore in general fall outside the scope of this provision.

<sup>72</sup> S 43(2)(a).

<sup>73</sup> S 43(2)(b).

<sup>74</sup> S 44(1) “related shares”.

<sup>75</sup> S 44(3). See in general Bohan and McCarthy (2008) pars 20.18–20.19 for examples. It is furthermore provided that, if the related shares are held in a discretionary trust (with no beneficial owners in possession), the disponer of that trust (settlor) would be regarded as having taken a benefit (s 44(3)(ii)).

<sup>76</sup> S 44(1) “specified amount”.

## 10.2.2 Jurisdictional Basis

### 10.2.2.1 Residency

When originally enacted, a charge to CAT was primarily based on the domicile of the disponent (only).<sup>77</sup> This corresponded with the position of the United Kingdom inheritance tax.<sup>78</sup> However, in 1999 the basis of charge was changed to provide that an inheritance or gift (other than a gift taken under a discretionary trust<sup>79</sup>) will in principle be taxable where either the disponent, the donee or the successor (not being a successor in relation to the discretionary trust tax charges) is resident<sup>80</sup> or ordinarily resident<sup>81</sup> in the state at the date of the disposition (in the case of a disponent) or date of gift (in the case of a donee) or date of inheritance (in the case of a successor).<sup>82</sup> The extension of the connection to the status of the beneficiaries (i.e. successors and donees) was not received without criticism. Some

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<sup>77</sup> Bohan and McCarthy (2008) pars 1.02 and 3.02. See also pars 3.23–3.45 for a comprehensive discussion on the meaning of domicile.

<sup>78</sup> See Ch 8 par 8.2.3.1.

<sup>79</sup> See par 10.6.3.3 n 203.

<sup>80</sup> In general, a person will be regarded as an Irish resident if he or she was present in the state (a) at any one time or several times in a year of assessment for a period in the whole year amounting to 183 days or more, or (b) at any one or several times in a year of assessment and in the preceding year of assessment for an aggregate period during the two years amounting to 280 days or more (Taxes Consolidation Act 39 of 1997 ss 818–825). See in general Bohan and McCarthy (2008) par 3.20 and Doyle (2008) 266–267 for further discussion.

<sup>81</sup> In general, a person will be regarded as ordinarily resident in Ireland if he or she has been resident in the state for the previous three years of assessment. Such a person will continue to be ordinarily resident in Ireland until he or she is not resident for three continuous years of assessment. See in general Bohan and McCarthy (2008) par 3.21 and Doyle (2008) 267–268 for further discussion.

<sup>82</sup> Ss 6(2)(a) and (c), 11(2)(a) and (b). See in general Doyle (2008) 835–836 and Bohan and McCarthy (2008) par 3.05. The new dispensation has been applicable to gifts and inheritances taken on or after 1 December 1999 (Bohan and McCarthy (2008) par 3.03). For the rules pertaining to gifts and inheritances taken before 1 December 1999, see s 6(1) for gifts and s 11(1) for inheritances and Bohan and McCarthy (2008) pars 3.14–3.18. An exception to the new residence-based rules has been retained for non-domiciled residents. See Doyle (2008) 835 and Bohan and McCarthy (2008) pars 1.02, 3.03 and 3.12 for more detail on these rules. See also Williams (2004) *Irish Tax Rev* 405 *et seq* for a discussion on the effect of the change in the territorial scope of CAT for non-Irish domiciled persons.

commentators were of the opinion that the tax base was broadened to an extraordinary width.<sup>83</sup>

The “date of disposition” (from the perspective of the disponent) means, (a) in the case of a bequest, the death of the testator or the relevant deceased, (b) in the case of a disposition which consists of the failure to exercise a right or a power, the date of the latest time when the disponent could have exercised the right or the power if that disponent were *sui iuris* and not under any physical disability and (c) in any other case, the date on which the last act of the disponent was executed by which the disponent provided or bound himself in respect of the disposition.<sup>84</sup> The “date of the gift” (from the perspective of the donee) means the date of the happening of the event on which the donee becomes beneficially entitled in possession to the benefit.<sup>85</sup> The “date of the inheritance” (from the perspective of the successor) means the date when the successor becomes beneficially entitled to the inherited property, right or interest.<sup>86</sup> The date of inheritance of the vast majority of inheritances is therefore the death of the disponent, which corresponds in most cases with the date of the disposition.<sup>87</sup>

#### ***10.2.2.2 Location of Assets***

In the case where neither the disponent, donee nor successor is resident or ordinarily resident in the state at the date of the disposition, gift or inheritance (respectively), a

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<sup>83</sup> See e.g. Madigan (2000) *Acc Ireland* 20.

<sup>84</sup> S 2(1) “date of disposition”. See in general Bohan and McCarthy (2008) pars 3.05 and 3.07.

<sup>85</sup> S 2(1) “date of gift”.

<sup>86</sup> S 2(1) “date of inheritance”. In the case of a gift made within two years prior to the death of the disponent, the date of the inheritance would be the date of the original gift.

<sup>87</sup> However, there may be a time lapse between the date of the disposition and the date of the inheritance where e.g. the testator bequeaths property subject to a life interest (usufruct). The date of inheritance for the holder of the bare *dominium* (“remainder successor”) would be the date of death of the life tenant (i.e. the usufructuary). See Bohan and McCarthy (2008) par 3.08.

charge to CAT arises only in the instance where the asset subject to the gift or inheritance is situated in the state at the date of the gift or the date of the inheritance.<sup>88</sup>

### 10.2.3 Double Taxation

Double taxation relief is offered through double taxation agreements negotiated with other countries,<sup>89</sup> or through unilateral relief.<sup>90</sup> The two double taxation agreements currently in force, namely a treaty concluded with the United Kingdom (under CATCA) and a treaty concluded with the United States (under previous CAT legislation), apply to both inheritances and gifts.<sup>91</sup>

Unilateral relief operates by virtue of the granting of a tax credit. Where a person is liable for CAT as well as a foreign tax in respect of property situated in that foreign jurisdiction at the time of the gift or inheritance, then a credit is given for the foreign tax against CAT, unless the foreign tax exceeds the CAT payable, in which event the credit would be limited to the amount of CAT.<sup>92</sup> The credit can only be relied on where a double taxation agreement does not apply.<sup>93</sup>

### 10.2.4 Object of Taxation: Property

A charge to CAT arises where a beneficiary becomes entitled to a benefit in property. A gift or inheritance consists of the whole or “appropriate part”<sup>94</sup> of the property in which

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<sup>88</sup> Ss 6(2)(d), 11(2)(c)(i). See in general Bohan and McCarthy (2008) pars 3.05 and 3.10.

<sup>89</sup> As provided for in s 106. See Bohan and McCarthy (2008) par 13.01.

<sup>90</sup> As provided for by s 107.

<sup>91</sup> See Bohan and McCarthy (2008) Ch 13.

<sup>92</sup> S 107(1) read with 107(2). See Bohan and McCarthy (2008) par 13.34 for examples.

<sup>93</sup> S 107(3).

<sup>94</sup> S 5(5) defines an appropriate part as “that part of the entire property in which the benefit subsists, or on which the benefit is charged or secured, or on which the donee [or beneficiary, see s 10(2)] is entitled to

Footnote continues on the next page

the beneficiary takes a benefit, or in which the benefit is charged or secured or on which the beneficiary is entitled to have it charged or secured.<sup>95</sup> A benefit is described as any “estate, interest, income or right [in property]”.<sup>96</sup> Property furthermore includes “rights and interests of any description”.<sup>97</sup> A person’s “free estate” is the estate which will pass on death under will or intestacy and includes property which comes into existence only by reason of his or her death, for example a pension fund payment or insurance benefit which is payable to the personal representative (executor) of the deceased.<sup>98</sup>

### 10.3 VALUATION

The Act provides general rules for the determination of the market value of property generally and special rules for the determination of the market value of annuities and shares in private companies. In the case where the subject matter of the gift or inheritance is a limited interest, the Act provides for a method whereby the incumbrance-free value of the underlying property is adjusted to determine the value of the limited interest. Provision is also made for some favourable valuation rules in respect of business property and agricultural property, which will be more fully discussed in paragraph 10.5.3 below.

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have it so charged or secured, which bears the same proportion to the entire property as the gross annual value of the entire property, and the gift [or inheritance, see s 10(2)] shall be deemed to consist of the appropriate part of each and every item of property comprised in the entire property”. The basic calculation for the appropriate part is therefore: value of property transferred = annual value of benefit/total annual value of property. See Bohan and McCarthy (2008) pars 4.12–4.14, 5.12 and 6.17 for the determination of the value of the appropriate part of property.

<sup>95</sup> Ss 5(2)(a) and 10(2). Bohan and McCarthy (2008) par 5.12 explains that, if a liability deprives the beneficiary of the present use of the property or part thereof, then the liability is treated as a deduction of the appropriate part of the property, e.g. where a testator bequeaths a fund to his son subject to an annuity payable to his surviving spouse. See also pars 5.14 and 5.31–5.39.

<sup>96</sup> S 2(1) “benefit”. Bohan and McCarthy (2008) par 2.04 state that the four terms are merely indicative of the type of category that falls within the term “benefit” and that it would appear not to be exhaustive. They submit that it would also include any advantage, profit or gain given to the recipient.

<sup>97</sup> S 2(1) “property”.

<sup>98</sup> Bohan and McCarthy (2008) par 4.35.



### 10.3.1 Valuation Date

The Act contains some special rules in respect of a “valuation date”. This date is important, because the property must be valued on such date, and, more importantly, because the charge to CAT arises only on such date. In the case of a gift, the valuation date is usually the date of the gift. In the case of an inheritance, the valuation date is usually the date of the finalisation of the deceased estate or the actual delivery of the benefit (whichever is the earlier).<sup>99</sup>

### 10.3.2 General Rule

The market value of property is estimated to be the price which, in the opinion of the taxing authorities, such property would fetch if sold in the open market on the date on which the property is to be valued, in such a manner and subject to such conditions as might reasonably be calculated to obtain for the vendor the best price for the property.<sup>100</sup> No reduction can be obtained on the assumption that the whole property is to be placed on the market at one and the same time.<sup>101</sup> The value of a gift or inheritance is ascertained ignoring any contingencies.<sup>102</sup> If a contingency happens, then the taxable value will be recalculated on the basis of the actual period for which the benefit was indeed enjoyed.<sup>103</sup> In such a case, the beneficiary can claim a refund of any excess CAT that has been paid.<sup>104</sup>

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<sup>99</sup> S 30. See also Doyle (2008) 844–845 and Bohan and McCarthy (2008) Ch 7 for a comprehensive discussion of the valuation date provisions.

<sup>100</sup> S 26(2). See Bohan and McCarthy (2008) pars 6.02–6.17 for a comprehensive discussion of the general valuation rule, especially in regard to blocked assets (par 6.09), businesses (par 6.10), goodwill (pars 6.11–6.12), property held in co-ownership (pars 6.13–6.16) and an appropriate part in property (par 6.17).

<sup>101</sup> S 26(3).

<sup>102</sup> S 29.

<sup>103</sup> S 29.

<sup>104</sup> Bohan and McCarthy (2008) par 16.24.



The value of an unincorporated business or an interest in an unincorporated business should be taken to be its net value,<sup>105</sup> which would be the market value of the assets used in the business, including the goodwill, reduced by the market value of the liabilities incurred for the purposes of the business.<sup>106</sup> Unquoted shares in public companies and minority holdings in private companies (that are not controlled by the beneficiary) are also valued at market value according to the general rules,<sup>107</sup> which is in practice ascertained according to the specific rules contained in the Taxes Consolidation Act.<sup>108</sup> In valuing private company shares, any specific restrictions or conditions on the disposal or the transfer of the shares are to be ignored in so far as they prevent the sale of those shares. However, the restrictions will be taken into account in establishing the market value thereof.<sup>109</sup> The Act contains a specific rule for unquoted shares in private controlled companies, which will be discussed below.

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<sup>105</sup> S 98.

<sup>106</sup> Bohan and McCarthy (2008) pars 10.63–10.64. See Brennan and Hennessee (2001) *Comm Law Prac* 270 *et seq* for a discussion on the various methodologies applicable to the valuation of businesses.

<sup>107</sup> See Bohan and McCarthy (2008) pars 6.22–6.30 for a comprehensive discussion on the guidelines used, depending on the percentage of shareholding being valued, as well as the various bases of valuing shares in a private company, namely valuation based on earnings, asset valuation and dividend yield valuation. See also Cremins (2006) *Irish Tax Rev* 60 *et seq* for a discussion on the valuation processes and general valuation principles applicable to shares.

<sup>108</sup> Taxes Consolidation Act s 548. The market value of Irish quoted shares is the lower of (i) the last price recorded on the Stock exchange Official List, or (ii) the price recorded on the relevant date (if more than one, halfway between the lowest and the highest). The market value of UK quoted shares is the lower of (i) the lower of the two prices shown in the quotations on the relevant date, plus one quarter of the difference between those two figures, or (ii) the price recorded on the relevant date (if more than one, halfway between the lowest and the highest). The value of foreign securities is converted at the exchange rate applicable at the valuation date. See Bohan and McCarthy (2008) par 6.21 for a comprehensive discussion.

<sup>109</sup> Bohan and McCarthy (2008) pars 6.18–6.20.



### 10.3.3 Unquoted Shares in Private Controlled Companies

The market value of a share in a private company that is controlled<sup>110</sup> by the beneficiary after taking a gift or inheritance is determined as if the share formed part of a group of shares<sup>111</sup> (the “family group”) sufficient to give the owner of the group control of the company.<sup>112</sup> No discount for a minority holding will be allowed.<sup>113</sup> Instead, the value will be ascertained as a proportionate part of the total family group of shares.<sup>114</sup> If there are various classes of shares, the rights of each of the different classes will be taken into account in the apportionment.<sup>115</sup>

### 10.3.4 Annuities

For the purposes of the valuation of an annuity, the Act distinguishes between annuities charged on property and other annuities.

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<sup>110</sup> A person is generally deemed to control a company where he or she (together with, for example, his or her relatives and nominees) is the registered owner of the majority of the shares (Bohan and McCarthy (2008) par 6.36). However, a person is also deemed to have control of a company (a) if he (together with, for example, his relatives and nominees), in general, can control over 50% of the votes of the company, or (b) if he (together with, for example, his relatives and nominees) has control of the board of directors, or the powers of the managing director, or the nomination of a majority of the directors or a managing director, or the power to veto the appointment of a director or any powers of a like nature to the foregoing (s 27(4)). A company that is controlled by a beneficiary is regarded as a relative of such beneficiary (s 27(3)), as a consequence of which control cannot be evaded through the use of a number of companies (Bohan and McCarthy (2008) par 6.35).

<sup>111</sup> A “group of shares means the aggregate of the shares in the company of the donee or successor, the relatives of the donee or successor, nominees of the donee or successor, nominees of the relatives of the donee or successor, and the trustees of a settlement whose objects include the donee or successor or relatives of the donee or successor” (s 27(1)).

<sup>112</sup> S 27. See in general Bohan and McCarthy (2008) par 6.31.

<sup>113</sup> Bohan and McCarthy (2008) par 6.31.

<sup>114</sup> Bohan and McCarthy (2008) par 6.31.

<sup>115</sup> See in general Bohan and McCarthy (2008) pars 6.38–6.47 for a discussion on the various classes of shares and classes of rights attaching thereto.



#### ***10.3.4.1 Annuities Charged on Property***

Where the benefit consists of an annuity charged or secured on any property, it is valued using the following formula: market value of property x (annual value of benefit/annual income of the property).<sup>116</sup> For example, where an annuity of €10 000, secured by a rental property (valued at €600 000) with an annual rental income of €30 000, is donated, the value of the annuity would be calculated at €200 000 (€600 000 x €10 000/€30 000).<sup>117</sup>

Where an annuity is taken for a period less than 50 years, or alternatively, where an annuity is granted for the duration of a life or lives, an adjustment is necessary to reflect the fact that the beneficiary does not have an absolute interest in the property according to the rules dealing with the determination of the value of limited interests.<sup>118</sup>

#### ***10.3.4.2 Annuities Not Charged on Property***

The Act provides that, if the benefit is an annuity or other periodic payment which is not charged or secured by any property, the gift or inheritance is deemed to consist of such sum as would, if invested on the date of the gift or inheritance in a security of the government which was issued last before that date for subscription in the state and is redeemable not less than 10 years after the date of issue, yield an annual income equal to the annual value of the annuity or other periodic payment receivable by the beneficiary.<sup>119</sup> If the annuity was granted for a fixed period or for the duration of a life or lives, the value should furthermore be adjusted in accordance with the rules pertaining to limited interests.<sup>120</sup>

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<sup>116</sup> S 5(2)(a). See in general Doyle (2008) 846 and example 34.15.

<sup>117</sup> See Doyle (2008) 846 example 34.15.

<sup>118</sup> See par 10.3.5 for the determination of the value of a limited interest. See also Doyle (2008) 848 example 34.19.

<sup>119</sup> Ss 5(2)(b) and 10(2). See Doyle (2008) 846 for an example.

<sup>120</sup> See par 10.3.5 for the determination of the value of a limited interest. See also Doyle (2008) 847 example 34.18.

### 10.3.5 Adjustment for Limited Interests

A limited interest is an interest for the duration of a life or lives or for a certain period or any interest which is not an absolute interest.<sup>121</sup> An interest in possession in a fixed trust, a usufructuary interest and a fideicommissary interest would therefore all be examples of limited interests for the purposes of CATCA. Where a gift or inheritance comprises a limited interest, the incumbrance-free value is reduced by the appropriate limiting factor in accordance with the tables contained in the First Schedule to the Act (which has remained unchanged since the initial passing of the original CAT Act in 1976).<sup>122</sup> The schedule contains two tables, namely Table A, which is based on life expectancy and which is used in the case where an interest is taken for a duration of life or lives, and Table B, which is based on a fixed period and which is used in the case where the interest is taken for a fixed period of time.<sup>123</sup> The value of the property is multiplied with the appropriate factor, which is, in the case of an interest taken for life or lives, dependent on the age<sup>124</sup> and sex of the person for the duration of whose life the interest is to be so valued.<sup>125</sup> Table A also contains a column of joint factors, which are used where an interest is taken for a joint continuance of two lives, for a joint continuance of three or more lives, for the longer of two lives or for the longest of more than two lives.<sup>126</sup> The value of an interest for the joint continuance of two lives is, for example, determined by multiplying the joint factor that is appropriate to the younger life.<sup>127</sup> When a person takes

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<sup>121</sup> S 2(1) “limited interest”. See also Doyle (2008) 846.

<sup>122</sup> See Bohan and McCarthy (2008) par 5.45 and Doyle (2008) 847–848 examples 34.17–34.18.

<sup>123</sup> The factors (in Table A) vary from 0.9519 (for a male under 1 year of age) to 0.0458 (for a male older than 100 years of age) and 0.9624 (for a female under 1 year of age) to 0.0698 (for a female older than 100 years of age). The factors in Table B vary from 0.0654 (for 1 year) to 0.9945 (for 50 years and over).

<sup>124</sup> The age is determined by the previous birthday.

<sup>125</sup> Sch 1 prt 1 rule 1 (for the duration of a single life). See Bohan and McCarthy (2008) par 5.48 for an example.

<sup>126</sup> The factors vary from 0.99 (for a person under 1 year of age) to 0.45 (for a person older than 100 years of age).

<sup>127</sup> Sch 1 prt 1 rule 2. See Bohan and McCarthy (2008) par 5.49 for an example. See also rules 3–5 (for the other special rules) and Bohan and McCarthy (2008) pars 5.50–5.52. For the calculation of an interest taken for a fixed period of time, see Sch 1 prt 1 rule 6 and Bohan and McCarthy (2008) par 5.53 for an example.

an absolute interest on the cessation of an intervening life interest, the taxable value will be the full open market value of the property on the death of the life tenant.<sup>128</sup> See paragraph 10.7 below for some example calculations.

#### 10.4 TAXPAYER AND RETURN FILING

The donee or successor is primarily liable for gift tax or inheritance tax.<sup>129</sup> However, the donor, personal representative, agent, guardian or trustee may also be held accountable for the payment of the tax.<sup>130</sup> The trustees of a discretionary trust (for the time being at the date of the inheritance) are primarily accountable for the payment of the DTT charges.<sup>131</sup>

CAT is a self-assessment tax with provision made for the delivery of the return together with the payment of the tax within four months of the valuation date.<sup>132</sup>

#### 10.5 RELIEF MECHANISMS

The Act provides for various forms of relief, which include (a) the deduction of certain liabilities and any consideration paid from the market value of a taxable gift or a taxable inheritance, (b) the provision of favourable valuation rules in respect of agricultural property and business assets and (c) the provision of certain exemptions.

##### 10.5.1 Deductible Liabilities

A deduction is allowed for all liabilities, costs and expenses that are properly payable out

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<sup>128</sup> Doyle (2008) 847.

<sup>129</sup> S 45(1).

<sup>130</sup> S 32.

<sup>131</sup> S 16(c).

<sup>132</sup> S 46.



of the taxable gift or inheritance.<sup>133</sup> Allowable expenses include, for example, deductions legally enforceable against the disponent or his or her personal representative such as funeral expenses, outstanding income tax or capital gains tax, hospital expenses, outstanding accounts (e.g. heating, light, food), bank overdrafts, outstanding mortgages and other testamentary expenses.<sup>134</sup> If a gift or inheritance consists of agricultural property or business property that qualifies for relief,<sup>135</sup> any liabilities, expenses or consideration should be proportionally reduced.<sup>136</sup> Certain liabilities are, however, prohibited,<sup>137</sup> for example certain foreign liabilities in respect of property situated in Ireland, where neither the disponent nor the beneficiary has been resident in Ireland, which are due to non-residents (except where the liability is contractually required to be paid in Ireland or where the liability is charged in respect of the Irish property which is the subject of the inheritance or gift), unless the foreign assets are insufficient to meet all the foreign liabilities, in which case the surplus expenses can be deducted against the Irish property.<sup>138</sup> Any tax, interest or penalties chargeable under the Act, or the costs, expenses or interest incurred in raising or paying such liabilities, are also not allowed.<sup>139</sup> It is provided that, where a liability is a burden on specific property, it should as far as possible be allowed as a deduction against that property.<sup>140</sup>

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<sup>133</sup> S 28(1).

<sup>134</sup> Bohan and McCarthy (2008) pars 5.04, 5.07. These expenses are usually paid from the residuary estate, although there may be a testamentary direction that an expense should be charged against a specific asset (par 5.04). See also Doyle (2008) 844.

<sup>135</sup> See par 10.5.3.

<sup>136</sup> S 89(2)(ii) and (iii).

<sup>137</sup> Such as contingent liabilities. See s 28(5)(a).

<sup>138</sup> S 28(5)(f). See in general Bohan and McCarthy (2008) pars 5.25 and 5.26, where the authors question whether this position would still be applicable within the EU in the light of the Mutual Assistance Directive. For other prohibited liabilities, see s 28(5) and Bohan and McCarthy (2008) pars 5.19–5.24.

<sup>139</sup> S 28(5)(d). See in general Bohan and McCarthy (2008) par 5.22; Doyle (2008) 844.

<sup>140</sup> S 28(11).



### 10.5.2 Consideration

Any consideration which a beneficiary gives to the disponer, or any person at the direction of the disponer, may be deducted from the incumbrance-free value.<sup>141</sup> Such a deduction includes any liability of the disponer which the beneficiary undertakes to discharge and any other liability to which the gift or inheritance is subject under the terms of the disposition under which it was created.<sup>142</sup> If a beneficiary paid all the premiums in respect of a life assurance policy, then he or she would have given full consideration for the policy and the proceeds would not be regarded as a taxable gift or inheritance. However, if the beneficiary only paid a proportion of the premiums, he or she would only be liable for CAT in respect of a proportion of the proceeds.<sup>143</sup> In the event of business partner's insurance, the premiums should therefore strictly speaking be equalised among all the persons involved (according to their different ages). However, Bohan and McCarthy mention that it is apparently the practice of the revenue authorities not to levy inheritance merely because the premiums were not equalised (subject to certain conditions).<sup>144</sup> A key-man policy would usually not give rise to a CAT liability, in view of the fact that it is normally effected and paid for by an employer.<sup>145</sup>

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<sup>141</sup> S 28(2); Bohan and McCarthy (2008) par 5.09. If the consideration is paid by someone else, then the beneficiary takes two benefits. E.g. where A sells an asset worth €500 000 to B for €100 000, but the consideration is paid by C, then B takes two benefits, namely one from A at a value of €400 000 and one from C at a value of €100 000.

<sup>142</sup> Subject to the proviso that no double deduction is allowed (s 28(2)). See in general Bohan and McCarthy (2008) par 5.09 and Doyle (2008) 845 example 34.14.

<sup>143</sup> Bohan and McCarthy (2008) pars 4.35, 18.59. See also *Barclays Bank v AG* [1994] AC 372 and s 83.

<sup>144</sup> Bohan and McCarthy (2008) par 18.77.

<sup>145</sup> Bohan and McCarthy (2008) par 18.78.

### 10.5.3 Preferential Valuations

#### 10.5.3.1 Agricultural Property

Favourable treatment has been afforded to agricultural property since the introduction of CAT legislation in 1975.<sup>146</sup> Currently, the Act provides that, where any gift or inheritance consists of “agricultural property”<sup>147</sup> at the date of the gift or inheritance and at the valuation date, and where such property is taken by a beneficiary who is, on the valuation date and after taking the gift or inheritance, a “farmer”<sup>148</sup> for the purposes of the Act, then the market value of the agricultural property (the “agricultural value”) may be reduced by 90 percent.<sup>149</sup> Any liabilities, costs, expenses and consideration attaching to the property must be proportionally reduced.<sup>150</sup> Shares which derive their value from agricultural property do not qualify for the relief.<sup>151</sup> However, such shares may qualify for business relief.<sup>152</sup> In 2005, the Act introduced certain claw-back provisions to counter the possible misuse of the section. Agricultural relief may now be withdrawn where the agricultural property (other than crops, trees or underwood) is disposed of or compulsorily acquired

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<sup>146</sup> Bohan and McCarthy (2008) par 9.01.

<sup>147</sup> “Agricultural property” includes agricultural land, pasture and woodlands situated in the state and crops, trees and underwood growing on such land. It also includes the farm buildings, farm house and mansion house. The description furthermore includes any farm machinery, livestock and bloodstock on such property (s 89(1) “agricultural property”). See Bohan and McCarthy (2008) pars 9.02–9.16 for a comprehensive discussion.

<sup>148</sup> A “farmer” refers to an individual whose assets are mainly represented by agricultural property. For the purposes of this test, at least 80% of the gross market value of all the property to which such individual is beneficially entitled (after taking the gift or inheritance) must consist of agricultural property as defined (s 89(1)). See Bohan and McCarthy (2008) pars 9.17–9.23 for a comprehensive discussion. See also Doyle (2008) 849–850 examples 34.20–34.21.

<sup>149</sup> Ss 89(1) (the reduced value is referred as the “agricultural value”) and 89(2). See Doyle (2008) 850–852 examples 34.21–34.24 and Bohan and McCarthy (2008) Ch 9 for a more comprehensive discussion.

<sup>150</sup> S 89(2). See example in Bohan and McCarthy (2008) par 9.28.

<sup>151</sup> Doyle (2008) 849.

<sup>152</sup> See par 10.5.3.2.



within six years of the date of the gift or the inheritance, without being replaced by other agricultural property within one year of the disposal or within six years of the compulsory acquisition.<sup>153</sup> The relief may also be withdrawn where the beneficiary is not a resident in the state for any of the three years of assessment immediately following the year of assessment in which the valuation date falls.<sup>154</sup>

### ***10.5.3.2 Business Property***

Business property relief was in essence copied from the United Kingdom legislation upon its incorporation into the CAT legislation in 1994.<sup>155</sup> Three reasons were advanced by the government for the introduction of this form of relief. Firstly, the business community regarded the absence of business relief as an unfair bias towards the agricultural sector (because agricultural relief had been provided for since the initial introduction of CAT in 1975). Secondly, it was thought that some relief would encourage entrepreneurial activity in the country. The third reason provided was that business relief could assist in the prevention of the forced break-up or liquidation of businesses.<sup>156</sup>

The Act currently provides that, where the whole or part of the taxable value of any taxable gift or taxable inheritance is attributable to the value of any “relevant business

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<sup>153</sup> S 89(4)(a). See in general Bohan and McCarthy (2008) par 9.42 and Doyle (2008) 853.

<sup>154</sup> S 89(4)(c). See in general Doyle (2008) 853.

<sup>155</sup> Carr (2001) *Irish Tax Rev* 135.

<sup>156</sup> Bohan and McCarthy (2008) par 10.01.

property”,<sup>157</sup> the whole or that part of the taxable value<sup>158</sup> may be reduced by 90 percent,<sup>159</sup> provided that the property was held by the donor for a minimum period of five years (in the case of a gift) or two years (in the case of an inheritance) prior to the date of the gift or the inheritance.<sup>160</sup> To neutralise any hardship caused by the minimum ownership requirements, the Act contains special provisions for circumstances where business property had been replaced by other business property or where the beneficiary had died within the prescribed period.<sup>161</sup> The relief may also be withdrawn or partially clawed back if the relevant business assets are disposed of or cease to qualify as business property within six years of the gift or inheritance, unless the property is replaced by other qualifying business property or again qualifies as relevant business property within one year. However, there will be no claw-back if the business ceases as a result of insolvency.<sup>162</sup>

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<sup>157</sup> “Relevant Business property” is defined in s 93(1) and includes any one of the following: (a) property consisting of a business or an interest in a business; (b) unquoted shares in or securities of a company, whether incorporated in the state or otherwise, where the beneficiary will (after the taking of the gift or inheritance) have control of more than 25 percent of the voting rights capable of being exercised in respect of the company; (c) unquoted shares in or securities of a private controlled company; (d) unquoted shares in or securities of a company, whether incorporated in the state or otherwise, where the beneficiary will (after the taking of the gift or inheritance) own an aggregate nominal value which represents 10 percent or more of the aggregate nominal value of the entire share capital and securities of the company, provided that the beneficiary has been a full-time working officer or employee of the company, or if that company is the member of a group, of one or more companies which are members of the group, throughout a period of five years prior to the date of the gift or inheritance; (e) any land or building, plant or machinery owned by the donor, which was used for the business carried on by a company of which the donor then had control or by a partnership of which the donor then was a partner; (f) certain quoted shares in family controlled companies, subject to certain conditions. See Bohan and McCarthy (2008) paras 10.06–10.27 for a comprehensive discussion. The relief does not apply to businesses which are involved in dealing with currencies, securities, stocks or shares, land or buildings, or the making or the holding of investments. See s 93(3) and Bohan and McCarthy (2008) paras 10.28–10.10.53 for a comprehensive discussion.

<sup>158</sup> It should be noted that the relief operates towards the “taxable value”, where any deductible liabilities and consideration have already been taken into account.

<sup>159</sup> S 92.

<sup>160</sup> S 94. See in general Bohan and McCarthy (2008) paras 10.54–10.57; Doyle (2008) 853 and McQuillan (2003) *Acc Ireland 20 et seq* (for a brief summary of the tax consequences (CAT, CGT and stamp duty) on the transfer of a business).

<sup>161</sup> Ss 95, 96, 97. See in general Bohan and McCarthy (2008) paras 10.58–10.62.

<sup>162</sup> S 101. See in general Doyle (2008) 854.

## 10.5.4 Exemptions

### 10.5.4.1 Exemptions Applicable to Both Inheritances and Gifts

For the purposes of both inheritances and gifts, the Act provides that the following acquisitions are (subject to certain conditions) exempt from CAT:

- property which is taken for public or charitable purposes;<sup>163</sup>
- certain heritage property (such as houses, gardens, pictures, prints, books, manuscripts, works of art, jewellery and scientific collections of national, scientific, historic or artistic interest), which are kept permanently in the state and in respect of which reasonable facilities for viewing are allowed to members of the public;<sup>164</sup>
- property taken by a “spouse”<sup>165</sup> from another spouse (even where the spouses have been separated);<sup>166</sup>
- property transferred between former spouses in terms of a court order following a divorce;<sup>167</sup>

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<sup>163</sup> S 76(2). See Bohan and McCarthy (2008) pars 11.03–11.10 for a discussion of what would be regarded as charitable under Irish law.

<sup>164</sup> S 77(1) to (6). See in general Bohan and McCarthy (2008) pars 11.17–11.29 and Doyle (2008) 843.

<sup>165</sup> Bohan and McCarthy (2008) par 11.15. A “spouse” is not defined in the Act. However, the term would be restricted to a partner in a legal marriage, which does not extend to same-sex couples and other cohabitants. Numerous commentators have consequently expressed their concern that the Irish law remains largely deficient in its recognition of same-sex relationships and family diversity. For further reading, see Willis (2002) *Conv Prop Law J* 58 *et seq*; Willis (2002) *Irish J Fam Law* 8 *et seq*; Gallagher (2003) *Conv Prop Law J* 76 *et seq*; Byrne (2004) *Irish Tax Rev* 485 *et seq*; Ryan (2006) *Irish J Fam Law* 3 *et seq* and Tobin (2008) *Irish J Fam Law* 10 *et seq*.

<sup>166</sup> Ss 70 (gifts) and 71 (inheritances). Inheritances were exempted with effect from 30 January 1985 and gifts were exempted with effect from 31 January 1990. See in general Bohan and McCarthy (2008) par 11.11 and Doyle (2008) 843.

<sup>167</sup> S 88. See Bohan and McCarthy (2008) par 11.15 for an outline of the various orders. See also discussion by Lillis and Walls (2003) *Irish Tax Rev* 269–271.

- subject to certain exceptions,<sup>168</sup> any retirement benefit or pension payment or redundancy payment acquired by an employee or former employee;<sup>169</sup>
- the proceeds of a policy that was specifically effected to be a source of finance for the payment of inheritance tax or gift tax, to the extent that it has been applied to pay the relevant tax;<sup>170</sup>
- an interest in a foreign life assurance policy (affected by a foreign assurance company) if neither the disponent nor the beneficiary was domiciled or resident in the state at the date of the disposition or at the date of the inheritance or gift respectively;<sup>171</sup>
- any unit of an investment undertaking or of a specified collective investment if neither the disponent nor the beneficiary was domiciled or resident in the state at the date of the disposition or at the date of the inheritance or gift respectively;<sup>172</sup>
- government securities where the beneficiary is neither domiciled nor ordinarily resident in the state at the date of the gift or the date of the inheritance and where the securities were held by the disponent for a minimum period of fifteen years immediately before the date of the gift or the date of the inheritance;<sup>173</sup>

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<sup>168</sup> The exclusion is not applicable where the employee is a relative of the employer, or where the employer is a private controlled company as provided for by the Act (s 80(3)(a)). The relief is furthermore restricted to payments under a scheme approved by the Commissioners under the income tax legislation, provided that the payments are not excessive (s 80(3)(c) and (d)).

<sup>169</sup> S 80(2). See in general Bohan and McCarthy (2008) par 18.79.

<sup>170</sup> Ss 72, 73. See in general Bohan and McCarthy (2008) pars 18.02, 18.08–18.35, 18.38–18.45 for a comprehensive discussion. See also Doyle (2008) (2008) 843. Bohan and McCarthy (2008) pars 18.34–18.35 mention the difficulty that arises in assessing the extent to which the proceeds of a policy are applied to pay CAT in the instance where the proceeds is payable to the personal representatives of the deceased, in view of the fact that the proceeds would be available to meet other testamentary expenses and debts. To avoid such a situation, an insured commonly utilises a trust fund policy, where the trust document directs the trustees to firstly apply the proceeds for the payment of inheritance tax.

<sup>171</sup> S 74 (a foreign policy issued in Ireland would otherwise be subject to a charge to CAT). See in general Bohan and McCarthy (2008) par 11.68.

<sup>172</sup> S 75. See in general Bohan and McCarthy (2008) par 11.67.

<sup>173</sup> S 81(2). See Bohan and McCarthy (2008) pars 11.40–11.41 for a discussion on the historic position of this section. The exemption is not available to the trustees of a discretionary trust, even in a case where none of the trustees and none of the beneficiaries are domiciled or ordinarily resident in Ireland. See also Doyle (2008) 843.



- compensation or damages received in respect of injury suffered in respect of a person's person, property, reputation, means or livelihood;<sup>174</sup>
- compensation received in respect of the death of another person;<sup>175</sup>
- winnings from betting, gambling, and lottery;<sup>176</sup>
- any benefit received from a bankrupt's friends or relatives or the remission of debts by the creditors of a bankrupt, where such contributions were made to enable the bankrupt to fulfil an offer of composition under the Bankruptcy Act;<sup>177</sup>
- normal and reasonable contributions made by a disponent in respect of the support, maintenance or education of his or her spouse, child or dependant relative;<sup>178</sup>
- any benefit received from a trust fund of a qualifying trust by an incapacitated individual;<sup>179</sup>
- any contribution to the support, maintenance and education of a minor child from a discretionary trust at a time when both parents are dead;<sup>180</sup>
- property acquired by a public company from an associated public company;<sup>181</sup>
- property which is taken exclusively for the purpose of discharging medical expenses of an individual who is permanently incapacitated;<sup>182</sup> and
- residential property acquired by a cohabitant, subject to certain strict conditions.<sup>183</sup>

<sup>174</sup> S 82(1)(a). See in general Bohan and McCarthy (2008) pars 11.50–11.51.

<sup>175</sup> S 82(1)(b). See in general Bohan and McCarthy (2008) par 11.52.

<sup>176</sup> S 82(1)(c). See in general Bohan and McCarthy (2008) par 11.53.

<sup>177</sup> S 82(1)(d). See also s 82(1)(e) for a similar exemption in respect of an arranging debtor. See in general Bohan and McCarthy (2008) pars 11.54–11.55.

<sup>178</sup> S 82(2). See in general Bohan and McCarthy (2008) pars 11.56–11.61.

<sup>179</sup> S 82(3). See in general Bohan and McCarthy (2008) par 11.62.

<sup>180</sup> S 82(4). See in general Bohan and McCarthy (2008) par 11.63.

<sup>181</sup> S 83(3). See in general Bohan and McCarthy (2008) par 11.64.

<sup>182</sup> S 84. See in general Bohan and McCarthy (2008) par 11.69.

<sup>183</sup> S 86. Bohan and McCarthy (2008) pars 8.19–8.21 discuss the historical position of this relief. See Bohan and McCarthy (2008) pars 11.73–11.89 and Keogh (2008) *Law Soc Gaz* 28 *et seq* for a comprehensive exposition of the contemporary provisions. See also Doyle (2008) 843 (for a brief summary).

#### *10.5.4.2 Exemptions Applicable to Gifts Only*

In respect of taxable gifts, the Act allows for a basic annual exemption of the first €3 000 of the total taxable value of all taxable gifts taken by a donee from any one disponent.<sup>184</sup> A person can therefore receive €3 000 tax-free from each and every disponent in the calendar year.<sup>185</sup>

#### *10.5.4.3 Exemptions Applicable to Inheritances Only*

The Act provides that the following inheritances are exempt from CAT:

- an inheritance taken by a parent from a child on a child's death, but only where the child took a non-exempt gift or inheritance from either or both of his or her parents within a period of five years immediately prior to his or her death;<sup>186</sup> and
- the whole or any part of a retirement fund, if it is taken by a child of the disponent who attained the age of twenty-one years at the date of the disposition.<sup>187</sup>

#### *10.5.4.4 The Group Thresholds*

Over and above the exemptions set out above, each taxpayer is entitled to three group thresholds, as explained in paragraph 10.1.2 above.

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<sup>184</sup> S 69.

<sup>185</sup> Bohan and McCarthy (2008) pars 11.01–11.02. There is no claw-back of the exemption where a gift becomes an inheritance by virtue of the disponent's death within two years (Doyle (2008) 841). See also Doyle (2008) 842 example 34.13.

<sup>186</sup> S 79. See in general Bohan and McCarthy (2008) par 11.34 and Doyle (2008) 843.

<sup>187</sup> S 85. See in general Bohan and McCarthy (2008) par 11.70.



### 10.5.5 Miscellaneous Reliefs

The Act provides furthermore for certain miscellaneous matters such as relief for certain marriage settlements made prior to the introduction of CAT in 1976,<sup>188</sup> relief from double aggregation,<sup>189</sup> and relief where multiple charges arise on the same event.<sup>190</sup>

## 10.6 TREATMENT OF SETTLEMENTS AND TRUSTS

### 10.6.1 The Trust: Broad Overview and Classification

Similar to the position in the United Kingdom law, it is basically important for the purposes of wealth transfer taxation to distinguish between a fixed trust, where each beneficiary has a fixed entitlement to a specific share in the trust property, and a discretionary trust, where the trustees have the discretion to distribute the income and/or capital for the benefit of the beneficiaries.<sup>191</sup>

### 10.6.2 The Position Prior to CATCA

Prior to the introduction of capital acquisitions tax, the British-based estate duty was levied in Ireland. Similar to the position in the United Kingdom, a person with an interest in possession in a fixed trust was treated as the outright owner of the property in which the interest subsisted. In respect of discretionary trusts, a special regime was introduced in 1969 to levy estate duty on the appropriate part of the property, determined with

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<sup>188</sup> See Sch 2 prt 1 par 8 and Bohan and McCarthy (2008) par 8.15.

<sup>189</sup> See s 103 and Bohan and McCarthy (2008) par 8.22.

<sup>190</sup> See s 105 and Bohan and McCarthy (2008) pars 8.23–8.25.

<sup>191</sup> See in general O'Connell and Fitzgerald (2003) *Conv Prop Law J* 90 and Bohan and McCarthy (2008) par 2.33.

reference to the income received by the beneficiary in the seven years prior to his or her death.<sup>192</sup>

When CAT was introduced in 1975, there was a complete move away from the IIP and PET regimes. Where a person acquires an interest in possession, the interest is valued as a limited interest. The ultimate (capital) beneficiary will be liable for CAT on the full value of the property upon the break-up of the trust. However, because of the fact that the use of a discretionary trust could postpone a charge to CAT indefinitely, a special regime (the initial charge) was introduced in 1984 for discretionary trusts. This regime was extended to include an annual charge in 1986. The DTT regime is still in force and will be discussed more fully below.

### 10.6.3 The Contemporary Position: CATCA

#### 10.6.3.1 *The Meaning of Settlement and Discretionary Trust*

The Act contains some special rules in respect of settlements or settled property. Although the Act does not contain a definition of a “settlement”, the term has been defined by various other statutes. According to the Taxes Consolidation Act, a settlement includes “any disposition, trust, covenant, agreement or arrangement, and any transfer of money or other property or of any right to money or other property”.<sup>193</sup> A settlement therefore includes arrangements such as trusts and civilian usufructs.<sup>194</sup>

For the purposes of the Act, a discretionary trust is specifically defined as (a) any trust whereby, or by virtue or in consequence of which property is held on trust to accumulate

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<sup>192</sup> See Ch 8 par 8.6.2.

<sup>193</sup> Taxes Consolidation Act s 10(1).

<sup>194</sup> See Bohan and McCarthy (2008) pars 16.02–16.09 for a comprehensive discussion on the meaning of “settlement”.



the income or part of the income of the property, or (b) any trust whereby, or by virtue or in consequence of which, property (other than property to which for the time being a person is beneficially entitled for an “interest in possession”) is held on trust to apply, or with a power to apply, the income or capital or part of the income or capital of the property for the benefit of any person or persons or of any one or more of a number or of a class of persons whether at the discretion of trustees or any other person and notwithstanding that there may be a power to accumulate all or any part of the income.<sup>195</sup> It has transpired that a power to accumulate the income or capital by the trustees could bring a trust within the ambit of a discretionary trust, even in a case where the beneficiary is “entitled in possession” to the trust property, for example in a (traditional) fixed trust.<sup>196</sup>

### 10.6.3.2 *Fixed Trusts*

The transfer of property to a fixed trust (where the beneficiaries have fixed interests) will usually constitute a gift or an inheritance under a disposition for the purposes of the beneficiary who acquires an interest in possession in such trust (e.g. the “life tenant”).<sup>197</sup> The life interest will, for the purposes of the calculation of CAT, be valued in accordance with the rules applicable to limited interests. The life expectancy of the beneficiary or the fixed period of time will therefore be relevant.<sup>198</sup> In view of the fact that a person only becomes liable to CAT on becoming entitled in possession to a benefit, the reversionary interest will not attract CAT. When property is subsequently distributed to a beneficiary absolutely on the termination of the settlement, the acquisition by the beneficiary will give rise to a charge to CAT on the full value of the property,<sup>199</sup> unless the reversionary interest holder paid consideration for the reversionary interest when it was first acquired,

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<sup>195</sup> S 2(1) “discretionary trust”.

<sup>196</sup> Keogan (2007) *Law Soc Gaz* 41.

<sup>197</sup> Keogan (2007) *Law Soc Gaz* 43; Bohan and McCarthy (2008) par 16.10.

<sup>198</sup> See par 10.3.5.

<sup>199</sup> Bohan and McCarthy (2008) par 16.11.



in which case a deduction will be allowed for an amount equal to the same proportion of the taxable value as the consideration bore to the market value of the reversionary interest at that point in time. See example 1 in paragraph 10.7 below.

Where the trustees of a fixed trust have the power to accumulate income or capital, the trust will be treated as a discretionary trust (which will be discussed below). In view of the fact that a fixed trust can either be subject to DTT or be subject to a double charge to CAT (where the life tenant is also the ultimate beneficiary), a fixed trust can be quite tax-inefficient.<sup>200</sup> Also, where the trustees have the discretion to distribute the property to a number of beneficiaries on the lapse of a fixed life interest and subsequently distribute the property to the life tenant there could effectively be a double charge to CAT.<sup>201</sup> Suppose, for example, that A settles property on B for a period of 10 years, with discretion to the trustees to distribute the property to B, C or D, then B will pay gift tax on the value of the life interest on the creation of the settlement. Where the property is distributed to B absolutely on the cessation of his life interest, B will be liable for CAT once again on the full value of the property.

### ***10.6.3.3 Discretionary Trusts***

In the case of a discretionary trust, where the beneficiaries do not become entitled in possession to any immediate benefits in the trust capital or income, the initial transfer into the settlement will not attract mainstream CAT.<sup>202</sup>

However, where the disponent is resident or ordinarily resident at the date of the disposition or where the assets transferred to the discretionary trust are located in the

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<sup>200</sup> Keogan (2007) *Law Soc Gaz* 43; Keogan and O’Keeffe (2007) *Irish Tax Rev* 79.

<sup>201</sup> Keogan (2007) *Law Soc Gaz* 43; Keogan and O’Keeffe (2007) *Irish Tax Rev* 79.

<sup>202</sup> Keogan (2007) *Law Soc Gaz* 40; Bohan and McCarthy (2008) par 16.10.

state,<sup>203</sup> the trustees will be deemed to take a “relevant inheritance”<sup>204</sup> of the trust property at the latest of the three following dates (which will be the date of the inheritance), namely (a) the date on which the property becomes subject to the discretionary trust, or (b) the date of death of the disponent or (c) the date on which there ceases to be a “principal object” (namely a potential beneficiary which can either be a spouse, a child or a child of a predeceased child of the disponent)<sup>205</sup> under the age of 21.<sup>206</sup> The tax chargeable on the taxable value of such a relevant inheritance is computed at the rate of six percent of such taxable value.<sup>207</sup> However, the initial DTT charge will decrease to three percent if a beneficiary or beneficiaries of the trust becomes or become beneficially entitled in possession to an absolute interest in the entire property within five years of the disposition.<sup>208</sup>

The valuation date is usually the later of (a) the valuation date as determined in terms of the normal rules<sup>209</sup> or (b) the date on which the trustees take a “relevant inheritance” (as determined above).<sup>210</sup> Where, for example, a discretionary trust is created under A’s will

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<sup>203</sup> The ordinary jurisdictional rules apply for the deemed inheritance by the trustees, except for the fact that the residence status of the trustees at the date of the (deemed) inheritance is expressly excluded as a jurisdictional connecting factor (see par 10.2.2.1). In the absence of this exception, a charge to DTT could have arisen simply by reason of the trustees being resident or ordinarily resident in the state. See Bohan and McCarthy (2008) par 3.08.

<sup>204</sup> See s 18(1).

<sup>205</sup> S 14.

<sup>206</sup> S 15(1). The fact that a charge to DTT is deferred until the youngest potential beneficiary (child of the disponent) reaches the age of 21 years creates ample opportunities for the provision for minor children through discretionary trusts in the event of the sudden death of parents. See O’Connell (2003) *Acc Ireland* 28 and Keogan and O’Keeffe (2007) *Irish Tax Rev* 77. However, the deferral of the tax opens up a door for tax evasion techniques. If a minor were to be included in the list of potential beneficiaries and the trust assets were to be appointed before the youngest child had reached the age of 21, no DTT would be payable. See O’Connell (2003) *Acc Ireland* 28.

<sup>207</sup> S 18(2).

<sup>208</sup> S 18(3). See s 18(1) for the calculation of the five-year period. See also Bohan and McCarthy (2008) pars 17.43–17.46 for some examples.

<sup>209</sup> See par 10.3.1.

<sup>210</sup> S 30. See Bohan and McCarthy (2008) par 17.30.



in favour of B, C and D (who are all over the age of 21 years) at the date of A's death on 31 March 2007, but the executors were only able to transfer the property on 31 March 2009, then the valuation date will be 31 March 2009, on which date the liability for the six percent initial charge will arise.<sup>211</sup>

To provide relief for instances where tax avoidance was not likely to have motivated the settlement, the Act provides that the DTT charge shall not apply in relation to a discretionary trust, which has been created exclusively (a) for public or charitable purposes in the Republic of Ireland or Northern Ireland,<sup>212</sup> or (b) for certain superannuation schemes that operate mainly on a discretionary basis,<sup>213</sup> or (c) for the purpose of a registered unit trust scheme,<sup>214</sup> or (d) for the benefit of one or more named individuals, who, because of age or physical, mental or legal incapacity, is or are unable to manage his/her or their own affairs,<sup>215</sup> or (e) for the purpose of providing for the upkeep of a house or garden.<sup>216</sup> DTT shall furthermore not apply in relation to a discretionary trust where the state takes an inheritance upon the termination of the settlement.<sup>217</sup>

Where, under or in consequence of any disposition, property is subject to a "chargeable discretionary trust" on 31 December of any year, the trustees are deemed to become beneficially entitled in possession to an absolute interest in that property on such date and

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<sup>211</sup> See example at Bohan and McCarthy (2008) par 17.30.

<sup>212</sup> S 17(1)(a).

<sup>213</sup> S 17(1)(b).

<sup>214</sup> S 17(1)(c).

<sup>215</sup> S 17(1)(d).

<sup>216</sup> S 17(1)(e).

<sup>217</sup> S 17(2)(a).



to take an inheritance on each such date.<sup>218</sup> The charge is levied at one percent per year.<sup>219</sup>

A “chargeable discretionary trust” is a discretionary trust in relation to which the disponent is dead and none of the “principal objects” (namely potential beneficiaries which can either be a spouse, a child or a child of a predeceased child of the disponent)<sup>220</sup> of the trust are under the age of 21 years.<sup>221</sup> To avoid a double charge to CAT, a chargeable discretionary trust is exempt from the annual levy in the year that the trust has been subjected to the initial six percent charge.<sup>222</sup> The same categories of discretionary trusts which are exempt from the initial six percent charge are also exempt from the annual levy.<sup>223</sup> The valuation date for the annual charge is the 31 December each year after the date on which a trust becomes a chargeable discretionary trust (provided that the annual levy will not also be charged in the first year).<sup>224</sup> Where, however, the valuation date (of the six percent charge) falls after the first chargeable date of the annual levy, the Act provides that the valuation date for the annual levy will be the same date as the valuation date of the six percent charge.<sup>225</sup> In the example above, the discretionary trust will be exempt from the annual levy on 31 December 2007. The annual levy due on 31 December 2008 will be postponed until the valuation date for the six percent charge on 31 March 2009. The next annual levy will be charged on 31 December 2009.<sup>226</sup>

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<sup>218</sup> S 20(1). See in general Bohan and McCarthy (2008) pars 17.47–17.51.

<sup>219</sup> S 23.

<sup>220</sup> Ss 14, 19.

<sup>221</sup> S 19.

<sup>222</sup> S 20(4).

<sup>223</sup> S 22.

<sup>224</sup> S 21(b)(i). See in general Bohan and McCarthy (2008) par 17.53.

<sup>225</sup> S 21(b)(ii).

<sup>226</sup> See Bohan and McCarthy (2008) par 17.53.

In view of the fact that some avoidance techniques were developed that sought to escape the requirements for a discretionary trust on the chargeable date (31 December) by, for example, the appointment by the trustees of a 30-day interest in possession in the entire trust property in favour of one or more beneficiaries, an anti-avoidance provision was introduced which provides the following:

- where under or in consequence of a disposition, property was subject to a discretionary trust *prior* to the chargeable date; and
- where such property is not on that chargeable date subject to that discretionary trust, because a person is beneficially entitled or has an interest in possession in such property for the time being; and
- where such property is to be subjected to that chargeable discretionary trust again within a period of five years, then the trust will be subject to the annual levy.<sup>227</sup>

Where the trustees appoint trust assets to a beneficiary ultimately, the acquisition by the beneficiary will attract mainstream CAT (if the beneficiary acquires the benefit for less than full consideration).<sup>228</sup> The beneficiary will be deemed to take an inheritance where the discretionary trust was created by will<sup>229</sup> or by a disposition made within two years prior to the death of the disponent<sup>230</sup> or by a disposition *inter vivos* in the case where such interest was only to come into operation on a death.<sup>231</sup> In all other circumstances, the beneficiary will be deemed to take a gift.<sup>232</sup> For this mainstream CAT charge the ordinary jurisdictional rules will apply,<sup>233</sup> except for a gift taken under a discretionary trust, which

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<sup>227</sup> S 20(2).

<sup>228</sup> Keogan (2007) *Law Soc Gaz* 40.

<sup>229</sup> S 31(b)(i).

<sup>230</sup> S 31(b)(ii).

<sup>231</sup> S 31(b)(iii). E.g. where an *inter vivos* settlement creates a life interest with the remainder to a discretionary trust. All appointments to trust beneficiaries after the death of the life tenant would be regarded as inheritances. See Bohan and McCarthy (2008) par 17.19.

<sup>232</sup> S 31.

<sup>233</sup> See par 10.2.2.

will in addition to all the ordinary rules, also be subject to CAT where the disponent is resident or ordinarily resident at the date of the gift.<sup>234</sup> For example, where A transferred non-Irish assets to a discretionary trust at a time when he was not resident or ordinarily resident in the state, a subsequent distribution by the trustees to a beneficiary (not resident or ordinarily resident at the date of the gift) at a time when A is resident or ordinarily resident in the state will qualify as a taxable gift for the purposes of CAT.<sup>235</sup>

## 10.7 TREATMENT OF LIMITED INTERESTS AND BARE *DOMINIUM*

### 10.7.1 The Position of Bare *Dominium*

For the purposes of CAT, bare *dominium* constitutes a reversionary interest, the taxation of which is deferred until the moment that the interest materialises into full ownership. See example 1 below. It should be evident that the deferral approach largely prevents taxpayers from concealing a passive transfer of property through passage of time.

### 10.7.2 The Creation of Limited Interests

The granting of a limited interest (whether *inter vivos* or on death) constitutes a taxable disposition to the extent that the interest is acquired for inadequate consideration. The limited interest is valued with reference to its period of enjoyment (whether the transfer occurs during life or on death).<sup>236</sup>

#### Example 1:

1.1 A (an Irish resident) donates bare *dominium* in South African property valued at €100 000 to his son C subject to a lifelong usufruct in favour of B (B did not provide any consideration to A). Assume that the value of the “life interest” valued with reference to B’s life expectancy at the date of the settlement

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<sup>234</sup> S 6(2)(b).

<sup>235</sup> Bohan and McCarthy (2008) par 3.04.

<sup>236</sup> See par 10.3.5.



is €70 000. B will be liable for CAT on the interest valued at €70 000 (less any exemptions). B (an Irish resident) dies five years later at a time when the market value of the property is €150 000. C will now take an inheritance from A (even if he is still alive) valued at €150 000 (less any exemptions).

1.2 A (an Irish resident) bequeaths bare *dominium* in South African property valued at €100 000 to his son C subject to a lifelong usufruct in favour of B. Assume that the value of the “life interest” valued with reference to B’s life expectancy at the date of the settlement is €70 000. B will be liable for CAT on the interest valued at €70 000 (less any exemptions). B (an Irish resident) dies five years later at a time when the market value of the property is €150 000. C will now take an inheritance from A valued at €150 000 (less any exemptions).

In the case of successive interests, the position will be as follows:

**Example 2:**

A (an Irish resident) bequeaths bare *dominium* in South African property valued at €100 000 to his son D subject to a lifelong usufruct in favour of B. A’s will provides that, on B’s death, C will be entitled to a lifelong successive interest in the property. B will be liable for CAT on the acquisition of the life interest calculated with reference to his own life expectancy (say €70 000). On the death of B (an Irish resident), C will become liable for CAT on the value of the interest calculated with reference to C’s life expectancy at that point in time (say €80 000). On the death of C (an Irish resident), D will become liable for CAT on the **full value** of the property.

### 10.7.3 The Termination of Limited Interests

A limited interest is terminated through passage of time, death or upon renunciation. The termination of an interest through the lapse of time or because of the death of an interest holder merely signals the acquisition of another interest in the hands of the successive beneficiary (either the successive interest holder or the reversionary interest holder). The transfer occurs between the initial transferor and the successive interest holder/bare *dominium* owner. As a consequence, any consideration paid for the earlier acquisition of the bare *dominium* by the bare *dominium* owner may be taken into consideration, as will appear more fully from the example below:

**Example 3**

Suppose that C (in example 1.2 above) paid consideration of €15 000 for the acquisition of the bare *dominium* (50% of the value of the bare *dominium* at that point in time (€30 000)). When C takes the



inheritance on B's death, a deduction will be allowed for 50% of €150 000. C will therefore be liable for CAT on €150 000 – €75 000 = €75 000 (less any exemptions).

Where a limited interest is terminated because of a renunciation, then special rules apply, the effect of which is generally to accelerate the acquisition for the successive interest holder or the bare *dominium* owner. The problem in this area is that any consideration paid by such beneficiary (to the original interest holder) on the renunciation cannot reduce the value of the transfer between the original owner and the successive interest holder/bare *dominium* owner.<sup>237</sup>

#### Example 4

Suppose that B (in example 1.1 above) renounces his usufruct in favour of C when the value of the usufruct is €50 000 and the value of the property is €120 000. C provides consideration of €5 000 to B for the renunciation. C will be liable for CAT on €120 000, which amount will not be reduced with the consideration of €5 000, because the transfer occurs between A (the original owner) and C.

## 10.8 GENERAL ANTI-AVOIDANCE RULE

Although the Act does not contain a general anti-avoidance provision, the Taxes Consolidation Act provides for a general provision which applies to any tax, levy, duty or charge placed under the administration and management of the Irish revenue authorities. The particular section provides that, in the event of a transaction giving rise to a tax advantage, revenue can hypothetically reconstruct the facts as if the transaction or scheme

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<sup>237</sup> The Act deems the initial disposition to have happened immediately before the ending of the relevant interest, which means that the primary inheritance tax liability will always be maintained as if the life tenant had died immediately prior to the earlier termination (s 33). In addition, the taking of the further interest on the renunciation will constitute a separate taxable event. However, to counter the double taxation, the Act provides that the net tax payable on the earlier event may be deducted as a credit against the later tax liability (up to the net amount of that liability), which effectively means that there will usually be no CAT payable on the renunciation (and only on the deemed inheritance on the full value of the property). See s 105. If there was any consideration paid for the renunciation, then such consideration will reduce the value of the taxable gift between the life tenant and remainder man. The consideration will not affect the value of the (deemed) taxable inheritance. This in turn means that any consideration paid for the interest will (because of the operation of the credit) have no effect on the tax payable. See CAT Manual pt 7 “Break-up of Settlements and Trusts”, available at <http://revenue.ie> (accessed on 30 August 2009). See Bohan and McCarthy (2008) pars 16.12–16.15 for example calculations.

has not taken place.<sup>238</sup> One of the main defences to this provision is if the persons have entered into the transaction for a “legitimate business purpose”.<sup>239</sup> However, Bohan and McCarthy mention that it is “difficult to see how such a defence would be available to CAT which depends on a gratuitous benefit for the charge to CAT to arise”.<sup>240</sup>

## 10.9 CAPITAL GAINS TAX

### 10.9.1 Capital Gains Tax Consequences

Capital gains tax was introduced in Ireland in 1975. A carry-over base-cost approach was initially applied in respect of unrealised capital gains on the death of the owner. However, a stepped-up base-cost approach was adopted in 1978, which is still in force today.<sup>241</sup> Gifts have, by contrast, always been regarded as chargeable disposals which are deemed to occur at open market value.<sup>242</sup>

A few brief comments on the position of trusts seem to be appropriate in view of the possible overlap with DTT. The basic idea is that the trustees of a trust are treated as a single continuing body of persons for the purposes of CGT.<sup>243</sup> Any disposal of assets to a trust will therefore be regarded as a disposal for the purposes of CGT. A transfer for inadequate consideration will be regarded as a gift, notwithstanding the fact that the disposer may have an interest in the trust.<sup>244</sup> Disposals of assets by trustees during the

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<sup>238</sup> Taxes Consolidation Act s 811. See Bohan and McCarthy (2008) par 20.28 *et seq* for a comprehensive discussion.

<sup>239</sup> Bohan and McCarthy (2008) par 20.29.

<sup>240</sup> Bohan and McCarthy (2008) par 20.29.

<sup>241</sup> Taxes Consolidation Act 39 of 1997 prt 19 Ch 3 s 573.

<sup>242</sup> Taxes Consolidation Act prt 19 Ch 3 s 547.

<sup>243</sup> Taxes Consolidation Act prt 19 Ch 3 s 574.

<sup>244</sup> Taxes Consolidation Act prt 19 Ch 3 s 575.

existence of the trust will be subject to CGT in the hands of the trustees according to the normal rules.<sup>245</sup> Where a beneficiary becomes absolutely entitled as against the trustees to any assets the assets are deemed to have been disposed of by the trustees to the beneficiary and the trustees will be subject to CGT<sup>246</sup> (unless the beneficiary becomes entitled to the property as a result of a life tenant's death, in which case there will be no taxable disposal and the base cost will be stepped up for the beneficiary<sup>247</sup>). In the event of a capital loss which cannot be deducted from other chargeable gains accruing to the trustees in the year, the loss will be treated as having accrued to the beneficiary.<sup>248</sup>

### 10.9.2 Interaction with CAT

Because the distribution of the asset to the beneficiary triggers a liability for CAT in the hands of the beneficiary, CATCA provides that any capital gains tax payable (by the trustees) may be allowed as a credit against the CAT in the hands of the beneficiary in so far as it has been paid, provided that the beneficiary does not dispose of the property within two years of having acquired it.<sup>249</sup> Bohan and McCarthy concede that the allowance of this credit is illogical for two reasons, namely (a) capital gains tax is a liability of the disponent (the trustees), whereas CAT is the primary liability of the beneficiary and (b) CAT is usually payable in advance of the capital gains tax.<sup>250</sup>

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<sup>245</sup> Taxes Consolidation Act prt 19 Ch 3 s 568.

<sup>246</sup> Taxes Consolidation Act 19 Ch 3 s 576(1).

<sup>247</sup> Taxes Consolidation Act prt 19 Ch 3 s 577. If the assets remain settled in the trust, the base cost will be stepped up in the hands of the trustee.

<sup>248</sup> Taxes Consolidation Act 19 Ch 3 s 576(2).

<sup>249</sup> S 104. See in general Bohan and McCarthy (2008) par 8.26–8.31 and Doyle (2008) 856 (example 34.25).

<sup>250</sup> Bohan and McCarthy (2008) par 8.26.



## 10.10 CONCLUSIONS

- (a) In Ireland the taxation of wealth transfers is currently levied in a single statute under Capital Acquisitions Consolidation Act (CATCA).<sup>251</sup>
- (b) Although a single tax referred to as “CAT” (capital acquisitions tax) is levied on both gifts and inheritances under a broad range of over-arching levying provisions, the Act distinguishes between acquisitions taken “on death” (referred to as “inheritances”) and acquisitions taken “otherwise than on death” (referred to as “gifts”).<sup>252</sup>
- (c) For some purposes, the distinction is irrelevant, whereas for others it is significant. The jurisdictional basis for both gifts and inheritances is established according to the same rules. However, where the status of the recipient becomes relevant (where the disponer is not resident in Ireland) the rules refer to a “date of gift” (in the case of a gift) and a “date of inheritance” (in the case of an inheritance). Although it seems as if there is a distinction between gifts and inheritances, both dates refer to the date when the beneficiary becomes beneficially entitled to the property comprised in the gift or inheritance.<sup>253</sup> The double tax agreements, unilateral relief provisions, tax rate and ordinary valuation rules (as discussed in paragraph 10.3) also apply to both gifts and inheritances.<sup>254</sup>
- (d) The preferential valuation regimes for agricultural property and business property apply for both gifts and inheritances. However, the minimum-ownership rules differ depending on whether the property is transferred by

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<sup>251</sup> See par 10.1.1 n 2 and accompanying text.

<sup>252</sup> See par 10.2.1.

<sup>253</sup> See par 10.2.2.

<sup>254</sup> See pars 10.2.3, 10.1.2 and 10.3.2-10.3.5.



virtue of a gift (in which case the Act requires a period of five years) or by virtue of an inheritance (in which case the Act requires a period of two years only). This is understandable if one considers that, unlike a gift, death is usually an uncalculated event.<sup>255</sup>

- (e) A unique feature of the Act is that the liability for the tax is generally deferred until the moment of acquisition in the hands of the beneficiary (referred to as the “valuation date”), which may occur later in time than the disposition under which it was created. The valuation date of a gift differs, however, from the valuation date of an inheritance. The special circumstances of transfers on death (which are subject to a process of probate) in contrast to transfers during life, are taken into consideration. The valuation date for an inheritance usually occurs only once the deceased estate had been finalised.<sup>256</sup>
- (f) But for a few exceptions, most of the exemptions apply equally to gifts and inheritances. However, a few exemptions are applicable only to either a gift or an inheritance. The parental exemption, for example, applies only to inheritances taken after parental gifts. In addition, the Group A threshold applying to parents is relevant only in respect of inheritances. Furthermore, the small gifts exemption applies only in relation to gifts.<sup>257</sup>
- (g) The approach to wealth transfer taxation in Ireland took a radical change when the English-based estate duty was replaced by a recipient based tax with the introduction of capital acquisitions tax (CAT) in 1975.<sup>258</sup> CAT

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<sup>255</sup> See par 10.5.3.

<sup>256</sup> See par 10.3.1.

<sup>257</sup> See par 10.5.4.

<sup>258</sup> See par 10.1.1.



represents a typical example of a recipient-based tax where the relationship between the transferor and the recipient is significant for the calculation of the tax. The paragraphs below will highlight some characteristics and problem areas (similar to the areas identified under the South African wealth transfer tax system in Chapter 7).<sup>259</sup>

- (h) In regard to the demarcation of the jurisdictional basis of the Act, the legislature was confronted with the dilemma whether the connection of the tax base should be established with reference to the transferor or with reference to the recipient. Currently, the jurisdictional basis of the tax is determined with reference to both the transferor and the recipient. The connection with the transferor is a remnant of the transferor-based estate duty that was levied in Ireland prior to the introduction of CAT.<sup>260</sup>
- (i) In respect of some “dispositions” the Act requires impoverishment and enrichment, whereas for others, enrichment is sufficient. The absence of the impoverishment requirement for an acquisition under a “failure to exercise a right” (provided for in paragraph (h)) has, for example, caused the application of CAT to be so broad that a failure to take up a valuable right or a failure to exercise an option below market value would fall within the ambit of the tax base. Furthermore, a “disposition” (in whichever form) does not require an intention to donate (or confer a benefit). However, commentators have pointed out that it seems unfortunate that *bona fide* commercial transactions are not sheltered from the scope of CAT (such as in the United Kingdom).<sup>261</sup>

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<sup>259</sup> See Ch 7 par 7.4.

<sup>260</sup> See par 10.2.2.1.

<sup>261</sup> See par 10.2.1.



- (j) In line with the trend of the Act to attribute transfers made and received by a company to the beneficial owners of the company, a value-shifting arrangement in a close company is attributed to the individual participators therein.<sup>262</sup>
- (k) Because of the broad ambit of the charging provisions, life policy benefits (whether acquired through a deceased estate or through a third party nomination) are comfortably charged to CAT under the normal rules. What is noteworthy is that a person takes a taxable gift or inheritance only to the extent that the benefits are received otherwise than for full consideration. A beneficiary of a policy will therefore not be liable for CAT on benefits received to the extent that he or she paid the premiums in respect of such policy or any other consideration for the acquisition thereof. Business assurance and key-man policies will therefore usually be sheltered from the tax base (provided that the deceased did not contribute to the policy).<sup>263</sup>
- (l) Although the concepts of a *fideicommissum* and a usufruct are foreign to Irish property law, these interests are considered as “limited interests” for the purposes of CAT and are therefore treated in a similar fashion to the interests of life tenants under fixed trusts. Bare *dominium* property is therefore classified as a “reversionary interest”.<sup>264</sup> For the purposes of CAT the taxation of bare *dominium* property is deferred until it materialises into full ownership.<sup>265</sup>

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<sup>262</sup> See par 10.2.1.

<sup>263</sup> See pars 10.2.1, 10.2.4 and 10.5.1.

<sup>264</sup> See par 10.6.3.1.

<sup>265</sup> See par 10.7.1.



- (m) As a consequence of the deferral of the taxation of the bare *dominium*, taxpayers will largely be prevented from concealing a passive transfer of property through passage of time.<sup>266</sup>
- (n) A limited interest is valued with reference to actuarial tables and its period of enjoyment, notwithstanding the fact that the full value of the bare *dominium* property would be taxed at a later event.<sup>267</sup> This approach is comfortably accommodated in the system because CAT is levied from the perspective of the recipient.
- (o) On the materialisation of the bare *dominium* into full ownership, the transfer occurs between the original owner and the bare *dominium* owner, as a consequence of which any consideration paid for the bare *dominium* by the bare *dominium* owner to the original owner may be taken into account in the calculation of CAT.<sup>268</sup>
- (p) The death of an interest holder does not pose any significant difficulties for the system because such an event merely accelerates the acquisition of a successive interest in the hands of either a successive usufructuary or a bare *dominium* owner.<sup>269</sup>
- (q) The renunciation of a limited interest also accelerates the acquisition of a successive interest. The problem in this area is that any consideration paid by the successive interest holder/bare *dominium* owner (to the original interest holder) for the renunciation cannot reduce the value of the transfer

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<sup>266</sup> See par 10.7.1.

<sup>267</sup> See par 10.7.2.

<sup>268</sup> See par 10.7.3.

<sup>269</sup> See par 10.7.3.

(of the property) between the original owner and the successive interest holder/bare *dominium* owner.<sup>270</sup>

- (r) Under the CAT regime, tax avoidance through the use of interest-free loans is countered by virtue of a provision that the free use or enjoyment of any property (to which a person is not beneficially entitled in possession) constitutes a gift of the annual value of such free use to the person enjoying the free use of the property.<sup>271</sup>
- (s) Because the indefinite deferral of CAT in the case of discretionary trusts crystallised as a problem area, CATCA introduced a special discretionary trust tax (DTT) regime in the 1980s. The regime provides for special charges on the trustees of the trust, which is in line with the tax system's notion to personify trusts for fiscal purposes. Firstly, there is an initial charge of six percent on any acquisition by the trust (received under a disposition as defined). In addition, a chargeable discretionary trust will become subject to an annual levy (taxed at one percent on the value of the assets). Any subsequent appointment of a trust in a beneficiary will then attract mainstream CAT.<sup>272</sup>
- (t) In the area of capital gains tax, commentators have pointed out that it seems awkward that the tax systems allows a credit for CGT against the CAT payable on a distribution of property to a trust beneficiary, because CGT is payable by the trustees, whereas CAT is payable by the beneficiary.<sup>273</sup> If one considers, however, that CGT payable on a distribution of property to a

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<sup>270</sup> See par 10.7.3.

<sup>271</sup> See par 10.2.1.

<sup>272</sup> See par 10.6.

<sup>273</sup> See par 10.9.



beneficiary is basically charged on the growth of the property from its entrance into trust to the moment of distribution, over which period the trust was also liable for annual DTT levies, it is arguable that the CGT credit is a measure to relieve the excessive tax burden on the property.

- (u) Substantial relief is afforded to business property and agricultural property in the form of a substantial remittance of the tax liability.<sup>274</sup>
- (v) Administrative inefficiency, which is generally regarded as one of the major drawbacks of a recipient-based tax with a larger number of taxpayers, does not seem to plague the system, arguably because CAT is collected in terms of a self-assessment system.<sup>275</sup>

The next chapter contains the final conclusions and recommendations of this thesis.

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<sup>274</sup> See par 10.5.3.

<sup>275</sup> See par 10.4.

## CHAPTER 11

### CONCLUSIONS AND RECOMMENDATIONS

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## 11.1 INTRODUCTION

In Chapter 1 it was stated that this study will at the outset investigate the conceptual justification for wealth transfer taxation in a South African context, especially in view of the fact that a deemed-realisation approach has been applied on the death of a taxpayer since the introduction of capital gains tax in the tax system in 2001. In addition, this thesis identified two key policy issues under the current (transferor-based) South African wealth transfer tax system, levied in the form of estate duty and donations tax. The first issue deals with the lack of integration experienced under the current system and the second issue deals with the centuries-old debate on whether a transferor-based tax or a recipient-based tax is best suited to tax wealth transfers.<sup>1</sup>

It was concluded in Chapter 4 that principles of equity demand that wealth transfer taxation is indeed warranted and desirable for the South African tax system, but that, from a theoretical perspective, transferor-based taxation (together with a deemed-realisation capital gains tax approach) is unjustifiable and that wealth transfer taxation should ideally be levied on the recipient.<sup>2</sup> Paragraph 11.2 below provides conclusions and recommendations on the improvement of neutrality between *inter vivos* transfers and transfers on death in the South African wealth transfer tax system, while paragraph 11.3 addresses the transferor-based tax/recipient-based tax debate to arrive at some recommendations for the South African context.

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

<sup>2</sup> See Ch 4 par 4.6(h) and (i).



## 11.2 THE INTEGRATION OF THE TAXATION OF *INTER VIVOS* TRANSFERS AND TRANSFERS ON DEATH

### 11.2.1 General

It was pointed out that the taxation of inheritances, some of the earliest forms of taxation, was gradually complemented by the taxation of gifts.<sup>3</sup> It was proposed that this study would attempt to outline the level of integration that should ideally exist between the taxation of *inter vivos* transfers and transfers on death in a South African context. To arrive at a conclusion in this regard, the systems in the United Kingdom, the Netherlands and Ireland were examined in Chapters 8, 9 and 10 to *inter alia* explore possible ways to improve the integration of *inter vivos* transfers and transfers on death in a wealth transfer tax system. This subsection briefly points to the lack of integration in the current South African system and outlines the level of integration between *inter vivos* transfers and transfers on death in the international systems. Thereafter, some recommendations are provided for the improvement of integration under the South African system.

### 11.2.2 Discrepancies in the South African Wealth Transfer Tax System

Chapter 7 pointed out a number of discrepancies that exist between the taxation of *inter vivos* transfers and transfers on death under the current South African wealth transfer tax system, which are not conducive to equity, such as the following:

- estate duty is levied under the Estate Duty Act,<sup>4</sup> whereas donations tax is levied under the Income Tax Act;<sup>5 6</sup>

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<sup>3</sup> See Ch 3 par 3.4(a).

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

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

<sup>6</sup> See Ch 7 par 7.2.2.1.



- estate duty is levied on a (limited) worldwide as well as a *situs* basis, whereas donations tax is only levied on a (limited) worldwide basis;<sup>7</sup>
- estate duty is levied with reference to a person “ordinarily resident” in the republic, whereas donations tax is levied on a “resident”;<sup>8</sup>
- the double taxation agreements concluded for the purposes of wealth transfer taxation, with the exception of the agreement entered into with the United Kingdom, apply only to transfers on death;<sup>9</sup>
- unilateral relief is available under the estate duty provisions, but similar relief is not contained under the donations tax provisions;<sup>10</sup>
- the Estate Duty Act contains special valuation rules for unquoted shares, whereas the donations tax provisions do not contain a similar valuation rule;<sup>11</sup>
- for the purposes of estate duty, usufructuary and other like interests are valued with reference to the life expectancy of the beneficiary (unless the period of enjoyment is fixed), whereas, for donations tax purposes, these interests are generally valued with reference to the life expectancy of the donor (unless the period of enjoyment is fixed);<sup>12</sup>
- some exemptions are, it is submitted, unjustifiably offered under the donations tax provisions, without corresponding relief provided for under the Estate Duty Act;<sup>13</sup>
- the general anti-avoidance rule contained in the Income Tax Act also applies to donations tax, whereas the Estate Duty Act does not contain a similar provision.<sup>14</sup>

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<sup>7</sup> See Ch 7 par 7.2.2.2.

<sup>8</sup> See Ch 7 par 7.2.2.2.

<sup>9</sup> See Ch 7 par 7.2.2.3.

<sup>10</sup> See Ch 7 par 7.2.2.3.

<sup>11</sup> See Ch 7 par 7.2.2.4.

<sup>12</sup> See Ch 7 par 7.2.2.4.

<sup>13</sup> See Ch 7 par 7.2.2.5.

<sup>14</sup> See Ch 7 par 7.2.2.6.



It is therefore not surprising that the Margo Commission (in the 1980s) and the Katz Commission (in the 1990s) identified the lack of integration between the two different tax regimes as an area in need of tax reform and proposed the introduction of an integrated regime (referred to as a “capital transfer tax”) to integrate donations tax and estate duty in the South African tax system.<sup>15</sup> Government still has to act on this recommendation.

### 11.2.3 The Level of Integration in the Countries Surveyed

It is evident from the comparative survey that the extent of integration between the taxation of donations (gifts) and inheritances differs from system to system. The most significant observation is that in all three systems gifts and inheritances are, contrary to the current position in South Africa, dealt with in a single statute.<sup>16</sup>

Despite the fact that gifts and inheritances are taxed in a single statute in the United Kingdom, the Netherlands and Ireland, all three acts differentiate between *inter vivos* transfers (referred to as “lifetime transfers” in the United Kingdom, “gifts” in the Netherlands and acquisitions taken “otherwise than on death” in Ireland) and transfers on death (referred to as “transfers on death” in the United Kingdom, “inheritances” in the Netherlands and acquisitions taken “on death” in Ireland).<sup>17</sup>

In the United Kingdom and the Netherlands, gifts and inheritances are taxed under separate charging provisions. In the United Kingdom the tax is referred to as “inheritance tax” in the case of both lifetime transfers and transfers on death, whereas in the Netherlands a distinction is made between “gift tax” (on gifts) and “inheritance tax” (on inheritances).<sup>18</sup> Ireland, on the other hand, levies an integrated tax (referred to as capital

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<sup>15</sup> See Ch 1 par 1.1 and Ch 3 par 3.3.2.3.

<sup>16</sup> See Ch 8 par 8.10(a); Ch 9 par 9.10(a) and Ch 10 par 10.10(a).

<sup>17</sup> See Ch 8 par 8.10(b); Ch 9 par 9.10(b) and Ch 10 par 10.10(b).

<sup>18</sup> See Ch 8 par 8.10(b); Ch 9 par 9.10(b).



acquisitions tax (CAT)) under a number of overarching charging provisions, which are designed to cater for both types of transfers.<sup>19</sup>

The provisions regarding the jurisdictional basis, unilateral double taxation relief and ordinary valuation rules<sup>20</sup> apply in general equally to *inter vivos* transfers and transfers on death in all three systems. In Ireland, the double taxation agreements cover both types of transfers. However, in the United Kingdom and the Netherlands some of the agreements apply to transfers on death only, which appears to be detrimental to tax neutrality, especially if one considers that the unilateral relief provisions provided for in those countries apply to both *inter vivos* transfers and transfers on death. The position is worse in the Netherlands, where the unilateral relief provisions are applicable only in the absence of a double taxation agreement, contrary to the position in the United Kingdom, where the unilateral provisions may provide relief even where a double taxation agreement is in place with a relevant country (which would mitigate inequities that may arise as a result of a double taxation agreement not covering lifetime transfers).<sup>21</sup>

The preferential valuation regimes for agricultural property (in the United Kingdom and Ireland), qualified country estates (in the Netherlands) and business property (in all three systems) apply equally to *inter vivos* transfers and transfers on death, except that all three systems' rules differentiate between the two transfers to a limited extent. For example, both the Dutch and Irish regimes require a longer period of minimum ownership in the case of a gift than in the case of an inheritance for the application of business relief (in the Netherlands and Ireland) and agricultural relief (in Ireland). In the United Kingdom,

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<sup>19</sup> See Ch 10 par 10.10(b).

<sup>20</sup> The valuation rules referred to in Ch 8 par 8.3, Ch 9 par 9.3 and Ch 10 par 10.3 (but not including the preferential valuation rules).

<sup>21</sup> See Ch 8 par 8.10(c); Ch 9 par 9.10(c) and Ch 10 par 10.10(c).



special rules apply for a lifetime transfer (which qualified as a PET) where the transferor dies within seven years from the date of the transfer.<sup>22</sup>

In the United Kingdom, the roll-over relief provided for non-agricultural woodlands applies to transfers on death only.<sup>23</sup>

In the area of exemptions, all three systems differentiate between *inter vivos* transfers and transfers on death, although the level of differentiation differs. With only a few exceptions, the Irish system provides an example of a regime where virtually all the exemptions apply to both gifts and inheritances.<sup>24</sup> In the Netherlands, separate provision is made for the exemption of gifts and the exemption of inheritances. In some cases, an exemption for a gift is also correspondingly offered for an inheritance. In regard to the other exemptions, differentiation is (but for a few exceptions) in general justifiable.<sup>25</sup> In the United Kingdom, the majority of the exemptions apply to both lifetime transfers and transfers on death. There are, however, certain exemptions that differentiate between the two types of transfers. Of special significance is the potential exemption afforded to certain lifetime transfers (referred to as the “PET regime”), which is not extended to transfers on death. This regime has fuelled tax avoidance schemes utilising trusts to such an extent that it resulted in the relevant property regime being adopted for most interest in possession trusts since 2006. Because of the severe horizontal inequity that arises between lifetime transfers and transfers on death as a result of the PET regime, it is not surprising that the recently published Mirrlees Review recommended that this regime be repealed from the inheritance tax system.<sup>26</sup>

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<sup>22</sup> See Ch 8 par 8.10(d); Ch 9 par 9.10(d) and Ch 10 par 10.10(d).

<sup>23</sup> See Ch 8 par 8.10(e).

<sup>24</sup> See Ch 10 par 10.10(f).

<sup>25</sup> See Ch 9 par 9.10(e).

<sup>26</sup> See Ch 8 par 8.10(f).



A unique feature of the Irish system is that the rules determining the date of liability (also the valuation date) differentiate between acquisitions taken “on death” and acquisitions taken “otherwise than on death”. Although CAT is usually due once the donee becomes entitled to the property under a gift, the liability for CAT on an inheritance is generally deferred until the estate administration has been finalised.<sup>27</sup> This, it is submitted, provides an excellent example of where the differentiation between the transfers serves as a measure to accommodate any special circumstances.

In both the Netherlands and Ireland the same rate structures apply equally to *inter vivos* transfers and transfers on death.<sup>28</sup> However, in the United Kingdom, transfers on death are taxed at 40 percent, whereas immediately chargeable lifetime transfers are taxed at a rate of 20 percent, unless the person dies within seven years from the transfer, in which case the property will be added to the deceased estate and any tax previously paid will be allowed as a credit. It was suggested that the different rate structures and credit system in the United Kingdom seem unnecessarily complicated and disturb the horizontal equity of the system.<sup>29</sup>

The table below displays the level of integration between *inter vivos* transfers and transfers on death in the wealth transfer tax systems of South Africa, the United Kingdom, the Netherlands and Ireland. The symbol ■ indicates an area where the provisions are fully integrated and the symbol □ indicates an area where discrepancies exist between the two types of transfers.

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<sup>27</sup> See Ch 10 par 10.10(e).

<sup>28</sup> See Ch 9 par 9.10(c) and Ch 10 par 10.10(c).

<sup>29</sup> See Ch 8 par 8.10(g).



	South Africa	United Kingdom	Netherlands	Ireland
Single statute	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Charging provisions	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Jurisdictional basis	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Unilateral tax relief	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Double tax agreements	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Ordinary valuation rules	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Preferential valuation rules (business property and/or agricultural property)	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/> however, special rule for a transfer on death following a PET	<input checked="" type="checkbox"/> however, different minimum-ownership rules	<input checked="" type="checkbox"/> however, different minimum-ownership rules
Exemptions	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Anti-avoidance rule	<input type="checkbox"/>	N/A	N/A	N/A
Rates	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>

#### 11.2.4 Conclusion and Recommendations

It is suggested that it seems conducive to equity, neutrality and tax administration that the rules relating to the jurisdictional basis, unilateral double taxation relief, ordinary valuation rules and preferential valuation regimes apply (in general) equally to *inter vivos* transfers and transfers on death in the wealth transfer tax systems comparatively surveyed. In addition, it seems fair that double taxation agreements apply to both *inter vivos* transfers and transfers on death, such as in Ireland. In most of the systems the same rates apply to all transfers. It is evident, however, that it remains necessary to distinguish between the two types of transfers, because this creates a flexible platform to accommodate special circumstances and differences, such as evidenced by the rules determining the valuation date in Ireland and the different minimum-ownership rules for gifts and inheritances under some of the preferential valuation regimes. Also, in the area of exemptions, it is sometimes warranted to take the type of transfer into consideration, such as the provision for an annual exemption for gifts. However, unjustified



discrepancies (even in the area of exemptions) undermine the equity of a system and should be avoided, such as evidenced by the PET regime in the United Kingdom.

Under the current estate duty and donations tax regimes, the lack of integration between *inter vivos* transfers and transfers on death could be improved by the following measures:

- For the purposes of donations tax, the extension of the tax base to the disposition of South African *situs* property by a donor other than a resident of the republic (in much the same way as provided for under the Estate Duty Act);
- For the purposes of defining the jurisdictional basis under the Estate Duty Act, the replacement of the term “ordinarily resident” in the republic with the term “resident” of the republic;
- The introduction of unilateral double taxation relief provisions for donations tax, based on the example provided under the Estate Duty Act;
- The adaption of the existing double taxation agreements to cover donations tax;
- The introduction of a valuation rule for unquoted shares for the purposes of donations tax, similar to the rule contained in the Estate Duty Act;
- For the purposes of estate duty, the amendment of the valuation rule for usufructuary or other like interests so that such an interest would be valued with reference to the life expectancy of the (deceased) interest holder just prior to his or her death (unless the period of enjoyment is fixed); which amendment would eliminate most of the anomalies under the current regimes (as extensively illustrated in Chapter 7).<sup>30</sup> Such an amendment would also necessitate the repeal of the section 5(1)(b) provisos and the exemption offered for the bare *dominium* owner who previously donated the usufructuary interest (or annuity), as explained in Chapter 7;<sup>31</sup>
- The review of the current exemptions offered under both regimes to eliminate any unjustified discrepancies; and

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<sup>30</sup> See Ch 7 par 7.4.4.4.

<sup>31</sup> See Ch 7 par 7.4.4.4.



- The inclusion of a general anti-avoidance rule in the Estate Duty Act, which could be premised on the rule currently provided for under the income tax legislation.

However, the appropriate level of integration would be to tax *inter vivos* transfers and transfers on death in a single integrated statute, similar to the systems in the United Kingdom, the Netherlands and Ireland. A single fiscal regime would provide the best platform to establish neutrality of treatment between *inter vivos* transfers and transfers on death.

It is consequently suggested that the Estate Duty Act and Part V of the Income Tax Act should be repealed and replaced with a new, integrated fiscal regime set up in terms of a single statute. Such a step would necessitate a comprehensive review of the current system, which could fruitfully be used as an occasion to re-evaluate key policy issues such as whether the system should operate as a transferor-based tax or a recipient-based tax. A major reform operation would also provide a platform to address problem areas such as those identified in Chapter 7.<sup>32</sup>

### **11.3 TRANSFEROR-BASED TAX VERSUS RECIPIENT-BASED TAX**

#### **11.3.1 General**

It was pointed out in Chapter 3 that common-law countries have traditionally preferred transferor-based (estate) taxation, whereas civil-law countries tended to impose recipient-based (acquisition) taxes.<sup>33</sup> With the replacement of the death duties system with estate

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<sup>32</sup> See Ch 7 par 7.4.

<sup>33</sup> See Ch 3 par 3.4(a).



duty and donations tax in 1955, South Africa has followed the trend of the common-law countries and moved away from recipient-based taxation.<sup>34</sup>

The adoption of the English source-based concept of income precluded the taxation of wealth transfers (with the exception of certain remuneratory donations) under ordinary income taxation in South Africa.<sup>35</sup> Although it was explained that wealth transfers could conceptually be accommodated in a comprehensive income tax or even a comprehensive consumption tax,<sup>36</sup> these possibilities were never explored by the South African tax reform commissions.<sup>37</sup>

It was suggested that a transition to a recipient-based wealth transfer tax system should be investigated for the purposes of the South African tax system, especially in view of the strong theoretical appeal of a recipient-based system (as summarised in 11.3.2 below). The possibility of merely including wealth transfers in the “gross income” of the recipient (for the purposes of the Income Tax Act of 1962) was explored in Chapter 4. It was, however, concluded that such a move would be politically and administratively unlikely. It was explained that, in a South African context, the taxation of wealth transfers in the hands of the recipients should instead be accomplished by a recipient wealth transfer tax, which may even be accommodated as a separate schedule to the existing Income Tax Act in much the same way as capital gains tax.<sup>38</sup>

Although the South African tax reform commissions supported transferor-based taxation, it was pointed out that recipient-based taxation was never properly considered by any of them. Also, these commissions were not confronted with the double taxation produced by

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<sup>34</sup> See Ch 3 par 3.4(i).

<sup>35</sup> See Ch 3 par 3.4(h).

<sup>36</sup> See Ch 2 par 2.5(a).

<sup>37</sup> See Ch 3 par 3.4(h).

<sup>38</sup> See Ch 4 par 4.6(f).



the simultaneous levying of capital gains taxation and estate duty/donations tax, because capital gains taxation was introduced in South Africa only in 2001.<sup>39</sup>

Internationally, some of the factors that (apparently) contributed to the choice of transferor-based taxes include (a) administrative simplicity; (b) the fact that an estate tax is paid within a few months after death, whereas the recipient-based taxes are usually collected on the finalisation of the estate administration; (c) the apparent difficulty of fitting trusts into a recipient-based tax, and (d) the different approaches to estate administration between common-law and civil-law countries.<sup>40</sup>

These issues, as well as aspects such as theoretical appeal, administrative feasibility, interaction with capital gains tax and certainty of law, are considered in the discussion below in establishing whether the South African transferor-based system should ideally be replaced with a recipient-based tax regime. In arriving at a thoroughly motivated recommendation in this regard, a selection of problem areas currently experienced under the estate duty and donations tax regimes were identified in Chapter 7.<sup>41</sup> This was done to assist this study in establishing whether recipient-based systems experience similar problems and whether such systems could offer more appropriate solutions.

After considering lessons from the systems comparatively surveyed, the subsection below aims to explain why an integrated recipient-based tax would be superior to the introduction of an integrated transferor-based tax for the purposes of the South African tax system. Chapter 8 provided an overview of the transferor-based tax (called “inheritance tax”) currently levied in the United Kingdom, a traditional common-law country. The system in the Netherlands (a civil-law jurisdiction), which was reviewed in Chapter 9, resembles an example of a classic recipient-based tax. What makes the Irish

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<sup>39</sup> See Ch 3 par 3.4(i).

<sup>40</sup> See Ch 3 par 3.2.3.

<sup>41</sup> See Ch 7 par 7.4.



system, described in Chapter 10, an appropriate choice for the comparative survey is that it provides an example of a common-law country that successfully replaced its estate tax with a recipient-based acquisitions tax.

### 11.3.2 Theoretical Appeal

It was pointed out in Chapter 4 that recipient-based wealth transfer taxation has strong theoretical appeal for the following reasons:

- The principle of ability-to-pay dictates that windfall gains should be taxed in the hands of the recipient, whose taxable capacity is increased by the unearned benefits;
- Equally situated taxpayers are taxed equally under a recipient-based tax, whereas the recipients of wealth transfers are taxed unequally under an estate tax;
- The double (capital gains) tax argument is deflected where wealth transfers are taxed on a recipient basis, because capital gains tax is a tax on the transferor, whereas an acquisitions tax is a tax on the recipient;
- A recipient-based tax encourages the redistribution of resources (a foundational justification for wealth transfer taxation in general), because each recipient will have an exemption threshold;
- From an economic perspective, deferred recipient-based taxation is apparently less likely to distort economic decision-making than taxing the person who accumulated (or saved) the wealth;
- A transferor-based tax is commonly perceived to be a “death tax”, whereas a recipient-based tax is more likely to be experienced as a “transfer tax”.<sup>42</sup>

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<sup>42</sup> See Ch 4 par 4.6(e).



### 11.3.3 Timing of the Tax

A recipient-based tax can easily be designed to deem the acquisition to occur at a later stage than the time when the beneficiary acquires an interest in the property. The tax may for example be deferred until the person acquires the enjoyment or possession of the property (such as provided for under the Irish CAT system)<sup>43</sup> or even until the interest in the property is realised at a later event, such as recommended by Dodge in a recent article on a proposed cash-flow “accessions tax” for the United States.<sup>44</sup> The possibility of deferral may address valuation issues, contingencies and even liquidity concerns.<sup>45</sup>

Although the deferred timing of a recipient-based tax was apparently one of the reasons why common-law countries preferred the imposition of transferor-based taxation,<sup>46</sup> it should be kept in mind that wealth transfer taxes raised significant revenues in the pre-income tax era<sup>47</sup> and that the timing of these taxes was indeed extremely relevant in those days. However, it was shown in Chapter 4 that the contribution of wealth transfer taxes to national tax revenues has generally dropped to below two percent.<sup>48</sup> As a consequence, the timing of wealth transfer taxation has become rather insignificant for the purposes of revenue-raising. In addition, Dodge explains that deferral in itself is not prejudicial to the tax system because “[t]he value of property is the sum of future returns reduced to present value”.<sup>49</sup> He emphasises that all future yield will appear in the wealth transfer tax base of one or more persons.<sup>50</sup>

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<sup>43</sup> See Ch 10 par 10.10(e).

<sup>44</sup> See Dodge (2009) *Hastings Law J* 997 *et seq*, who suggests that a realisation-based accessions tax is appropriate for the US.

<sup>45</sup> See Dodge (2009) *Hastings Law J* 1020.

<sup>46</sup> See Ch 3 par 3.2.3.

<sup>47</sup> See Ch 4 par 4.3.1.

<sup>48</sup> See Ch 4 par 4.3.1.

<sup>49</sup> Dodge (2009) *Hastings Law J* 1035.

<sup>50</sup> Dodge (2009) *Hastings Law J* 1035.



It is therefore suggested that the benefits derived by deferring the tax liability could fruitfully be employed in the South African wealth transfer tax system, if the current estate duty and donations tax regimes were to be replaced by a recipient-based regime. The deferral-benefit in the realm of limited interests will be discussed in more detail in paragraph 11.3.4.3 below and the deferral-problem posed by discretionary trusts will be addressed in paragraph 11.3.4.4 below.

### **11.3.4 Common Problem Areas**

Chapter 7 identified a number of significant problem areas under the donations tax and estate duty regimes.<sup>51</sup> It is evident from the discussions in Chapter 8 (United Kingdom), Chapter 9 (the Netherlands) and Chapter 10 (Ireland) that most of these problem areas are common to wealth transfer taxation in general. Paragraph 11.3.4.1 deals with the issues relating to the demarcation of the jurisdictional basis. Paragraphs 11.3.4.2 to 11.3.4.4 discuss the three problem areas where it is submitted that a recipient-based approach would offer a more appropriate solution for the South African context. Paragraph 11.3.4.5 points out that grossing-up rules are unnecessary in a recipient-based system and paragraph 11.3.4.6 refers to the neutral problem areas in respect of which it is immaterial whether the taxation is levied on a transferor basis or whether it is levied on a recipient basis.

#### ***11.3.4.1 Jurisdictional Basis***

For the demarcation of the jurisdictional basis of a wealth transfer tax the connection with the tax base is sometimes established with reference to residency only (such as the position in the Netherlands)<sup>52</sup> or a combination of residency/domicile and location of

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<sup>51</sup> See Ch 7 par 7.4.

<sup>52</sup> See Ch 9 par 9.10(g).



assets (such as the United Kingdom and Ireland).<sup>53</sup> What is significant to note is that this choice is somewhat independent from whether a system operates on a transferor basis or a recipient basis. Although estate duty and donations tax are primarily levied on a worldwide basis with reference to the resident status of the transferor (combined with a *situs* basis for non-residents),<sup>54</sup> certain foreign assets owned by residents are excluded from the tax base.<sup>55</sup> The issue of whether it is still justifiable to exclude these assets was raised in Chapter 7.<sup>56</sup> It is beyond the scope of this thesis to provide any recommendations on this issue, except to observe that it could be addressed in whichever form wealth transfers are taxed in the South African tax system.

Although it seems obvious that a transferor-based tax focuses on the resident status of the transferor,<sup>57</sup> recipient-based systems do not necessarily link up with the resident status of the recipient, although such an approach would appear to be theoretically sound.<sup>58</sup> In the Netherlands, the jurisdictional basis is established with reference to the status of the transferor. Apparently, this is a remnant of transferor-based taxation that was imposed earlier.<sup>59</sup> It was also explained that a connection with the transferor is (globally speaking) the most popular approach. In addition, the 1982 OECD model convention allocates a higher preference to a contracting state levying taxation with reference to the status of the transferor (than a state levying taxation with reference to the recipient).<sup>60</sup> It is therefore not surprising that the Irish tax system provides for a connection with the recipient as

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<sup>53</sup> See Ch 8 par 8.2.3 and Ch 10 par 10.2.2.

<sup>54</sup> See Ch 7 par 7.2.2.2.

<sup>55</sup> See Ch 5 par 5.2.2.1 and Ch 6 par 6.2.2.1.

<sup>56</sup> See Ch 7 par 7.4.1.

<sup>57</sup> This is the position in South Africa and the UK. See Ch 5 par 5.2.2.1, Ch 6 par 6.2.2.1 (SA) and Ch 8 par 8.2.3.1 (UK).

<sup>58</sup> See comments by Dutch scholars in Ch 9 par 9.2.4.1.

<sup>59</sup> See Ch 9 par 9.10(f).

<sup>60</sup> See Ch 9 par 9.10(h).



well the transferor,<sup>61</sup> thereby acknowledging on the one hand that the status of the taxpayer should be used from a theoretical perspective and, on the other hand, overcoming the difficulties mentioned above. This dual-connection approach is apparently quite common in other European wealth transfer tax systems.<sup>62</sup> Although it is beyond the scope of this thesis to make a recommendation on how a jurisdictional basis of a recipient-based system (if implemented in South Africa) should be established, it is noteworthy that the problems experienced in this area under recipient-based taxation are not insurmountable.

#### *11.3.4.2 The Treatment of Life Insurance Benefits*

Because wealth is “transferred” where a person finances a life policy in favour of a third party, it is in principle understandable that these benefits should be accommodated in the tax base. However, it would seem that transferor-based taxation has more difficulty in dealing with these benefits than recipient-based systems, arguably because the theoretical basis of a recipient-based tax focuses on the net benefits acquired from the perspective of a beneficiary, which is submitted to constitute the best approach to third-party life insurance benefits.

It was pointed out that the problem with life insurance benefits from the angle of (transferor-based) estate duty is that the policy benefits are not channelled through the deceased estate of the insured.<sup>63</sup> Although this was overcome by a deeming provision in South Africa,<sup>64</sup> the problem is that the mere inclusion of the benefits in the deceased estate would have created a harsh result had the beneficiary’s position not been taken into

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<sup>61</sup> See Ch 10 par 10.10(h). This approach has also been suggested for the system in the Netherlands. See Ch 9 par 9.2.4.1.

<sup>62</sup> See Ch 9 par 9.2.4.1.

<sup>63</sup> See Ch 6 par 6.2.4.2.1 n 55.

<sup>64</sup> See Ch 6 par 6.2.4.2.1.



account. It is therefore not surprising that these benefits are accommodated under the South African estate duty regime on a recipient basis.<sup>65</sup> For the purposes of estate duty, the proceeds included in the tax base of the deceased insured may be reduced by the premiums paid by the beneficiary. In addition, the beneficiary is ultimately responsible for the estate duty attributable to the benefits.<sup>66</sup> Such an approach does not reflect the underlying policy of a transferor-based tax.<sup>67</sup> Although it is unclear why third-party policy benefits escape the (transferor-based) inheritance tax base in the United Kingdom,<sup>68</sup> it may at least be observed that the accommodation of these benefits in a transferor-based tax seems to be problematic.

For the purposes of recipient-based taxation, the area of life insurance is not without any challenges. Because a third party acquires life insurance benefits through contractual operation and not by virtue of a “gift” or an “inheritance”, the inclusion of the benefits under the main charging provisions may require some special provisions. For example, in the Netherlands life insurance benefits are deemed to be an inheritance by the beneficiary from the deceased insured through the construction of a fictitious acquisition.<sup>69</sup> However, where the main charging provisions are designed to cover a broad range of transfers, such as under the Irish CAT system, these benefits are comfortably charged to tax under the normal rules. As a consequence, third-party benefits are charged to CAT in the hands of the beneficiary to the extent that such beneficiary did not provide adequate consideration for the benefits.<sup>70</sup>

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<sup>65</sup> See Ch 7 par 7.4.3.

<sup>66</sup> See Ch 6 pars 6.2.4.2.1 and 6.4.

<sup>67</sup> See Ch 7 par 7.4.3.

<sup>68</sup> See Ch 8 par 8.10(l).

<sup>69</sup> See Ch 9 par 9.10(j).

<sup>70</sup> See Ch 10 par 10.10(k).



However, the simple and neutral approach followed under the Irish system is not necessarily mirrored in other recipient-based taxes, because of problems such as the establishment of the economic source of a policy. Prior to 1 January 2010, third-party benefits were taxed in the Netherlands in the hands of the beneficiary where the deceased contributed “something” to the policy. Although the gross value of the proceeds was in principle included, a deduction was offered for all the premiums paid by the beneficiary. This approach was amended with effect from 1 January 2010 to narrow down the deemed inheritance to embrace only benefits “to the extent” that the beneficiary did not provide adequate consideration for these.<sup>71</sup> Third-party benefits are therefore (currently) treated in a way similar to that under the Irish CAT system.

It is submitted that the system in the Netherlands (as amended in 2010) and the Irish CAT regime offer the most appropriate approach to the treatment of life insurance benefits by including only the *pro-rata* benefits (directly or indirectly) “transferred” to the beneficiary, rather than offering a deduction for the premiums against the gross value of the proceeds. Although the deduction of premiums provides some relief, it is submitted that such an approach negates the very nature of life insurance, because the premiums comprise not only a negligible contribution to the capital of the policy but also compensation actuarially calculated to discount the risk factors involved. Also, the *pro-rata* approach eliminates the necessity for provisions exempting key-man benefits and benefits payable in terms of buy-and-sell arrangements from the scope of the tax.<sup>72</sup>

Although recipient-based taxes are not immune to problems relating to third-party life insurance benefits, it seems as though they are better positioned to deal with these issues than transferor-based taxes. Under the South African wealth transfer tax system, life insurance benefits have indeed been taxed on a recipient basis. However, this approach is not conducive to the underlying theory of the system, which focuses on the transfer of

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<sup>71</sup> See Ch 9 par 9.10(j).

<sup>72</sup> See Ch 9 par 9.10(j) and Ch 10 par 10.10(k).



wealth from the perspective of the transferor. It is therefore suggested that a transition to recipient-based wealth transfer taxation in South Africa would benefit the system from the perspective of life insurance benefits.

A final observation is that the current inclusion of all benefits reduced by premiums together with the exception of certain policies payable to a spouse or child, key-man policies and policies effected in terms of buy-and-sell arrangements (subject to certain requirements), seems to be overly complicated and too broad, thereby disturbing the equity of the system and fuelling a lucrative estate planning industry.<sup>73</sup> It is suggested that the *pro-rata* approach followed in Ireland and the Netherlands (since 1 January 2010), seems to provide a simpler and fairer measure to tax these benefits.

#### ***11.3.4.3 The Treatment of Limited Interests and Bare Dominium***

The treatment of limited interests and bare *dominium* property (in the common-law systems referred to as fixed interests and reversionary interests respectively) is a complex area involving the accommodation of the creation and termination of these interests in the tax base, which is also inextricably linked to the valuation of these interests.

There are basically two broad approaches to the position of bare *dominium* property, which is not dependent on whether the system operates on a transferor or on a recipient basis. In terms of the first approach (which will be referred to as the “non-deferral approach”), the taxation of the bare *dominium* (or reversionary interest) is not deferred until it materialises into full ownership, but is immediately taxable. Such an approach is currently followed under the South African *transferor*-based system<sup>74</sup> as well as the *recipient*-based Dutch system.<sup>75</sup> In both systems the usufructuary interest and bare

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<sup>73</sup> See the issues outlined in Ch 6 par 6.2.4.2.1.

<sup>74</sup> See Ch 7 par 7.4.4.2.

<sup>75</sup> See Ch 9 par 9.10(k).



*dominium* property are valued with reference to actuarial tables. In terms of the second approach (referred to as the “deferral approach”), the taxation of the transfer of bare *dominium* property is generally deferred until the bare *dominium* property (or reversionary interest) materialises into full ownership. This approach was followed in the United Kingdom’s *transferor*-based inheritance tax system (prior to the 2006 amendments)<sup>76</sup> and is currently applied in the Irish *recipient*-based CAT system.<sup>77</sup> Although the current United Kingdom regime offers, strictly speaking, a third approach, by taxing limited interests under the discretionary trusts regime (relevant property regime),<sup>78</sup> it is suggested that such an option is totally foreign and would not be feasible in a South African context. This unconventional approach is not explored further in the discussion below.

A common problem experienced under the non-deferral approach followed in South Africa and the Netherlands is that the immediate taxability of the bare *dominium* property may be used to facilitate a passive transfer of wealth through passage of time, which may be amplified by the fact that the value of bare *dominium* (which is usually relatively low) is likely to fit into an exemption bracket.<sup>79</sup>

However, the problems associated with the “aged-donor” phenomenon under the South African system<sup>80</sup> are not mirrored in the Dutch system.<sup>81</sup> What should be noted is that the phenomenon does not arise as a consequence of the difference in valuation approaches followed under the estate duty and donations tax regimes, but as a result of taxing the transfer from the perspective of the transferor in a system where the taxation of the bare

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<sup>76</sup>See Ch 8 par 8.10(n).

<sup>77</sup> See Ch 10 par 10.10(l).

<sup>78</sup> See Ch 8 par 8.10(s).

<sup>79</sup> See Ch 7 par 7.4.4.2 and Ch 9 par 9.10(l).

<sup>80</sup> See Ch 7 par 7.4.4.3.

<sup>81</sup> See Ch 9 par 9.10(m).



*dominium* is not deferred. It is evident from the Dutch system that a recipient-based approach ensures that the creation of interests (whether during life or on death) are treated in an equal manner.

Both the South African and Dutch systems seem to struggle with the accommodation of the *termination* of limited interests in the tax base. In both systems the mere lapse of a limited interest through passage of time has no tax consequences as such (except to the extent that such an event may lead to a taxable acquisition of a successive interest in the Netherlands). This position is justifiable because there is nothing left of the interest to “give away” or to “gain”. It is also understandable that both systems recognise in principle the renunciation of an interest as a taxable event, because the renunciation may confer a benefit to the successor of the enjoyment of the property.<sup>82</sup> However, it seems as though the approach to the termination of an interest because of the death of the interest holder is problematic.

Under the South African system, the cessation of an interest enjoyed by the interest holder just prior to his or her death is specifically included in the estate duty tax base. It was pointed out that this position is, although debatable, on merit understandable if one considers that the untimely death of an interest holder (earlier than expected or before the expiration of a fixed period interest) may passively confer a benefit on the successor to the enjoyment of the property in much the same way as where the interest holder renounces the interest. However, it was shown that the difference in the valuation approaches under the donations tax regime (where limited interests are valued from the perspective of the transferor) in contrast to the estate duty regime (where limited interests are valued from the perspective of the successor) cause a number of anomalies which may largely be rectified by an amendment to the estate duty valuation rules to the effect that all limited interests are valued from the perspective of the transferor. Such a transition would furthermore create neutrality between a “transfer” as a result of

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<sup>82</sup> See Ch 7 par 7.4.4.4 and Ch 9 par 9.7.3.



renunciation and a “transfer” as a result of death. However, it was pointed out that it is arguable that it seems strange and unnatural to consider the life expectancy of the interest holder just immediately before his or her death.<sup>83</sup>

On the other hand, it seems as if the recipient approach followed in the Netherlands, where the focus is on what is acquired by a beneficiary (and not on what is “given away”), offers a more natural approach. It seems to make more sense to determine a person’s life expectancy on the acquisition of an interest (in the beginning), than to establish a “hypothetical” life expectancy just prior to death (at the end). It is suggested that this may in fact be the reason why the South African legislature had chosen to value limited interests on the death of an interest holder over the successor’s life expectancy.

However, the accommodation of the death of an interest holder has also transpired to be problematic in the Netherlands. Contrary to the position in South Africa, an indirect “transfer” of wealth on the death of an interest holder is not captured in the tax base. As a result, there is no neutrality between a “transfer” of the unexpired period of enjoyment on a renunciation (which is included in the tax base) and a “transfer” of the unexpired period of enjoyment on the death of the interest holder (which is not included in the tax base). It was already pointed out that the justification for the inclusion of a “transfer” on the death of an interest holder is debatable. What complicates this issue in a recipient-based system is that the focus of the tax is on the acquisition of property, not on the termination thereof. However, the nub of the problem is that it is virtually impossible to accurately value a limited interest upon acquisition because its period of enjoyment is uncertain. Nevertheless and leaving aside the issue of whether a passive “transfer” occurs on death, it was shown that the absence of tax consequences on death creates some opportunities for tax avoidance through the use of artificial actuarial values, in the absence of any special provisions. The inclusion of the section 10 fiction was an attempt by the legislature to counter tax avoidance. It appears, however, as if the limited scope of the

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<sup>83</sup> See Ch 7 par 7.4.4.4.



fiction falls short in a number of ways. It was therefore suggested that the Dutch system appears to be struggling to find a balance between, on the one hand, acknowledging that death (being a natural cause for the cessation of a limited interest) does not truly reflect an event where benefits are transferred to another, and on the other hand, recognising the possibility of exploitation.<sup>84</sup>

It is arguable that the difficulties explained above could be avoided by merely providing for a deemed transfer on the death of the interest holder of the “unexpired period” of the interest to the successor of the enjoyment of the property, merely to act as a “correction” in the system. However, it may be difficult to justify a transfer on death (as explained above) and such a step would also struggle with the unnatural approach of valuing a benefit with reference to the life expectancy of the interest holder just immediately before his or her death.

What is significant to note is that the difficulties surrounding the death of an interest holder under a non-deferral approach are largely related to the fact that the taxation of the bare *dominium* is not deferred until it materialises into full ownership in such a system.

On the other hand, the difficulties surrounding the death of an interest holder and the possibility of concealing a passive transfer through lapse of time is largely avoided under a deferral approach, such as followed in the United Kingdom (prior to 2006) and Ireland.<sup>85</sup> In these systems each interest is generally taxed as and when it materialises into a “present interest” (meaning an interest conferring on the interest holder the right to the fruits of the property or the enjoyment thereof), which is also conducive to liquidity.

Because the date of liability for tax is deferred until the moment that the interest holder (or owner) acquires the enjoyment and/or fruits of the underlying property (which is

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<sup>84</sup> See Ch 9 par 9.10(n).

<sup>85</sup> See Ch 8 par 8.10(o) and (q); Ch 10 par 10.10(m) and (p).



actually the moment that his or her taxable capacity is increased), a deferral approach best supports the principle of ability-to-pay.

When the Margo Commission briefly commented that it may be advisable to alter the approach towards limited interests under the South African wealth transfer tax system by treating a limited interest holder as the owner of the underlying property,<sup>86</sup> it is highly likely that the Commission was basing its proposition on the approach applied in the United Kingdom prior to March 2006. Although a usufruct, bare *dominium* property and *fideicommissum* are foreign to United Kingdom property law, these interests were taxed under the interest-in-possession regime (“IIP regime”) applicable to fixed trusts (prior to March 2006). Under the inheritance tax regime, usufructuary and fideicommissary interests are treated as “fixed (life) interests” and bare *dominium* property and fiduciary interests are treated as “reversionary interests”.<sup>87</sup> In the event where the granting of the limited interest is immediately taxable, inheritance tax would be levied on the full value of the underlying property and no concession would be granted, because a fixed interest is not valued with reference to actuarial tables. Every accrual of a “present interest” would therefore be treated as a disposition of the underlying property. However, it was pointed out in Chapter 8 that the provision of a concession would make no sense from a transferor perspective (where the tax is levied on what is given away) where the taxation of the bare *dominium* is deferred. The no-concession approach may, however, be justifiable in a United Kingdom context where the holder of a fixed life interest is legally regarded as the “beneficial owner” of the underlying property, especially if one considers that such an interest is usually freely disposable.<sup>88</sup> However, it is suggested that it would be absurd and unfair to regard the holder of a non-transferable usufructuary interest as the “owner” of the underlying property in a South African context, especially if one considers that these interests are generally subject to a number of restrictions.

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<sup>86</sup> See Ch 7 par 7.4.4.2.

<sup>87</sup> See Ch 8 par 8.10(m).

<sup>88</sup> See Ch 8 par 8.10(p).



Usufructuary interests are, for example, not transferable under South African law and the underlying property does not fall in the estate of the usufructuary. Furthermore, these interests are often restricted to a short period of time.

Another problem that was pointed out under the United Kingdom regime is that any consideration paid by the bare *dominium* owner would not reduce the taxable transfer, because a necessary consequence of the deferral approach (in a transferor-based system) is that the transfer occurs between the interest holder and the bare dominium owner (and not the original owner and the bare *dominium* owner).<sup>89</sup>

The Irish CAT regime, where limited interests and bare *dominium* property are also taxed under the fixed trusts regime as fixed interests and reversionary interests, provides an example of a recipient-based system applying a deferral approach.<sup>90</sup> It is significant to observe that the no-concession problem is not mirrored under such a system, because the focus is on the beneficiary. Where a limited interest such as a usufruct is initially granted, a valuation concession is granted in the hands of the usufructuary (which is also the taxpayer), or even a successive usufructuary (in the case of a successive usufruct).<sup>91</sup> However, on the materialisation of the reversionary interest into full ownership, the full value of the property is taxed in the hands of the reversionary interest holder (bare *dominium* owner). Because such a transfer occurs between the original owner and the bare *dominium* owner (and not the interest holder and the bare *dominium* owner such as in the United Kingdom), any consideration paid for the bare *dominium* will pro-rata reduce the value of the transfer.<sup>92</sup> A minor problem occurs in the event of a renunciation in that any consideration paid by the bare *dominium* owner to the original interest holder

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<sup>89</sup> See Ch 8 par 8.10(r).

<sup>90</sup> See Ch 10 par 10.10(l).

<sup>91</sup> See Ch 10 par 10.10(n).

<sup>92</sup> See Ch 10 par 10.10(o).



will not reduce the taxable transfer to the bare *dominium* owner.<sup>93</sup> It is suggested, however, that provisions could be introduced to cater for this scenario.

In conclusion, it is proposed that a deferral approach provides the most appropriate way to accommodate limited interests and bare *dominium* (or fixed interests and reversionary interests) in a wealth transfer tax. The benefit of deferring the taxable event lies in the minimisation of abuse of the low bare *dominium* value, thereby countering schemes whereby property is passively transferred through passage of time. Moreover, the difficulty of capturing a “transfer” on the early termination of an interest on the death of the interest holder is avoided. In addition, the “aged-donor” phenomenon is deflected under such an approach (because the *inter vivos* “splitting” of interest would have no effect).

Furthermore, it should be clear that, in a South African context, the operation of a deferral regime would best be accommodated in a *recipient*-based system, because it allows the system to still accommodate actuarial values for limited interests, for example on the granting of a usufructuary interest. In addition, any consideration paid for the bare *dominium* by the bare *dominium* owner (to the original owner) could be taken into account in the calculation of the bare *dominium* owner’s tax liability (because the transfer of the property occurs between the original owner and the bare *dominium* owner).

A final observation is that, although a deferral approach was followed in South Africa under the Death Duties Act of 1922, it was illustrated in Chapter 7 that such an approach was part of a combined estate-and-succession-duty regime, involving a nightmare of complexities.<sup>94</sup> This regime was a far cry from the regimes currently operative in Ireland (or even the United Kingdom).

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<sup>93</sup> See Ch 10 par 10.10(q).

<sup>94</sup> See Ch 7 par 7.4.4.5.



#### *11.3.4.4 Discretionary Trusts*

It was mentioned in Chapter 3 that the indefinite deferral of the acquisition of trust property in the hands of a beneficiary of a discretionary trust has apparently contributed to the preference for transferor-based estate taxes in some countries.<sup>95</sup> It is submitted, however, that the problems arising from the complex nature of discretionary trusts reaches much deeper than only deferred distributions to beneficiaries and that the problems are not only restricted to recipient-based taxation, as will appear more fully from the discussion below.

The problem in respect of a transfer of property to a discretionary trust centres on the characteristics required for a taxable transfer. Where the charging provisions require an intention to benefit (or donate), such as under the South African system and the regime in the Netherlands, the issue is whether a disposition occurs towards the trust in the absence of an intention to benefit the trustees.<sup>96</sup> The problem is exacerbated where the system requires enrichment in the hands of the beneficiary. Because of similar issues the approach towards a subsequent appointment of trust property to a beneficiary (by the trustees) is in general also troublesome. A further complicating matter is the absence of tax consequences on the death of a contingent beneficiary, or the disposal of a contingent interest during the duration of a trust has contributed to the use of discretionary trusts as generation-skipping tools in sophisticated tax avoidance schemes.

In analysing a system's approach to wealth transfers involving discretionary trusts, it is apparent that there are three positions to take into consideration, namely (a) a transfer of property into a discretionary trust, (b) the approach towards the contingent interests during the duration of a trust and (c) a subsequent appointment of trust property to a beneficiary of a trust. Table 11-1 below attempts to provide a brief summary of the

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<sup>95</sup> See Ch 3 par 3.2.3.

<sup>96</sup> See Ch 5 par 5.6.2 and 5.6.3 and Ch 9 par 9.6.3.1.



position of discretionary trusts in the South African system and the other systems surveyed.

Table 11-1: Discretionary Trusts

	Transferor-based		Recipient-based	
	South Africa	United Kingdom	Netherlands	Ireland
<b>Transfer into Discretionary Trust</b>	Uncertainty because of requirements of intention/enrichment  Special provisions were introduced to deem transfer to trust to be a transfer to trustees  Donations Tax	No requirements for intention/enrichment  An immediately chargeable transfer  Inheritance Tax	Uncertainty because of requirements of intention/enrichment  Initially: case law surprisingly held > taxable transfer to a stranger. But: 2010 introduced APV regime  No tax consequences	No intention to benefit required, but focus of tax is on enrichment of beneficiary  No CAT in terms of general charging provisions  Introduced: Special DTT regime Entrance charge 6%
<b>Duration of Trust</b>	Contingent interests: No tax consequences on beneficiary's death or disposal of contingent interest  No special regime	Contingent interests: No tax consequences on beneficiary's death or disposal of contingent interest  Introduced: Relevant Property Regime Periodic charge of 6% every 10 years	Contingent interests: No tax consequences on beneficiary's death or disposal of contingent interest  Introduced: APV regime. Inheritance tax on settlor's death	Contingent interests: No tax consequences on beneficiary's death or disposal of contingent interest  Introduced: Special DTT regime Annual charge of 1%
<b>Transfer out of Discretionary Trust</b>	Uncertain position in law  Specifically exempt from donations tax  No tax consequences	Exit from trust not captured under general charging provisions  Introduced: Relevant Property Regime Exit charge (fraction of periodic charge)	Uncertain position in law  Introduced: APV Gift or inheritance from settlor or heir > gift/inheritance tax	Captured under general charging provisions  Normal CAT



It is noteworthy that the challenges posed by discretionary trusts have created problems for recipient-based as well as transferor-based wealth transfer taxes. Special regimes to cater for these institutions were introduced in transferor-based systems such as the United Kingdom as well as recipient-based systems such as the Netherlands and Ireland.<sup>97</sup>

Although the Margo Commission and Katz Commission proposed the introduction of a special regime to counter generation-skipping through discretionary trusts under the South African wealth transfer tax system in the 1980s and 1990s respectively, the legislature has not acted on these proposals to date.<sup>98</sup> Considering that this thesis investigates the possibility of replacing the current transferor-based system with a recipient-based regime, the question may be posed which system (recipient-based or transferor-based) would deal more satisfactorily with discretionary trusts in a South African context. Keeping in mind that trusts are generally personified for fiscal purposes in South Africa, it is suggested that the Dutch *afgezonderd particulier vermogen* (APV) regime, where trusts are basically “looked through” for income tax as well as inheritance and gift tax purposes in the Netherlands,<sup>99</sup> would be inappropriate for the South African context, because it would make no sense to tax the income of the trust in the hands of the trustees (or beneficiaries if distributed to them) for income tax purposes, while regarding the settlor to still be the owner of the trust property (for wealth transfer tax purposes). By contrast, the regimes operative in the United Kingdom and Ireland are both underpinned by the idea that trusts should (to a certain extent) be treated as separate taxpayers.

The United Kingdom relevant property regime and the Irish DTT regime are basically mirror-images of each other. Because the focus of the United Kingdom inheritance tax system falls on the disposition from the point of view of the transferor, a transfer to a

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<sup>97</sup> See Ch 8 par 8.10(t); Ch 9 par 9.10(p) and Ch 10 par 10.10(s).

<sup>98</sup> See Ch 7 par 7.4.6.

<sup>99</sup> See Ch 9 par 9.10(p).



discretionary trust attracts inheritance tax in terms of the normal rules. Under the Irish CAT system, where the focus lies on the acquisition in the hands of the beneficiary, CAT is charged on an appointment of property to a beneficiary (in terms of the normal charging provisions). The United Kingdom relevant property regime basically provides for a periodic levy during the duration of the trust together with a special exit charge on the appointment of trust property in a beneficiary, whereas the Irish regime provides for a periodic levy during the duration of the trust together with a special entrance tax on the transfer of property into a trust.<sup>100</sup> However, the significant difference between the two regimes is their interaction with capital gains tax, as will more fully appear from the tables below, where the wealth transfer tax and capital gains tax consequences involving discretionary trusts are compared under the United Kingdom tax system and the Irish tax system:

**Table 11-2: United Kingdom**

Transfer into Trust		Duration of Trust and Appointment in Beneficiary		
Wealth Transfer Tax	Capital Gains Tax	Wealth Transfer Tax: Duration	Capital Gains Tax	Wealth Transfer Tax: Appointment
Inheritance Tax	CGT	Periodic charge Every 10 years	CGT on growth over the duration of the trust, levied when appointment is made to beneficiary	Exit charge (fraction of periodic charge)
<u>Transferor</u>	<u>Transferor</u> (unless stepped up on death)	<u>Trustees</u>	<u>Trustees</u>	<u>Trustees</u>
		<b>Double taxation on the growth</b>		
<b>Double taxation on transferor: Hold-over Relief (In Case of Gift)</b>		<b>Double taxation on trustees when appointment is made: Hold-over relief</b>		

<sup>100</sup> See Ch 8 par 8.10(t) and Ch 10 par 10.10(s).



Table 11-3: Ireland

Transfer into Trust		Duration of Trust and Appointment in Beneficiary		
Wealth Transfer Tax	Capital Gains Tax	Wealth Transfer Tax: Duration	Capital Gains Tax	Wealth Transfer Tax: Appointment
6% Entrance charge	CGT	Annual charge	CGT on growth over the duration of the trust, levied when appointment is made to beneficiary	CAT (full charge)
<u>Trustees</u> (Recipient)	<u>Transferor</u> (Settlor) (unless stepped up on death)	<u>Trustees</u> (Recipient)	<u>Trustees</u>	<u>Beneficiaries</u> (Recipient)
		<b>Double taxation on the growth</b>		
<b>NO double taxation on transferor: However, credit for CGT available against CAT</b>		<b>NO double taxation on trustees/beneficiary when appointment is made: However, credit for CGT available against CAT</b>		

It is arguable that the periodic charges under both regimes may be an over-kill if one considers that the growth in the trust assets is in any event subject to capital gains tax. However, the more prominent issue is the double taxation that occurs on a transfer into trust and an appointment of property in a beneficiary.

Under the United Kingdom (transferor-based) inheritance tax regime, double taxation arises in the hands of the transferor on an *inter vivos* transfer into a trust as well as in the hands of the trustees upon the appointment of property in a beneficiary. The double taxation is, however, mitigated by the provision for hold-over relief. Critics have indeed pointed to the failure of the United Kingdom legislature to successfully integrate the various taxes involved on transfers to and from discretionary trusts.<sup>101</sup>

By contrast, the Irish recipient-based regime seems to cope better with the harmonisation of CAT and capital gains tax. Although the system offers a credit for capital gains tax

<sup>101</sup> See Ch 8 par 8.10(u).



against CAT payable in respect of the same event, commentators have pointed out that the relief lacks justification, especially because the taxes are payable by various taxpayers (on a transfer into trust as well as on an appointment to a beneficiary). If one considers, however, that CGT payable on a distribution of property to a beneficiary is basically charged on the growth of the property from its entrance into trust to the moment of distribution, over which period the trust was also liable for annual DTT levies, it is arguable that the CGT credit is a measure to relieve the excessive tax burden on the property.<sup>102</sup>

Although it falls outside the scope of this thesis to establish whether or not a special regime for discretionary trusts should be introduced for the purposes of South African wealth transfer taxation,<sup>103</sup> it is relevant to determine whether such a regime (if implemented) would best be accommodated under a transferor-based system or a recipient-based system, considering that one of the objectives of this study is to establish whether the existing (transferor-based) wealth transfer tax system should be replaced by a recipient-based system. Because it is evident from the discussion above that the interaction of a special discretionary trust regime with capital gains tax is a prominent role player in the harmonisation of a tax system, the South African context should be considered in this regard. What needs to be kept in mind is that, under the South African capital gains tax system, a transfer to a trust constitutes a taxable disposition in the hands of the transferor (the settlor). However, although an appointment of property to a beneficiary constitutes a disposition by the trustees, the capital gains tax regime attributes any gain that accrues as a result of such appointment (over the duration of the period that the assets were kept on trust) to the particular beneficiary.<sup>104</sup>

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<sup>102</sup> See Ch 10 par 10.10(t).

<sup>103</sup> In order to make a proper proposal on whether the South African legislature should introduce a special regime, all the alternatives should be considered. An example of a withholding/credit system (which was actually proposed for South Africa by the Katz Commission), was not even examined in this thesis. See Ch 7 par 7.4.6. For further reading and criticism on a withholding/credit system, see Dodge (2009) *Hastings Law J* 1041. See also the proposals by the Dutch scholars in Ch 9 par 9.6.3.2.

<sup>104</sup> See Ch 5 par 5.6.1.3.

The tables below attempt to provide an idea of how the interaction would operate in a South African context. For this purpose, two hypothetical systems are assumed, namely:

- A transferor-based estate duty and donations tax regime (as currently operative in the South African tax system), where a discretionary trust regime is provided for on the basis of the regime operative in the transferor-based United Kingdom inheritance tax regime (Table 11-4 below); and
- *Assuming that the current system is replaced by a recipient-based wealth transfer tax:*

A recipient-based acquisitions regime (similar to the CAT system operative in Ireland) where a discretionary trust regime is provided for on the basis of the regime operative in the Irish CAT system (Table 11-5 below).

**Table 11-4: Hypothesis for South Africa: Current Estate Duty and Donations Tax System together with Discretionary Trust Regime (as provided for under the United Kingdom regime)**

Transfer into Trust		Duration of Trust and Appointment in Beneficiary		
Wealth Transfer Tax	Capital Gains Tax	Wealth Transfer Tax: Duration	Capital Gains Tax	Wealth Transfer Tax: Appointment
Donations tax/Estate Duty	CGT	Periodic charge Every 10 years	CGT on growth over the duration of the trust, levied when appointment is made to beneficiary	Exit charge (fraction of periodic charge)
<u>Transferor</u>	<u>Transferor</u> (Deemed Realisation)	<u>Trustees</u>	<u>Beneficiaries</u> (because of attribution rules)	<u>Trustees</u>
		<b>Double taxation on the growth</b>		
<b>Double taxation on transferor</b>		<b><u>NO</u> double taxation when appointment is made</b>		



**Table 11-5: Hypothesis for South Africa: Recipient-based wealth transfer tax regime (based on CAT system in Ireland) together with Discretionary Trusts Regime (as provided for under the Irish CAT regime)**

Transfer into Trust		Duration of Trust and Appointment in Beneficiary		
Wealth Transfer Tax	Capital Gains Tax	Wealth Transfer Tax: Duration	Capital Gains Tax	Wealth Transfer Tax: Appointment
6% Entrance charge	CGT	Annual charge	CGT on growth over the duration of the trust, levied when appointment is made to beneficiary	CAT (full charge)
<u>Trustees</u> (Recipient)	<u>Transferor</u> (Settlor)	<u>Trustees</u> (Recipient)	<u>Beneficiaries</u> (because of attribution rules)	<u>Beneficiaries</u> (Recipient)
		<b>Double taxation on the growth</b>		
<b><u>NO</u> double taxation on transferor</b>		<b>Double taxation on beneficiaries when appointment is made</b>		

If Tables 11-4 and 11-5 above are compared, it seems as though a transferor-based system (with provision for a discretionary trust regime) produces double taxation in the hands of the transferor in the case of a transfer into trust. On the other hand, a recipient-based system (with provision for a discretionary trust regime) produces double taxation in the hands of the beneficiaries. In each case, the question is whether the double taxation is legitimate. It is submitted that the double taxation on the transfer into trust (under the transferor-based regime) constitutes illegitimate double taxation, for the reasons pointed out in Chapter 4 above.<sup>105</sup>

In the case of the recipient-based system, the double taxation produced is a necessary corollary of the deferral scheme for trusts. As explained by Dodge (in his article on a

<sup>105</sup> See Ch 4 par 4.4.1.2.



proposed accessions tax for the United States),<sup>106</sup> capital gains tax would normally be imposed first and only thereafter would an acquisitions tax be imposed on the (after tax) wealth that is transferred gratuitously.<sup>107</sup> Assuming that the discretionary trust was instead regarded as the taxpayer under the recipient-based system (and the main taxable event therefore not deferred until the appointment in the beneficiary), then the double taxation argument would disappear.<sup>108</sup> Regarding the trust as the taxpayer would cause the full charge for capital acquisitions tax to be shifted from the appointment of the property in the beneficiary to the initial acquisition by the trust (taxable in the hands of the trustees) and the six percent initial charge to be replaced by a six percent exit charge when the property leaves the trust (taxable in the hands of the trustees). This “reversed” system is illustrated in Table 11-6 below:

**Table 11-6: Hypothesis for South Africa: Recipient-based wealth transfer tax regime (based on CAT system in Ireland) together with Discretionary Trusts Regime (reversed DTT regime)**

Transfer into Trust		Duration of Trust and Appointment in Beneficiary		
Wealth Transfer Tax	Capital Gains Tax	Wealth Transfer Tax: Duration	Capital Gains Tax	Wealth Transfer Tax: Appointment
CAT (full charge) Trust regarded as taxpayer	CGT	Annual charge	CGT on growth over the duration of the trust, levied when appointment is made to beneficiary	6% Exit charge
<u>Trustees</u> (Recipient)	<u>Transferor</u> (Settlor)	<u>Trustees</u> (Recipient)	<u>Beneficiaries</u> (because of attribution rules)	<u>Trustees</u> (Recipient)
		<b>Double taxation on the growth</b>		
<b>NO double taxation</b>		<b>NO double taxation</b>		

<sup>106</sup> The double taxation produced on the appointment of property is also relevant for Dodge’s accessions tax proposal, because capital gains (being income) realised on the appointment of trust property are taxed either to the trust or the beneficiaries under the US tax system. See Dodge (2009) *Hastings Law J* 1038 n 176.

<sup>107</sup> Dodge (2009) *Hastings Law J* 1039.

<sup>108</sup> Dodge (2009) *Hastings Law J* 1042.



It is therefore submitted that the double taxation produced under the recipient-based system (in Table 11-5 above) is legitimate, because it is merely a consequence of the timing of the taxes (and not the same property/income taxed in the hands of the same taxpayer).

A final (minor) issue relates to the timing of the tax. Under the recipient-based Irish CAT discretionary trust regime, the main charge to CAT is levied on the appointment of trust property to a trust beneficiary, contrary to the relevant property regime operative in the United Kingdom. If South Africa were to adopt a recipient-based regime (similar to the CAT system and special DTT regime), then the question may be posed whether the unlimited deferral of the (main) tax liability would pose any significant problems for the tax system, especially in the absence of a rule against perpetuities in the South African trust law.<sup>109</sup> Two answers can be provided here. Firstly, it was already pointed out above that the timing of wealth transfer taxation is relatively insignificant given its low revenue yield.<sup>110</sup> Secondly, if timing seems to be an issue, then the system outlined in Table 11-6 above presents evidence that the tax burden can easily be shifted to the initial acquisition by the trust.

In conclusion, it seems as if discretionary trusts set challenges for recipient-based as well as transferor-based wealth transfer taxes. It is evident from the systems comparatively surveyed that systems often introduce special regimes to cater for the unique features of transfers to and from discretionary trusts. It was shown, however, that a recipient-based regime for discretionary trusts interacts better than a transferor-based regime with a co-existing capital gains tax system, which would also be the position for a South African context (as explained above). Furthermore, it was shown that the deferral of the (main) tax liability to the appointment of trust property in a beneficiary does not pose any problems for a recipient-based wealth transfer tax system.

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<sup>109</sup> See Ch 5 par 5.6.1.2.

<sup>110</sup> See par 11.3.3.



#### 11.3.4.5 *Grossing-up Rules*

In the case of a transferor-based tax, an *inter vivos* transfer would principally exclude the tax attributable to the transfer, whereas a transfer on death (the value of the deceased estate) would not exclude the tax, as a consequence of which *inter vivos* transfers and transfers on death are not treated equally. An example in Chapter 7 illustrated that this is indeed the position under the current South African wealth transfer tax system.<sup>111</sup>

This problem is sometimes overcome by grossing-up rules which provide that the value of the transfer should include the tax attributable to it, such as found under the United Kingdom inheritance tax regime.<sup>112</sup> However, the valuation of property taking an amount of tax into account, which is on the other hand dependent on the value of the property, requires a complicated mathematical calculation which may make it difficult for some taxpayers to calculate their tax liabilities.<sup>113</sup>

By contrast, there is no need to equalise wealth transfers under an acquisitions tax, because the tax (borne by the recipient) would not reduce the value of the acquisition.

#### 11.3.4.6 *Other Problem Issues*

It is evident that the remaining problem areas outlined in Chapter 7 have to a large extent also been encountered in the United Kingdom, the Netherlands and Ireland (in some or other form). What is significant to observe, however, is that these issues (and any solutions offered) are independent from whether the system operates on a transferor basis or a recipient basis. These issues include:

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<sup>111</sup> See Ch 7 par 7.4.8.

<sup>112</sup> See Ch 8 par 8.10(w).

<sup>113</sup> South Africa has experienced difficulty in this area under the application of the s 4(q) spousal exemption. In *CSARS v Executor Frith's Estate* (2001) 2 SA 261 (SCA) the court was confronted with the question whether the value of the s 4(q) benefit was calculated taking the estate duty liability into account, or not. See Ch 6 par 6.5.2.2 n 192 – n 195 and accompanying text.



- the defining of the characteristics of an *inter vivos* transfer;<sup>114</sup>
- the provision for special rules to accommodate e.g. omissions; value-shifting arrangements and estate-freezing techniques (such as interest-free loans) in the tax base;<sup>115</sup> and
- the provision of relief for business properties and/or agricultural properties.<sup>116</sup>

### 11.3.5 Estate Administration Process and Administrative Issues

It was pointed out in Chapter 3 that the distinctly different estate administration processes followed in common-law and civil-law countries have apparently influenced the preference for either transferor-based or recipient-based taxation. Anglo-American law provides for a process of probate, where an executor finalises the administration of an estate and pays all the outstanding debts and taxes; this contributed to the notion of transferor-based taxation in those countries. Conversely, the civil-law jurisdictions generally follow a process where the liabilities and outstanding tax charges are carried over to the heirs, which apparently influenced a preference for recipient-based taxes in those countries.<sup>117</sup> It is understandable that an estate tax would be difficult to administer in a civil-law country in the absence of a process of probate or estate administration. However, a process of probate should not counter the proper operation of a recipient-based tax.

Although one can in principle concede that it would be administratively simpler to keep a deceased estate liable for the duty,<sup>118</sup> it is difficult to admit that this point outweighs the

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<sup>114</sup> See Ch 8 par 8.10(i); Ch 9 par 9.10(i) and Ch 10 par 10.10(i).

<sup>115</sup> See Ch 8 par 8.10(j), (k); Ch 9 par 9.10(o) and Ch 10 par 10.10(j), (r).

<sup>116</sup> See Ch 8 par 8.10(v); Ch 9 par 9.10(q) and Ch 10 par 10.10(u).

<sup>117</sup> See Ch 3 par 3.2.3.

<sup>118</sup> This point was heavily relied on by all three the South African tax reform commissions. See Ch 3 par 3.3.2.3. It was also indicated in Ch 3 par 3.2.3 that administrative convenience represents one of the main reasons why estate taxation had generally been preferred in traditional common-law countries.



advantages of a recipient-based tax outlined above, especially if one considers that it would be relatively easy to involve the executor in the compliance process, such as provided for in the Dutch system.<sup>119</sup> It is therefore not surprising that it has been claimed that the administrative advantages of a transferor-based tax are not that significant.<sup>120</sup> This view is bolstered if one considers that an executor, under the current South African estate duty regime, is already required to recover estate duty from heirs or beneficiaries in certain instances.<sup>121</sup>

In addition, most taxpayers in South Africa are in any event required to submit information on inheritances and donations received by them in their income tax returns. In fact, the possibility was already raised that a recipient-based tax could even be accommodated in a separate schedule to the Income Tax Act, as in the case of capital gains tax.<sup>122</sup> The use of the income tax assessment form as a reporting vehicle seems especially relevant considering that inheritances and donations are actually akin to income in the economic sense of the word.<sup>123</sup> In fact, donations tax has been levied under income tax legislation in an independent form since 1955.<sup>124</sup> In addition, an incorporation of the new system under the Income Tax Act may benefit from its administrative provisions and the anti-avoidance rule. However, the question whether or not the incorporation of the new system under income tax legislation would be feasible from an administrative point of view requires further investigation. This falls outside the ambit of this thesis, particularly because it requires information on SARS's administrative

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<sup>119</sup> See Ch 9 par 9.10(r).

<sup>120</sup> O'Brien Report (1982) 444.

<sup>121</sup> See Ch 6 par 6.4.

<sup>122</sup> See Ch 4 par 4.6(f).

<sup>123</sup> See Ch 2 par 2.2.2.2 This is also recommended by Dodge for his accessions tax proposal for the US. See Dodge (2009) *Hastings Law J* 1010.

<sup>124</sup> See Ch 3 par 3.3.2.2.



capacity. Which provisions of the Income Tax Act could apply to the new regime would also have to be assessed, a study which would have to point out any incompatibilities.

### 11.3.6 Certainty of Law

Estate duty and donations tax are well embedded in the South African system. These taxes have been the subject of numerous court cases and tax practitioners and some taxpayers are familiar with the basic structure of these taxes.

### 11.3.7 Conclusions and Recommendations

In the light of the discussion above, it is submitted that the advantages of a recipient-based tax outweigh those of a transferor-based tax. This conclusion is further bolstered if one considers that tax reform commissions in the United Kingdom, United States, the Netherlands and Ireland have advocated the acquisition or retention of recipient-based taxes.<sup>125</sup> It is interesting, though, to observe that the proposal to governments by the commissions in the United Kingdom and United States, to convert the transferor-based taxes to recipient-based taxes, fell on deaf ears.<sup>126</sup> This may, at least in part, explain some of the pressure currently experienced on the transferor-based taxes in those countries. It is furthermore not surprising 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>127</sup>

The replacement of the existing wealth transfer tax system with a recipient-based regime would be a step in the right direction if greater equity were to be sought in respect of the taxation of capital in the South African tax system. It is therefore recommended that the

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<sup>125</sup> See Ch 3 par 3.2.3.

<sup>126</sup> See Ch 3 par 3.4(f).

<sup>127</sup> See Ch 3 par 3.4(e).



Estate Duty Act and Part V, Chapter II of the Income Tax Act should be repealed and replaced with a single, recipient-based wealth transfer tax regime. The recipient-based systems operative in the Netherlands and Ireland may serve as useful examples in the design of a new integrated tax for South Africa. It is suggested that the over-arching integrated charging provisions of the Irish system seem to present a modern and efficient way to levy taxation on *inter vivos* transfers as well as transfers on death.<sup>128</sup> Similar provisions could be designed for the purposes of the South African context. However, some basic principles and rules of the existing estate duty and donations tax regimes (such as valuation rules) could be adapted in such a way that a transition could be effected with minimal disruption, also taking into consideration the recommendations made above on integration issues. The proper design of the relevant law (be it a separate statute or as a further part or schedule to the Income Tax Act) as well as the administrative implications that will ensue will have to be properly investigated by National Treasury in liaison with SARS.

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<sup>128</sup> See Ch 10 par 10.2.1.