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A CRITICAL ANALYSIS OF ALTERNATIVES FOR ESTATE DUTY FROM A SOUTH AFRICAN VIEWPOINT

by

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ABSTRACT

A CRITICAL ANALYSIS OF ALTERNATIVES FOR ESTATE DUTY FROM A SOUTH AFRICAN VIEWPOINT

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Estate duty (or estate tax, as it is sometimes called) has been abolished in nine countries including Canada, Australia, New Zealand and Sweden which are members of the Organisation for Economic Co-operation and Development (OECD) (Page, 2009:293). Estate tax has also been temporarily abolished in the United States of America for deaths after 31 December 2009 and before 1 January 2011. Some argue that the United States will also permanently abolish estate tax or replace it with some other form of wealth transfer tax such as inheritance tax (Batchelder, 2007:5-54), accessions tax (Dodge, 2009:997-1062), inclusion-in-income approach (Dodge, 1978:997-998; Pareja, 2008:841-897), a deemed realisation approach (Dodge, 2001:423-553) or even reinstate the estate tax after this one-year repeal period (CCH, 2010:9-10).

Although studies about these alternatives to estate duty have been performed internationally, no recent study could be identified as to the most suitable wealth transfer tax system for South Africa. This study investigated alternatives to estate duty for South Africa and concluded that estate duty should be abolished in South Africa. It is suggested that only capital gains tax should be levied at the time of death.

Keywords: Accessions tax, Capital gains tax, Deemed realisation approach, Estate duty, Estate tax, Inclusion-in-income approach, Inheritance tax

OPSOMMING

'N KRITIESE ONTLEDING VAN ALTERNATIEWE VIR BOEDELBELASTING VANUIT 'N SUID-AFRIKAANSE UITGANGSPUNT

deur

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Boedelbelasting is in nege lande wat lede is van die Organisasie vir Ekonomiese Samewerking en Ontwikkeling (OESO), insluitende Kanada, Australië, Nieu-Seeland en Swede, geskrap (Page, 2009:293). Boedelbelasting is ook tydelik in die Verenigde State van Amerika vir sterftes na 31 Desember 2009 en voor 1 Januarie 2011 herroep. Sommige is van mening dat die Verenigde State ook boedelbelasting permanent sal skrap, of dat dit vervang sal word met 'n ander vorm van belasting op die oordrag van welvaart soos erfenisbelasting (Batchelder, 2007:5-54), aanwinstebelasting (Dodge, 2009:997-1062), 'n insluiting-by-inkomste metode van belasting (Dodge, 1978:997-998; Pareja, 2008:841-897), 'n geagte realisasie metode van belasting (Dodge, 2001:423-553) of selfs dat boedelbelasting na hierdie een-jaar herroepingsperiode heringestel sal word (CCH, 2010:9-10).

Alhoewel studies oor die alternatiewe vir boedelbelasting internasionaal gedoen is, kon geen onlangse studie geïdentifiseer word oor die mees gepaste stelsel vir die belasting van oordrag van welvaart in Suid-Afrika nie. Hierdie studie ondersoek alternatiewe tot boedelbelasting vir Suid-Afrika en maak die gevolgtrekking dat boedelbelasting in Suid-

Afrika geskrap moet word. Daar word aanbeveel dat slegs kapitaalwinsbelasting op die datum van dood gehef moet word.

Sleutelwoorde: Aanwinstebelasting, Boedelbelasting, Erfenisbelasting, Geagte realisasie-metode, Insluiting-by-inkomste-metode, Kapitaalwinsbelasting

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CHAPTER 1
INTRODUCTION

1.1 BACKGROUND

Benjamin Franklin (1789) stated in 1789 that "… in this world nothing can be said to be certain, except death and taxes". Ironically, estate duty (as estate tax is called in South Africa) has been labelled by many as "death taxes" and "a tax on death itself rather than a tax on the transfer of wealth" (Mitchell, 2009; Dodge, 2009:1003). This negative view of estate duty supported the arguments for the abolishment of estate duty in countries such as the United States, where it was stated by Rowlingson (2008:153-154) that "you shouldn't have to visit the undertaker and taxman on the same day" and "you shouldn't be double taxed when you die".

Wealth transfer tax, which includes estate duty, was abolished in countries such as Canada, Australia, New Zealand (Duff, 2005:72) and Sweden (Lee, 2007:678). Estate tax has been temporarily abolished in the United States for deaths after 31 December 2009 and before 1 January 2011. Some argue that the United States will also permanently abolish estate tax or replace it with some other form of wealth transfer tax such as inheritance tax (Batchelder, 2007:5-54) or even reinstate estate tax (CCH, 2010:9-10) after this one-year repeal period.

Alternatives identified to estate duty include inheritance tax (Batchelder, 2007:5-54), accessions tax (Dodge, 2009:997-1062), inclusion-in-income approaches (Dodge, 1978:997-998; Pareja, 2008:841-897) and a deemed realisation approach (Dodge, 2001:423-553). In terms of the estate duty system, the tax liability rests upon the transferor, whereas under the alternatives identified, with the exception of the deemed realisation approach, the tax liability rests upon the transferees. Support is given internationally by writers such as Alstott (2007:542), Batchelder (2007:51), Dodge (2009:1000), Duff (2005:49) and Pareja (2008:896) for a system where the transferee is

taxed rather than the transferor. Estate duty, where the transferor is taxed, was implemented in South Africa in terms of the Estate Duty Act No. 45 of 1955 and this system of wealth transfer tax has been applicable in South Africa ever since. It is therefore submitted that further research needs to be performed in relation to these alternatives as a possible replacement of estate duty in South Africa in line with the international trend.

Although studies on these alternatives as indicated above have been performed internationally, no recent study could be identified as to the most suitable wealth transfer tax system for South Africa. South African studies performed on estate duty between 1993 and 1998 focused on the effects of the suggested implementation of capital gains tax in 2001. Studies completed at the University of Johannesburg during 2005 relating to estate duty with reference to the introduction of capital gains tax have been identified. These studies were, however, unpublished master's articles and not dissertations, as indicated on the SABINET database. A study performed by Muljee (2008) after the implementation of capital gains tax in 2001 investigated the reasons to abolish estate duty, with specific reference to the double taxation effect of estate duty and capital gains tax at death. This study will briefly refer to some reasons supporting the abolishment of estate duty but will mainly focus on investigating alternatives to estate duty. As with estate duty, there are numerous advantages and disadvantages to each of the abovementioned alternatives which will be investigated in this study based on South Africa's current tax system. This study will conclude with recommendations being made regarding a suitable wealth transfer taxation method for South Africa.

1.2 PROBLEM STATEMENT

Estate duty has been abolished in nine countries (including Canada, Australia, New Zealand and Sweden) which are members of the Organisation for Economic Co-operation and Development (OECD) (Page, 2009:293). Reasons submitted for the abolishment are similar to some of the problems experienced by South Africa with regard to estate duty (National Treasury, 2010:82). Studies have been performed in other countries regarding the advantages and disadvantages of different wealth transfer tax methods, in light of those countries' specific circumstances. No similar comparative recent study could be identified from a South African perspective.

This study will aim to investigate if South Africa should follow the international trend and abolish estate duty or whether estate duty should be reformed or even replaced with some other, more efficient wealth transfer taxation method.

1.3 PURPOSE STATEMENT

The main purpose of this study is to analyse various alternative methods of wealth transfer tax from a South African estate duty point of view critically in order to recommend a wealth transfer tax for South Africa.

1.4 RESEARCH OBJECTIVES

The main purpose of this study is supported by the following research objectives:

- to critically analyse the literature on alternative methods of wealth transfer tax and estate duty in South Africa in order to establish a theoretical construct for this study;
- to critically analyse and compare the various alternative methods of wealth transfer tax from a South African estate duty point of view using the theoretical construct as underpin; and
- to make recommendations regarding an appropriate wealth transfer tax for South Africa.

1.5 BENEFITS OF THE PROPOSED STUDY

Various country-specific international studies, identifying alternative wealth transfer taxation methods, have been performed during the last four years. Consensus could however not be reached as to which wealth transfer tax method is more efficient and effective and consequently different wealth transfer tax methods are used all over the world. No similar recent South African study specifically referring to South Africa's current tax legislation and fiscal policies could be identified. A knowledge gap therefore exists as to which of the existing methods, if any, are best for South Africa.

From a theoretical perspective this study proposes to examine the advantages and disadvantages of the various wealth transfer methods. The theoretical knowledge gathered in this way will be used to determine if modifications to an existing model are necessary in order for such a model to be applicable and effective in a South African context.

From a practical perspective the findings of this study may assist the National Treasury in their proposal to review taxes upon death by investigating an effective replacement for estate duty in South Africa.

The delimitations and assumptions on which the study is based are explained below. The literature review will commence with a background of the current law and developments in South Africa. Arguments in favour of and against a wealth transfer tax will be discussed. This study will then identify and discuss alternative methods of wealth transfer tax. The advantages and problems associated with each alternative will be identified and critically analysed to arrive at a suggested wealth transfer tax system for South Africa.

1.6 DELIMITATIONS AND ASSUMPTIONS

1.6.1 Delimitations

The following are delimitations in this study:

- the principles, advantages and problems of the various alternative methods of wealth transfer taxes will be analysed. It is not intended to analyse the detailed tax implications, technical areas and regulations such as valuation, timing issues and other specific regulation requirements pertaining to each alternative;
- all taxes on gratuitous transfers will not be considered but will mainly focus on the transfer of wealth at the time of death;
- the reasons for abolishing wealth transfer taxes will be limited to studies performed in the United States of America, Canada, New Zealand and the United Kingdom; and
- the alternative wealth transfer tax methods to be investigated will be limited to inheritance tax, accessions tax, a deemed realisation approach, an inclusion-in-income approach, and combinations of such approaches.

1.6.2 Assumptions

This study will be performed based on the assumption that taxpayers have assets which will be subject to wealth transfer taxes.

1.7 DEFINITION OF KEY TERMS

The key terms used in this study are listed and defined below.

Accessions tax refers to a wealth transfer tax where the transferee instead of the transferor is taxed. The tax is based on the cumulative gifts and bequests (accessions) received by an individual over such person's lifetime. An accessions tax normally provides for a lifetime exemption and is based on a rate structure separate from the income tax rate structure (Dodge, 2009:999).

Deemed realisation approach deems the deceased to have disposed of his/her assets for an amount equal to the market value of the assets. Capital gains tax is levied as if the asset were disposed for an amount equal to this market value. The heir or legatee is deemed to have acquired the asset for a base cost equal to that same market value (Dodge, 2001:430-431).

Estate tax is also referred to as estate duty and is a tax on the value of the estate of a person when he or she dies (section 2 of the Income Tax Act No. 58 of 1962). The tax is imposed on the transferor.

Inclusion-in-income approach refers to an approach where the recipient includes gifts and bequests in his/her income in the year received. There is no lifetime exemption as is the case with the accession tax (Dodge, 2009:999).

Inheritance tax refers to an approach where the transferee is taxed on inheritances received. The tax is based on the inheritances received and is not influenced by other income or other gratuitous receipts (Pareja, 2008:871).

Transferee is a term used for the person who received a gratuitous receipt transferred by the transferor. Reference to transferee includes an heir, legatee, beneficiary and donee and these terms will be used interchangeably in this study.

Transferor is a term used for the person transferring his/her wealth or the person making the gratuitous receipt to the transferee. Reference to transferor includes a deceased person and a donor and these terms will be used interchangeably in this study.

Wealth transfer tax represents a tax on the transfer of wealth, cash or in-kind assets, by a transferor to a transferee in terms of the estate of a deceased person or donation by a donor (Alstott, 2007:502).

The abbreviations used in this study are contained in Table 1 below.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
CGT	Capital gains tax
OECD	Organisation for Economic Cooperation and Development
SARS	South African Revenue Service

1.8 RESEARCH DESIGN AND METHODS

1.8.1 Description of inquiry strategy and broad research design

Given the nature of the research problem, the broad research design of this study will be a non-empirical study. An extensive literature review will be performed on the various alternate methods of taxing wealth to establish a theoretical platform for the study. This will provide a good understanding of the issues and debates surrounding the different methods. Local and international studies will be investigated regarding this topic.

The theoretical construct gathered in this way will be critically analysed and compared from a South African perspective in order to suggest alternatives to the current estate duty system in South Africa.

According to Mouton (2001:180), the main sources of error associated with a literature review is, however, "selectivity in the sources; unfair treatment of authors; misunderstanding the source; selective interpretation to suit one's own viewpoint; poor organisation and integration of review", which will be borne in mind in analysing the different methods of taxing the transfer of wealth.

1.9 SUMMARY

This chapter introduced the focus of the study. This was done by providing a background to the study and by stating the research problem and objectives. Furthermore, the delimitations and assumptions of the study were listed, key terms were identified and the research design and methods were explained.

An overview of the current laws and developments relating to estate duty in South Africa is provided in the next chapter. Arguments against and in favour of a wealth transfer tax are identified before investigating literature on different types of wealth transfer tax which may qualify as suitable alternatives to the current estate duty system in South Africa. In Chapter 2 the different wealth transfer tax methods are discussed. In Chapter 3 the different methods are analysed by making use of calculations to compare South Africa's current estate duty system with the alternative wealth transfer tax methods identified. Finally, a summary of the findings and conclusion is provided in Chapter 4.

CHAPTER 2
WEALTH TRANSFER TAXES

2.1 INTRODUCTION

The international trend to abolish estate duty as well as the arguments against a wealth transfer tax cannot be ignored in South Africa. Before reviewing the literature regarding the arguments against and in favour of a wealth transfer tax, as well as on alternatives to estate duty, background on current law and developments in South Africa is discussed in this chapter.

2.2 AN OVERVIEW OF THE CURRENT LAW AND DEVELOPMENTS IN SOUTH AFRICA

South Africa has adopted estate duty in 1955 as the method for taxing the transfer of wealth at the time of death of a person. Limited attention to the Estate Duty Act No. 45 of 1955 (hereafter referred to as the Estate Duty Act) has caused this act to remain relatively unchanged over the last couple of years in comparison with the Income Tax Act No. 58 of 1962 (hereafter referred to as the Income Tax Act) to which annual amendments are made. Very little has academically been written or even presented in the media in general, suggesting that estate duty should be abolished. Internationally, on the other hand, various countries abolished estate duty without replacement or replaced it with some other method of wealth transfer tax. However, in the Budget Review of 2010 (National Treasury, 2010:82), it was indicated that South Africa will also revisit the current estate duty system.

Before considering alternatives to estate duty for South Africa, it is important to gain a general understanding of the current law, as well as challenges and developments relating to estate duty in South Africa. In order to do so, reference will be made to the Estate Duty Act and the considerations and recommendations by the Katz Commission. The Budget Review of 2010 will also be considered and used as a means of highlighting the importance of this study.

2.3 TAXES AT THE TIME OF DEATH

Estate duty is levied at a flat rate of 20% on the dutiable amount of the estate in terms of section 2, read with the First Schedule of the Estate Duty Act. The dutiable amount of the estate consists of property (section 3(2) of the Estate Duty Act), less specific allowable deductions (section 4 of the Estate Duty Act), less the abatement of R3 500 000 (section 4A of the Estate Duty Act). For purposes of determining the dutiable amount, section 5(1)(*g*) of the Estate Duty Act determines that property not sold in the course of liquidation of the estate should be valued at the fair market value of the property at the date of death of a person or, in terms of section 5(1)(*a*), at the price realised by sale if the property was sold through a *bona fide* purchase and sale agreement in the course of the liquidation of the estate.

Estate duty is a debt due to the State in terms of section 25 of the Estate Duty Act and the Commissioner of Inland Revenue may institute proceedings to sequestrate the estate in order to recover such debt. The liability to pay the estate duty rests upon the executor of the estate (section 12 of the Estate Duty Act) and in limited situations upon the person receiving the inheritance (section 11 of the Estate Duty Act). The executor must satisfy the Commissioner that due provision has been made to pay the duty under the Estate Duty Act before delivering or transferring any property of the deceased to an heir or legatee (section 18 of the Estate Duty Act).

The problem of double taxation on the deemed disposal of property came about with the introduction of capital gains tax on 1 October 2001. In terms of paragraph 40 of the Eighth Schedule of the Income Tax Act it is deemed that a deceased person has disposed of his/her assets to his/her estate for an amount received or accrued equal to the market value of those assets at the date of that person's death. The same market value used to determine the net asset value for estate duty will thus be used as proceeds in order to calculate the capital gain on the deemed disposal of that asset. The example below illustrates the capital gains tax and estate duty payable at the time of death.

Calculation 1: Capital gains tax and estate duty payable at the time of death

Mr X died on 28 February 2010 at the age of 58 years. His only liability at his date of death was his mortgage bond of R500 000. At the date of death, the total market value of his assets was R4 100 000, which consisted of the following:

Asset	***Market value at date of death (R)***	***Base cost (R)***
Primary residence	*2 500 000*	*1 000 000*
Personal assets	*100 000*	*20 000*
Other assets not subject to any exclusions	*1 500 000*	*1 000 000*
	4 100 000	***2 020 000***

CAPITAL GAINS TAX	**R**
Primary residence	
Proceeds	2 500 000
Less base cost	(1 000 000)
	1 500 000
Less primary residence exclusion	(1 500 000)
Capital gain on primary residence	-

Personal assets

Personal-use assets are not subject to capital gains tax in terms of paragraph 53 of the Eighth Schedule of the Income Tax Act.

Other assets	
Proceeds	1 500 000
Less base cost	(1 000 000)
	500 000
Total capital gain (R0 + R500 000)	500 000
Less exclusion on death	(120 000)
	380 000
Taxable capital gain (R380 000 x 25%)	95 000
Tax @ 40% (assumed maximum marginal tax rate)	**38 000**

ESTATE DUTY	
Property (market value)	
Primary residence	2 500 000
Personal assets	100 000
Other assets	1 500 000
Liabilities	
Mortgage on primary residence	(500 000)
Normal tax liability (refer to capital gains tax calculation above)	(38 000)
Net asset value	3 562 000
Less abatement	(3 500 000)
Dutiable amount of estate	62 000
Estate duty @ 20% on R62 000	**R12 400**
Total tax liability (R38 000 + R12 400)	**R50 400**

It is therefore evident that property, not subject to any exclusion or deduction under the Eighth Schedule of the Income Tax Act and/or the Estate Duty Act, could be taxed more than once on the date of a person's death based on the market value on the date of the deceased person's death. For capital gains tax, 25% of the capital gain, calculated with reference to the market value on the date of death, will be taxed at the marginal tax rate for that individual taxpayer and for estate duty the taxpayer will have to pay 20% estate duty on the same market value of such property in the estate. The capital gains tax paid is allowed as a deduction in order to arrive at the dutiable amount of the estate on which estate duty is levied at 20%. This deduction does, however, not eliminate the double taxation effect since the deduction is against the net asset value of the estate and not against the estate duty payable.

2.4 KATZ COMMISSION RECOMMENDATIONS

The Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa (hereafter referred to as the Katz Commission) was appointed in 1994 to inquire into the tax structure of South Africa (National Treasury, 1999:65). This Katz Commission (1997:11) recommended that estate duty should be retained in South Africa and should not be replaced with an inheritance tax system. An inheritance tax system aims to tax the various transferees to whom wealth was transferred by the estate as opposed to taxing the

estate. The Commission (1997:11-13) therefore submitted that an inheritance tax system will be more cumbersome to administer than an estate duty system.

This finding relating to the administrative burden does not synchronise with the proposal of the National Treasury to revisit the current estate duty, as stated in the 2010 Budget Review discussed below, and is investigated further in Chapter 3.2.

2.5 BUDGET 2010 PROPOSALS

South Africa's current budget deficit of 7,3% of the Gross Domestic Product (GDP) for 2009/2010, which is expected to be 6,2% of the GDP for 2010/2011 (National Treasury, 2010:14) contributes to the improbability of the Government simply removing estate duty revenue from their income stream without replacing the gap with some other source of income. Since the Government's income consists mainly of tax revenue (National Treasury, 2010:161) it can be expected that such loss of income will probably be compensated for with tax revenue obtained through some other form of wealth transfer tax or by simply increasing tax rates or the tax base of existing taxes.

In the 2010 Budget Review, the National Treasury indicated that taxes upon death will be reviewed in South Africa. The reasons include the current double taxation effect of estate duty and capital gains tax on death as explained in Chapter 2.3, the high administration burden of estate duty in comparison with the limited revenue that it raises and its inefficiency since wealthy individuals escape these taxes through proper tax planning (National Treasury, 2010:82). These reasons are discussed in more detail in Chapter 2.6.2.

Before alternative methods to wealth transfer taxes are analysed, it is important to determine if a wealth transfer tax is indeed necessary for a country to apply and, if so, why.

2.6 WEALTH TRANSFER TAXES

A wealth transfer tax represents a tax on the transfer of wealth, cash or in-kind assets, by a transferor to a transferee in terms of the estate of a deceased person or donation by a donor (Alstott, 2007:502). Arguments in favour of and against a wealth transfer tax are discussed below.

2.6.1 Support for wealth transfer taxes

According to the well-known economist Adam Smith (1776:397), equity amongst taxpayers should be achieved by taxpayers contributing towards the support of the government in proportion to their respective abilities. Pareja (2008:855) also submits that this ability-to-pay principle of Adam Smith (vertical equity), equality of opportunity (horizontal equity) and wealth distribution are some common reasons why people support a wealth transfer tax. These reasons are discussed in more detail below.

- ***Equity and the redistribution of wealth***

Vertical equity is achieved by imposing progressive rates as a taxpayer's income increases. This is based on the principle that a person earning more has a greater ability to pay and consequently has to contribute more towards the support of government (Smith, 1776:397). In South Africa, individual taxpayers are taxed according to progressive rates, varying between 18% and 40%, on income received during a year of assessment.

Horizontal equity implies that taxpayers with similar income amounts should be taxed at the same rate, regardless of the source of their income. A taxpayer earning a salary of R100 000 per year should thus be taxed similar to a taxpayer inheriting R100 000 a year. Estate duty is therefore a tax aiming to achieve horizontal equity by taxing wealth that is merely transferred from one person to another (without having worked for it) at a flat rate of 20%.

The Katz Commission (1997:1-2) established that there is a huge disparity of incomes and assets between South Africans, which can be reduced through a wealth transfer tax. However, Lee (2007:696) submits that tax revenues collected by government are applied for paying for public services and are redistributed as *income* in some form of income support (such as subsidies). She submits that redistribution in such a form does not form a wealth base and does therefore not aid in wealth distribution as such. This is evident in her study from the fact that the wealth ownership has remained fairly constant in the United Kingdom for 30 years, regardless of the estate tax being applicable.

- ***Raising revenue***

Wealth transfer taxes raise revenue for government, although the amount is minimal in most cases (Lee, 2007:698). As discussed in Chapter 3.2, on average estate duty contributed 0,14% to the total tax revenue of the South African government over the past 18 years. Although a small percentage, it is submitted that the loss of revenue thereof will have to be compensated for by an increase in tax revenues elsewhere (Lee, 2007:700).

2.6.2 Why wealth transfer taxes are unpopular

A system whereby the transfer of wealth is taxed is not supported by everyone. In 1984, Rogers (1984), a well-known preacher and founder of the Love Worth Finding Ministries, said in one of his sermons: "… you cannot legislate the poor into freedom by legislating the wealthy out of freedom. And what one person receives without working for, another person must work for without receiving. The government can't give to anybody anything that the government does not first take from somebody. And when half of the people get the idea they don't have to work because the other half's going to take care of them, and when the other half get the idea it does no good to work because somebody's going to get what I work for. That, dear friend, is about the end of any nation."

Adam Smith (1776:417) was also of the view that "[a]ll taxes upon the transference of property of every kind, so far as they diminish the capital value of that property, tend to diminish the funds destined for the maintenance of productive labour. They are all more or less unthrifty taxes that increase the revenue of the sovereign, which seldom maintains

any but unproductive labourers, at the expense of the capital of the people, which maintains none but productive". Even in South Africa this holds true. People that qualify for monetary support from the government are those in need. They have to use such subsidies to pay their daily living expenses. They do not invest the money from the subsidy in order to create wealth for themselves since they simply do not have extra resources available to invest. Attention should rather be given to positively encourage those who do have the resources available, to assist those who do not by, for example, encouraging them to create jobs for those in need. An estate tax where you are 'penalised' for accumulating wealth (and indirectly for creating jobs) by applying your skills and knowledge is doubtful to be regarded as and to encourage wealth distribution.

The following arguments against a wealth transfer tax are presented in addition to the above mentioned:

- ***Double taxation***

One of the main criticisms against an estate tax system is the double taxation effect resulting from the simultaneous application of estate duty and capital gains tax at death (Duff, 2005:97-98; National Treasury, 2010:82). Canada initially proposed to adopt a similar system but instead abolished estate duty in 1972 and adopted a capital gains tax system whereby accrued gains are taxed at death (refer to Chapter 3.3). Small business owners organised a campaign under the banner of the Canadian Council for Fair Taxation against the simultaneous application of estate tax and capital gains tax at death. The group's founder and President, Bulloch, submitted that the simultaneous application amounted to "… an attack on the middle-class values of hard work, thrift and initiative" and "… confiscation of the money and resources of the huge middle segment of the population". (Duff, 2005:97-98.).

Dodge (2001:425-426) submits that it is common in a tax system to tax the same amount to different taxpayers but the same amount should not be taxed twice to the same taxpayer. Under South Africa's current estate duty system, amounts are taxed as part of normal income tax once received by or accrued to a taxpayer (paragraph 1 of the "gross income" definition of the Income Tax Act). Furthermore, the same taxpayer is taxed again

if such an amount is donated or distributed to another person by his/her estate. The result is an undesirable situation where the same person is taxed more than once on the same amount. This situation could be prevented by a system where the transferee is taxed on amounts inherited rather than the transferor or by a deemed realisation approach as discussed in Chapter 2.7.

- ***Forced sales to pay taxes – equity and ability to pay***

The principle of equity submits that taxpayers should receive the same tax treatment, regardless of whether they inherited cash or an asset such as a family farm or small business. This was also submitted as an argument in justifying a wealth transfer tax in Chapter 2.6.1 However, no distinction is made between cash or other in kind assets in most wealth transfer tax methods, including South Africa's current estate duty system. Assets transferred are frequently illiquid assets and the heir might be forced to dispose of the asset in poor market conditions or may even be forced to borrow funds to pay the estate duty. The beneficiary who inherits cash would not encounter this problem, thus leading to inequity between such taxpayers. (Pareja, 2008:844, 858.).

Pareja (2008:844) submits that, in a system such as the estate duty system, this forced sale perception creates problems to a lesser extent than under a system where gifts and bequests are included in income of taxpayers receiving gifts or bequests. This is because a separate wealth transfer tax system is normally designed to target the very wealthy as a result of the exemptions granted under such a system. However, according to Pareja (2008:844-845), there is still a general perception amongst the public that wealth transfer taxes force people to liquidate their inheritances, even under a separate wealth transfer tax system.

In a study performed based on the inheritance tax in the United Kingdom (although it is called an inheritance tax in the United Kingdom, it is actually an estate tax), Lee (2007:694) is of the opinion that the burden to pay the estate duty falls on those with a modest wealth and not on the very wealthy. Very wealthy individuals can afford proper tax planning to avoid estate duty. They have the resources available to give away part of their wealth during their lifetime whilst still retaining sufficient resources to support their

lifestyles for the rest of their lives. On the other hand, more people with moderate wealth have to bear the estate duty charge simply due to increasing house prices, which consequently make them subject to estate duty. Such taxpayers do not necessarily always have resources available to engage in advance tax planning to prevent estate duty from being payable at the time of death.

In South Africa it could be submitted that estate taxes, without proper tax planning, largely affect the wealthy. The high unequal distribution of wealth and poverty might indicate that very few South Africans have an estate that will be subject to estate duty. Furthermore, the rebate of R3 500 000, together with the marital exclusion contained in section 4A of the Estate Duty Act, effectively exempts many transferors and estates from being subject to the wealth transfer tax. This can, however, not be submitted as an argument justifying such a tax. The cost in comparison with the income generated by such a tax needs to be considered and is further discussed below and in Chapter 3.2.

- ***High administration and compliance cost with low revenue yield***

The tax revenue raised by estate tax does not appear to compensate for the high administration and compliance cost associated with an estate tax system. According to Vasek, "the National Federation of Independent Business estimated that the government and individuals collectively spend some 65 cents for each dollar of estate and gift tax collected – that's $5 to $6 billion annually – for enforcement and compliance activities" (Pareja, 2008:862).

One of the reasons for abolishing estate tax in Australia was also the high administration costs in relation to the small amount of revenue that it raised (Duff, 2005:110).

Bacheldor (2007:12) submits that the reason for the complexity of the estate tax system and the high compliance cost associated with the system can be attributed to efforts to close loopholes used by tax planners to minimise estate tax at death. It is questionable whether such costs can be justified, if compared to the low percentage that the estate tax contributes to Government's total tax revenue (refer to Table 3 in Chapter 3.2).

- ***Neutrality principle***

The tax neutrality principle implies that a wealth transfer tax should not result in people changing their behaviour solely to avoid or minimise their wealth transfer tax liability (Pareja, 2008:864). Estate planning by individuals to reduce the value of taxable estates undermines this neutrality principle. Estate planning tools include the use of trusts and the making of annual gifts whereby the annual gift exclusion is utilised.

Dodge (1978:1183) submits that wealth saved would be taxed frequently, while wealth consumed would be taxed only once. This holds true for South Africa, since income received or accrued is firstly taxed under the normal income tax rules in the year received and then also under estate duty as well as capital gains tax at death if the income were applied to obtain an asset. The current estate duty system might discourage saving by encouraging people to either dispose of assets before death (through proper estate planning) or to consume the wealth during their lifetime to minimise the dutiable amount of the estate and thereby cause people to act in a way in which they would not otherwise have done.

- ***Public choice theory***

Duff (2005:75) explains the public choice theory as “the economic study of nonmarket decision making” or “the application of economics to political science”. Duff (2005:75) submits that if the political costs pertaining to a wealth transfer tax outweigh the perceived benefits associated with that tax, the existence of such a wealth transfer tax might be politically vulnerable. This can be illustrated through an example in the United Kingdom where a massive protest action by taxpayers against a so-called poll tax (introduced in 1990), which they perceived as inequitable and unsustainable, led to the resignation of Margaret Thatcher (the then Prime Minister) who supported the tax. All three candidates for her position as Prime Minister undertook to abandon the tax once appointed. (Lee, 2007:692.).

Duff (2005:74) submits that the abolition of wealth transfer taxes in Canada, Australia and New Zealand can be explained through the application of the public choice theory of politically efficient revenue structures.

2.7 ALTERNATIVE METHODS OF WEALTH TRANSFER TAX

Various methods of taxing wealth transfers are applied and studied internationally. Some of the alternative methods of wealth transfer tax include a deemed realisation approach where capital gains tax is levied, an accessions tax, an inheritance tax and an inclusion-in-income approach. Variations exist relating to each approach identified and some studies even proposed a combination of two or more of these methods. With the exception of the deemed realisation approach, the majority of alternatives supports an approach where the transferee, rather than the transferor is taxed. This study will investigate these options in more detail below.

2.7.1 Taxing the transferee rather than the transferor

Thomas Adams, a leading economist, argued that “if we must tax, it is better to tax him who merely receives than him who earns” (Rowlingson, 2008:153).

Recent studies performed by Alstott (2007:542), Batchelder (2007:51), Dodge (2009:1000), Duff (2005:49) and Pareja (2008:896) support a system where the transferee, rather than the transferor is taxed. According to Dodge (2009:1000), there is a strong theoretical and political appeal to move from a system where the transferor is taxed to a system where the transferee is taxed. It is furthermore submitted that taxing the transferor rather than the transferee is a “design flaw” in the estate tax system (Dodge, 2009:1001).

Taxing of the transferee might overcome the double-taxation problem which resulted from the current estate duty and capital gains tax at death, since the transferee (heir) is a different taxpayer than the transferor (estate) (Dodge, 2009:1007). This transferee-orientated system will also support wealth distribution, since it provides an incentive to give

more broadly (Bacheldor, 2007:13; Pareja, 2008:86). A transferee-orientated wealth transfer tax therefore supports the ability-to-pay principle as referred to in Chapter 2.6.2.

The alternative wealth transfer tax methods analysed in this study will consequently mainly focus on alternatives where the transferee, rather than the transferor is taxed, with the exception of the deemed realisation approach discussed below.

2.7.2 A deemed realisation approach

A deemed realisation approach deems the deceased to have disposed of his or her assets for an amount equal to the market value of the assets on the date before the death of the taxpayer. The heir or legatee is deemed to have acquired the asset for a base cost equal to that same market value. (Dodge, 2001:430-431.). The tax is still borne by the transferor under this approach, as is the case with the current estate duty. Canada abolished gift and inheritance taxes and adopted the deemed realisation approach during 1972 (Duff, 2005:101-102).

South Africa follows a similar approach with the implementation of capital gains tax at death in 2001. However, South Africa levies both capital gains tax and estate duty on death, as discussed in Chapter 2.3, leading to a double-taxation effect, which is a major criticism against estate duty. Since the tax is borne by the transferor, there is no incentive to give more broadly as discussed under 2.7.1 above. The ability-to-pay principle is also not supported by this approach since the tax is not borne the taxpayer who received the benefit (the transferee) and who has an increased ability to pay. Under this approach, taxpayers may dispose of their growth-assets at an earlier, stage while they are still alive, in order to dispose their assets at a lower market value. Consequently, wealth distribution might be encouraged to occur at an earlier stage and not only at death under a deemed realisation approach.

Lee (2007:700) submits that a capital gains tax on death (a deemed realisation approach), without another form of wealth transfer tax as well, is believed to be fairer. Taxpayers perceive capital gains tax to be fairer than an estate tax, since they understand the arguments for doing so (Lee, 2007:701). This is because it is the increase in the value of

the asset that is taxed (a new source of revenue) and not the amount that was already taxed when initially earned by the same taxpayer.

In 2001 Dodge (2001:529) concluded that a deemed realisation approach could solve most of the problems experienced by the estate tax. However, in a recent study in 2009, Dodge (2009:997-1062) also favoured an alternative where the transferee, rather than the transferor is taxed and recommended an accessions tax. In light of this, it appears that a transferee-orientated wealth transfer tax might be superior to the deemed realisation approach, but will need further investigation.

2.7.3 Accessions tax

Under an accessions tax, the transferee instead of the transferor is taxed, as is the case under the deemed realisation approach above. The accessions tax is based on the cumulative gifts and bequests (accessions) received by an individual over such person's lifetime. An accessions tax normally provides for a lifetime exemption and is based on a rate structure separate from the income tax-rate structure. (Dodge, 2009:999.). The tax burden therefore increases as one's lifetime accessions increases.

The progressive rate structure of an accessions tax encourages wealth dispersion since it provides an incentive to spread bequeaths over a number of transferees (Dodge, 2009:1004).

Batcheldor (2007:5-7) proposes a combination of accessions tax and the inclusion-in-income approaches (see Chapter 2.7.5) and submits that it is unfair to include money earned from hard work in income but not money inherited, since both persons have the same economic income. She proposed that inheritances should be included in the income of the transferee and that the progressive tax rates should be based on the amount that a transferee has inherited as well as on the transferee's other income (Batcheldor:2007:5-7). This approach will also contain a lifetime inheritance exemption and inheritances above the exemption limit will be taxed at the income tax rate as well as the fixed-percentage surtax (Bacheldor, 2007:16). Furthermore, this approach will support the ability-to-pay

principle by calculating the tax burden on the amount inherited as well as other income (Bacheldor, 2007:7).

One of the problems with an accessions tax is that the net amount received by each person will have to be determined, which might be more cumbersome to administer. It is submitted that this might be the problem with any transferee-orientated approach and is not unique to an accessions tax approach. One way in which this problem might be resolved is that the revenue authorities could expect transferors (donors) and third parties (executors, trustees and insurance companies) to report wealth transfers to them (Dodge, 2009:1009-1010).

2.7.4 Inheritance tax

The term “inheritance tax” is a term broadly used by writers in different contexts. Some, as is done in the United Kingdom, for example, refer to an estate tax as an inheritance tax (Page, 2009:293). The term is sometimes used to refer to an accessions tax or to any recipient-focused wealth transfer tax (Pareja, 2008:871).

Under an inheritance tax system, as referred to in this study, the transferee is taxed annually on inheritances received. The tax is only based on the inheritances received and is not influenced by other income or gratuitous receipts, as is the case with an accessions tax. (Pareja, 2008:871.) Countries such as Ireland replaced their estate taxes with an inheritance tax (Tax Policy Centre, 2010).

In a study performed by Batchelder (Tax Policy Briefing Book, 2008) it was determined that the majority of the countries selected had an annual inheritance tax. The underlying data in support of this finding is contained in Table 2 below.

Table 2: Type of wealth transfer tax in 34 countries

	Estate and gift tax	Annual inheritance tax	Accessions tax	Inclusion tax	None
Australia					1
Austria			1		
Belgium		1			
Bulgaria		1			
Canada					1
Czech Republic		1			
Denmark	0.25		0.5	0.25	
Estonia					1
Finland		1			
France		1			
Germany		1			
Greece		1			
Hungary		1			
Iceland		0.5		0.5	
Italy					1
Ireland			1		
Japan	0.5	0.5			
Korea		1			
Lithuania		0.5		0.5	
Luxembourg		1			
Netherlands		1			
New Zealand					1
Norway		1			
Poland		1			
Portugal	0.5	0.5			
Russia				1	
Serbia		1			
Slovenia		1			
Spain		1			
Sweden					1
Switzerland	0.5	0.5			
Turkey		1			
U.K.	1				
U.S.	1				
Total	**3.75**	**19.5**	**2.5**	**2.25**	**6**

Source: The Tax Policy Briefing Book (2008)

The Katz Commission (1997:11-13) considered in their Fourth Report whether South Africa should retain its system of estate duty or whether it should be replaced with an inheritance tax. The Commission concluded that the estate duty system should be retained. It was submitted that an inheritance tax is more complex and cumbersome to administer, since it involves more than one tax entity in comparison to the current estate duty system. Because estate duty is a well-established method for taxing the transfer of

wealth in South Africa over many years (since 1955), the collection systems relating to estate duty are well-established and there are a number of already decided case law. The Commission submitted that resources available to the SARS can rather be used more effectively elsewhere. (Katz Commission, 1997:11-13.).

It appears that, although the inheritance tax system is superior to an estate duty system in many instances, the main reason for the recommendation by the Katz Commission not to implement an inheritance tax system was the fact that it is more cumbersome to administer (Katz Commission, 1997:11-13).

According to Dodge (2009:1008), all the problems associated with an estate tax (such as valuation, liquidity and vulnerability to tax avoidance) will not be solved by an inheritance tax.

2.7.5 Inclusion-in-income approach

This approach treats inheritances similar to normal income received. The recipient includes gifts and bequests in his/her income in the year received and there is no lifetime exemption, as is the case with the accession tax (Dodge, 2009:999).

Trusts are usually mainly used for estate planning purposes. In terms of section 7 of the Income Tax Act, certain income produced by reason of or in consequence of a donated asset by the donor is attributed back to the donor, even though the donor did not actually receive the benefit of such income. Dodge (1978:1180-1181) submits that a system, similar to South Africa's complex section 7 of the Income Tax Act, and the complex tax rules pertaining to the taxation of trusts would no longer be needed under an inclusion-in-income approach. No distinctions would need to be made, as is currently the case with trusts, between current income, accumulated income, capital gains and gift or bequest amounts distributed to beneficiaries, since the beneficiary (and not the trust or estate) will be taxed on all amounts distributed to them, regardless of the nature or source of the distributions.

According to Dodge (1978:1184), entities such as estates and trusts merely facilitate gratuitous transfers and serve the ends of individuals. By using entities such as trusts, the tax consequences are deferred. The main reason why such entities are currently taxed under complex tax rules is to prevent this deferral of tax consequences (Dodge, 1978:1184). Dodge (1978:1195) submits that the tax loss incurred by not preventing the deferral of tax consequences will be offset by the eventual taxation of the income from the trust and estate that has appreciated upon the time of distribution. The need for less complex tax rules and the reduced administration and compliance costs, associated with combating tax avoidance by taxpayers using entities such as trusts, may also outweigh such possible tax loss.

No separate progressive tax rate is applied to bequest amounts in an income-inclusion-approach, since such a rate structure would complicate this approach by necessitating the (sometimes difficult and troublesome) distinction between amounts that constitute normal income and amounts that constitute bequests (Dodge, 1978:1190).

Pareja (2008:870) submits that this method is the most equitable because it treats everybody equally by simply adding the gratuitous receipts to the taxable income of each individual on the date of receipt or accrual. Furthermore, this approach supports the ability-to-pay principle by taxing the transferee who received the bequest which effectively increased his/her ability to pay. This approach also facilitates compliance, since separate returns regarding bequests are not necessary and separate recordkeeping of prior accessions is not required.

Although the inclusion-in-income-approach appears to address most of the problems associated with other approaches, it does not appear to address the problem of public perception regarding forced sales, as discussed in Chapter 2.6.2 (Pareja, 2008:870). Transferees might still be forced to sell illiquid assets in order to pay taxes under this approach.

2.8 CONCLUSION

Estate duty and other forms of wealth transfer tax were abolished in countries all over the world including in Canada, Australia, New Zealand and the United States. Alternatives to estate duty were identified and the existing literature on the alternatives was reviewed in this chapter. Alternatives identified were a deemed realisation approach, accessions tax, inheritance tax and an inclusion-in-income approach. Of the alternative methods identified no method can be said to be flawless and each one is accompanied by its own set of shortcomings and advantages.

A transferee-orientated approach (such as an accessions tax, an inheritance tax and an inclusion-in-income approach) supports the ability-to-pay principle since the person that inherits the wealth has the greater ability to pay and has to bear the tax. Such an approach also provides an incentive to give more broadly in order for numerous transferees to bear the tax on the different assets allocated to them. However, the transferee might still be forced to sell inherited assets in order to pay the taxes.

All of the transferee-orientated approaches taxes the transferee and the amount of tax revenue generated from such approaches will mainly depend on the exemption levels set and the tax rates implemented under each approach. This will need careful consideration and the cost associated with the administration and compliance of such taxes will have to be compared with the revenue generated.

It is doubtful that the Government will succeed in earning more revenue from any alternative identified in comparison with the current estate duty system. Increased taxes under a different wealth transfer tax will not be accepted favourably by the public. By taxing a different taxpayer, the transferee, than the transferor who initially generated the wealth, the tax burden is merely shifted from one person to another without generating more net tax revenue and without aiding in more efficient and effective wealth distribution. The transferor will still select the transferees, thereby not aiding in wealth distribution in form of distributing assets to the poor.

By analysing the different methods it is doubtful that any alternative in itself will aid in wealth distribution. The effectiveness of wealth distribution does not lie in the wealth transfer tax approach implemented, but rather in how the Government applies the tax revenue collected in order to distribute wealth.

By looking at the international trend to abolish wealth transfer tax in first-world countries, as well as taking into account the shortcomings of the estate duty system in South Africa (such as the double taxation effect of estate duty and capital gains tax at the date of death), it needs to be considered as to whether estate duty is still efficient and effective in South Africa. This is done in the next chapter by analysing the literature reviewed in this chapter and by making use of calculations to compare South Africa's current estate duty system with the alternative wealth transfer tax methods identified.

CHAPTER 3
AN ALTERNATIVE METHOD OF WEALTH TRANSFER TAX FOR SOUTH AFRICA

3.1 INTRODUCTION

Alternative wealth transfer tax methods have been identified in the previous chapter. In order to establish which method might be superior for South Africa, methods are compared in this chapter by making use of simplified calculations.

3.2 A CRITICAL ANALYSIS OF ALTERNATIVE METHODS FROM A SOUTH AFRICAN PERSPECTIVE

Estate duty constitutes a very small percentage of the total gross tax revenue of South Africa. Table 3 below summarises the estate duty tax revenue collections as a percentage of the total gross tax revenue over the previous 18 years.

Table 3: Estate duty revenue as a percentage of gross total tax revenue

Year	Estate duty revenue R million	Gross total tax revenue R million	Percentage
1992/93	84.9	83 729.3	0.10%
1993/94	118.3	97 487.7	0.12%
1994/95	125.3	113 774.5	0.11%
1995/96	181.3	127 278.0	0.14%
1996/97	181.8	147 332.3	0.12%
1998/99	256.4	184 785.9	0.14%
1999/00	304.2	201 265.9	0.15%
2000/01	442.7	220 119.1	0.20%
2001/02	481.9	252 295.0	0.19%
2002/03	432.7	281 939.3	0.15%
2003/04	417.1	302 442.6	0.14%
2004/05	506.9	354 978.8	0.14%
2005/06	624.7	417 195.7	0.15%
2006/07	747.4	495 548.6	0.15%
2007/08	691.1	572 814.6	0.12%
2008/09	756.7	625 100.2	0.12%
2009/10	740.0	590 425.0	0.13%

Source: National Treasury (2010:162-164)

From the percentages in Table 3 above, the average estate duty revenue is a mere 0,14% of the total gross tax revenue. Since the information was obtained for the previous 18 years and the percentage remained relatively constant, it is not expected that the percentage will increase drastically in the near future.

The Government is reluctant to replace or abolish estate duty, because it was submitted that an estate duty system is less cumbersome to administer (Katz Commission, 1997:11-13). Furthermore, the estate duty system supports the Government's fiscal policy of wealth distribution (Katz Commission, 1997:1). However, the compliance and administration cost associated with such a system cannot be ignored. Tax planners spent hours of their time designing an estate plan for taxpayers to minimise their estate duty liability at the time of death; in turn, the legislatures spent hours of their time in combating loopholes in the tax legislation utilised by such tax planners and the SARS spent time and costs on operating, monitoring and enforcing the estate duty system.

It is doubtful whether such a small contribution to the total tax revenue collected by the Government will effectively aid in a more equal distribution of wealth. Effective equal distribution of wealth might rather be obtained through proper allocation of revenues collected to the expenditure accounts supporting distribution of wealth and proper administration of such expenses. Inquiry needs to be made as to how the tax revenues collected are applied and, even more so, as to how it can be applied and administered more effectively to support the Government's fiscal policy of wealth distribution. This is, however, beyond the purpose of this study and could be considered as a topic for future study.

Furthermore, the estate duty system does not appear to satisfy the ability-to-pay principle. Under South Africa's current estate duty system, the liability to pay the estate duty falls mainly on the estate (transferor or executor of the estate) and not on the transferee who actually received the benefit of the transfer and who ultimately has an increased ability to pay. All the identified transferee-focused wealth transfer methods discussed in Chapter 2.7 therefore support the ability-to-pay principle.

In order to compare the tax revenue generated through South Africa's current estate duty system, current capital gains tax system, an amended capital gains tax system (similar to the one of Canada referred to in Chapter 3.3) and a basic inclusion-in-income approach, tax calculations were performed below based on a simplified example.

Calculation 2: Tax revenue generated through the application of different wealth transfer tax methods

Mr X died on 28 February 2010 at the age of 58 years. His only income for the 2010 year of assessment was his income from employment, which amounted to R450 000, and his only liability was his mortgage bond of R500 000. In terms of his will, all his assets were bequeathed to his children. At the date of death, the total market value of his assets was R4 100 000, which consisted of the following:

Asset	***Market value at date of death***	***Base cost***	***Capital gain***
	R	***R***	***R***
Primary residence	*2 500 000*	*1 000 000*	*1 500 000*
Personal assets	*100 000*	*20 000*	*80 000*
Other assets not subject to any exclusions	*1 500 000*	*1 000 000*	*500 000*
	4 100 000	***2 020 000***	***2 080 000***

	Current estate duty and capital gains tax system	Current capital gains tax system only	Capital gains tax system based on Canadian legislation	Basic inclusion-in-income system
	R	R	R	R
Other income	450 000	450 000	450 000	450 000
Bequests received				
- Primary residence	-	-	-	2 500 000
- Personal assets	-	-	-	100 000
- Other assets not subject to any exclusions	-	-	-	1 500 000
Taxable capital gain	95 000	95 000	290 000	-
Capital gain (refer to calculation above)	2 080 000	2 080 000	2 080 000	-
Less primary residence exclusion	(1 500 000)	(1 500 000)	(1 500 000)	-
Less personal-use-asset exclusion	(80 000)	(80 000)	-	-
Less exclusion at death	(120 000)	(120 000)	-	-
Taxable income	545 000	545 000	740 000	4 550 000
Normal tax	160 960	160 960	238 960	1 762 960
Less primary rebate	(9 756)	(9 756)	(9 756)	(9 756)
Normal tax liability	151 204	151 204	229 204	1 753 204
Estate duty payable	-	-	-	-
Property (market value of assets)	4 100 000	-	-	-
Less mortgage bond	(500 000)	-	-	-
Less normal tax liability	(151 204)	-	-	-
Less estate duty rebate	(3 448 796)	-	-	-
Total tax liability	**151 204**	**151 204**	**229 204**	**1 753 204**

The following should be noted with regard to the calculations performed above:

- South Africa's current 2010 tax legislation was used to calculate the total tax payable under the current estate duty system and capital gains tax system;
- the estate duty rebate is R3 500 000 but the rebate amount is limited to the actual dutiable amount of R3 448 796;
- the calculations were performed based on the marginal income tax rates and rebates applicable to the 2010 year of assessment. The current 25% capital gains tax inclusion percentage applicable to individuals as well as the R120 000 exclusion, at

the date of death, was used for the South African approach. A 50% inclusion rate was used, with no annual exclusion, for the amended capital gains tax approach calculation, which is similar to the Canadian treatment referred to in Chapter 3.3; and

- it is submitted that an accessions tax or an inheritance tax will give similar results to those of the inclusion-in-income approach, except that a separate rate structure would have to be applied to the accessions or inheritances. Under an accessions tax other donations received from all persons during the year will also have to be included and the lifetime exemption will have to be deducted. The resulting tax revenues generated from an accessions tax or inheritance tax will mainly depend on the rate structure decided on and the exemption amount elected. Such calculations will therefore involve playing around with percentages and exemptions and are thus not included in the comparative calculations performed in the example above. For example, if a transferee inherited assets worth R4 100 000 (as in the example above), inheritance tax will have to levied at a rate of 3,69% (R151 204/R4 100 000) to generate the same amount of tax revenue as under the current estate duty and capital gains tax system. A higher or lower percentage might yield the same tax revenue, depending on the exemption amount granted.

From the calculations above it can be seen that, based on the amounts used in the example, South Africa's current estate duty system (where capital gains tax are also payable) yields the same tax revenue as the current capital gains tax system, without the estate duty system. The amended capital gains tax approach yields higher tax revenue because of the higher taxable capital gain inclusion percentage of 50% and because there is no annual capital gain exemption and also no personal-use-asset exemption applicable. As can be expected, the inclusion-in-income approach yields the highest tax revenue since 100% of the amount is taxed at the maximum marginal tax rate of 40%, with no exemption. It is therefore evident that careful consideration will have to be given to the inclusion percentages and exemptions used, since they have a major impact on the tax revenues generated through the different approaches.

Based on the information in the example above, the current estate duty system (together with the current capital gains tax system), will only generate more tax revenue if the dutiable amount of the estate exceeds the current estate duty abatement of R3 500 000. In

order to generate R0,01 more tax revenue under South Africa's estate duty system (combined with the current capital gains tax system) than under a system where there is no estate duty but only the current capital gains tax system, two options were considered in the calculations performed below. These are either to increase the value of the property in the estate from R4 100 000 to R4 151 204,05 (option 1) or to decrease the normal tax liability that is allowed as a deduction against the value of the property by decreasing the other income from R450 000 to R316 417 (option 2). By executing both these options, the dutiable amount of the estate will be R0,05, which will result in R0,01 estate duty being payable if a rate of 20% is applied. This is illustrated by the calculations below.

Calculation 3: Current estate duty and capital gains tax system vs. current capital gains tax system

	Current estate duty and capital gains tax system	**Current capital gains tax system only**
OPTION 1	**R**	**R**
Normal income	450 000,00	450 000,00
Taxable capital gain	95 000,00	95 000,00
Capital gain (refer to calculation above)	2 080 000,00	2 080 000,00
Less primary residence exclusion	(1 500 000,00)	(1 500 000,00)
Less personal-use-asset exclusion	(80 000,00)	(80 000,00)
Less exclusion at death	(120 000,00)	(120 000,00)
Taxable income	545 000,00	545 000,00
Normal tax according to tax tables	160 960,00	160 960,00
Less primary rebate	(9 756,00)	(9 756,00)
	151 204,00	151 204,00
Estate duty payable @ 20% of R0,05	0,01	-
Property (market value of assets)	4 151 204,05	-
Less mortgage bond	(500 000,00)	
Less normal tax liability	(151 204,00)	-
Less estate duty rebate	(3 500 000,00)	-
Total tax payable	**151 204,01**	**151 204,00**

OPTION 2	**Current estate duty and capital gains tax system** **R**	**Current capital gains tax system only** **R**
Normal income	316 417,00	316 417,00
Taxable capital gain	95 000,00	95 000,00
Capital gain (refer to calculation above)	2 080 000,00	2 080 000,00
Less primary residence exclusion	(1 500 000,00)	(1 500 000,00)
Less personal-use-asset exclusion	(80 000,00)	(80 000,00)
Less exclusion at death	(120 000,00)	(120 000,00)
Taxable income	411 417,00	411 417,00
Normal tax according to tax tables	109 755,95	109 755,95
Less primary rebate	(9 756,00)	(9 756,00)
	99 999,95	99 999,95
Estate duty payable @ 20% of R0,05	0,01	-
Property (market value of assets)	4 100 000,00	-
Less mortgage bond	(500 000,00)	
Less normal tax liability	(99 999,95)	-
Less estate duty rebate	(3 500 000,00)	-
Total tax payable	**99 999,96**	**99 999,95**

From the preliminary information gathered and analysed at this stage, it appears that South Africa should consider abolishing estate duty, together with the current donations tax, without replacement. Donations tax is currently levied at the same rate of 20% applicable to estate duty. The main reason for donations tax is to prevent taxpayers from donating their assets while they are still alive in order to minimise their estate duty liability at the date of death. It is therefore submitted that, if estate duty is abolished, donations tax should also be abolished.

Attention should rather be paid to the current, established capital gains tax system whereby taxable capital gains are included in income. Although some of the alternative methods might yield higher tax revenue, if adopted, an entire new wealth transfer tax method will have to be implemented for South Africa. This could impact the entire tax legislation and result in high compliance and administration costs. Furthermore, careful consideration will then still have to be given to the design and effects of such an alternative in order to eliminate the double taxation effect that such an approach, together with the

current, established capital gains tax might have. If this cannot be achieved, the main criticism against the current system in South Africa will continue to exist with the new adopted alternative as well.

The death of a taxpayer already results in a deemed disposal at market value for capital gains tax purposes under paragraph 40 of the Eighth Schedule of the Income Tax Act. Similarly, an *inter vivos* donation of an asset is deemed to be a disposal in terms of paragraph 38 of the Eighth Schedule and any other event whereby a taxpayer disposed of an asset owned by him/her, is a capital gains tax disposal event in terms of paragraph 11 of the Eighth Schedule of the Income Tax Act.

Further investigation into the current exclusions under the Eighth Schedule will, however, be necessary. Personal-use assets are specifically excluded from capital gains tax under paragraph 53 of the Eighth Schedule of the Income Tax Act. For an individual without any other interests and businesses, this current provision will have the effect that no assets of such an individual will be taxed whereas, under our current estate duty system, all such personal use assets fall within the estate and are taxed at a rate of 20%.

If estate duty is abolished, the deemed disposal at market value at death might alter the behaviour of taxpayers while they are still alive. Taxpayers might dispose of their assets during their lifetime in order to pay capital gains tax on a lower market value. This might aid in the distribution of wealth at an earlier stage and not simply only at death. Further studies will, however, have to be performed on the possible change in behaviour to substantiate this, which is beyond the scope of this study.

Amendments will also have to be made to South Africa's current capital gains tax legislation if the forced-sales-to-pay-taxes issue has to be addressed. Consideration will have to be given to the legislation in countries such as Canada where this approach is currently applicable.

3.3 REFERENCE TO CANADIAN CAPITAL GAINS TAX LEGISLATION AT THE TIME OF DEATH

South Africa's tax legislation dealing with capital gains is similar to Canada's capital gains tax legislation. Canada, however, abolished estate duty and adopted the capital gains tax system in 1972, whereas South Africa only implemented capital gains tax with effect from 1 October 2001. The capital gains tax rules applicable in Canada are summarised below with reference to the Canada Revenue Agency's guide in preparing returns for deceased persons (Canada, 2009b:21-26).

- Similar to the South African treatment, a person is deemed to have disposed of his/her capital assets at proceeds equal to the fair market value on the date before the date of death. The person is deemed to have acquired the deemed proceeds of the deemed disposition right before death and the capital gain or loss is calculated as deemed proceeds less the adjusted cost base. Capital gains and capital losses are included in taxable income at an inclusion percentage of 50%, compared to South Africa's 25% inclusion percentage for individuals.
- Unlike South Africa, a capital loss is not allowed on the disposition of a depreciable asset and also not on the disposition of personal-use property. The recapture of capital cost amount of the depreciable asset (this is similar to the South African recoupment provisions in section 8(4)(a) of the Income Tax Act) must be included in income on the deceased's final return. For depreciable assets only, the terminal loss (this is similar to the scrapping provision of South Africa) must be deducted from income on the deceased's final return. No loss on personal-use property may, however, be deducted from income.
- For non-depreciable property transferred to a spouse, common-law partner, testamentary spousal or common-law partner trust, a depreciable farm transferred to a child or a depreciable fishing property transferred to a child an election can be made to defer the capital gain or loss on the deemed disposal at death. If elected, the deemed proceeds are treated as being equal to the property's adjusted cost base (similar to the base cost refer to in paragraph 20 of the Eighth Schedule to the Income Tax Act) right before death. The deceased will not have a capital gain or loss,

since the transfer postpones any gain or loss to the date the beneficiary disposes of the property. If this option is not elected, it is deemed under normal rules that the deceased has disposed of the property for proceeds equal to the property's fair market value right before death and the tax is therefore not deferred.

- The deferral election explained above is also applicable to depreciable property transferred to a spouse, common-law partner, testamentary spousal or common-law partner trust, a depreciable farm transferred to a child, or a depreciable fishing property transferred to a child. However, instead of deeming that the property was disposed of for proceeds equal to the property's adjusted cost, if elected, it is deemed that the property was disposed of at a special amount calculated by using a specified formula. The effect of this election will be that the deceased will not have a capital gain, recapture of capital cost allowances, or a terminal loss, because it is postponed to the date that the beneficiary disposes of the property.
- A taxpayer may also elect the deferral provisions when a share of the capital stock of a family farm or family fishing corporation or an interest in a family farm or family fishing partnership is transferred to a child.
- Furthermore, it can be elected to delay payment of the capital gains tax amount owing from the deemed disposal of capital property. Interest is, however, charged on any unpaid amount from the day after the due date until the amount is paid in full. Security has to be provided for the amount owing.
- If a capital loss is realised, the taxpayer may elect to carry back the loss to the three years before the date of death, thereby reducing any taxable capital gains incurred in those years. Alternatively, the capital loss can be set off against other income in the final return, the return in the year before death, or the returns of both years.
- In addition to the deferral provision, a capital gains deduction of $750 000 per lifetime is allowed on the disposition of qualified small business corporation shares, qualified farm property and qualified fishing property (Canada Revenue Agency, 2009a:12). This provision is similar to the small business asset exclusion of South Africa of R750 000 in terms of paragraph 57 of the Eighth Schedule to the Income Tax Act.
- Canada does not have a personal-use-asset exclusion similar to South Africa's paragraph 53 of the Eighth Schedule of the Income Tax Act. However, a capital gain is only calculated if the proceeds or base cost is more than $1 000. If both the

proceeds and base cost is less than $1 000, there is no capital gain or loss (Canada Revenue Agency, 2009a:19).

- Canada also does not have primary residence exclusion similar to the one contained in paragraph 45 of the Eighth Schedule of the Income Tax Act of South Africa. No capital gain or loss is calculated if the property were the principal residence of a taxpayer for the entire period that the taxpayer owned the residence. A capital gains tax calculation and apportionment will, however, have to be made if it was not used as his/her primary residence at any time during the period that the taxpayer owned the residence.

The deferral provisions contained in the Canadian capital gains tax provisions might solve the forced sales problem associated with all of the alternative wealth transfer methods identified in Chapter 2.7. Beneficiaries might not be required to sell inherited family-owned properties below market value simply to pay taxes. South African legislatures could, however, consider expanding these deferral provisions to include all small businesses and not only farming and fishing properties.

Under current South African capital gains tax legislation, a taxpayer has to account for a capital gain or capital loss on a primary residence disposed of for more than R2 000 000. Of the capital gain or loss realised, R1 500 000 may be excluded (paragraph 45 of the Eighth Schedule of the Income Tax Act). If these provisions are compared to provisions in the Canadian legislation above, it appears that the Canadian legislatures might have succeeded in treating taxpayers more equally. No Canadian will have to account for tax if a primary residence is disposed of and all Canadians have to account for tax if the residence was not used over the entire period of ownership as a principal residence. Canadian legislation therefore does not refer to any amounts (thresholds) which would effectively divide the nation between wealthy and poor. In contrast, under South African law, it is only the wealthy that has to pay tax on the disposal of a primary residence. Only the wealthy with a primary residence sold for more than R2 000 000 and a capital gain realised of more than R1 500 000 have to pay capital gains tax on such disposal. It is submitted that the result of such a treatment is similar to South Africa's estate duty system where only the wealthy is taxed on a net asset value of more than R3 500 000.

With the implementation of capital gains tax in South Africa in 2001, the National Treasury indicated that the biggest share of capital gains tax revenues can be attributed to the wealthiest of individuals and that this high inequality in South Africa makes it absolutely necessary to include capital gains in the tax base (SARS, 2001:10-11). Although the application of the vertical and horizontal equity principles is very important in a tax system (see Chapter 2.6), both estate duty and capital gains tax focus on taxing wealthy individuals. The same wealthy person is taxed at death under two different taxes, leading to double taxation and an over-enforcement of the vertical equity principle. Legislating the poor into freedom by legislating the wealthy out of freedom could well be the end of a nation, as stated in Chapter 2.6.2 (Rogers, 1984).

3.4 CONCLUSION

Estate duty is no longer an effective and efficient wealth transfer tax method for South Africa. The simultaneous application of estate duty and capital gains tax at the time of death leads to double taxation of the same amount in the hands of the same taxpayer. Furthermore, the limited tax revenue that the system generates does not appear to compromise for the associated compliance costs.

The capital gains tax system was implemented in South Africa in 2001 and is efficient and effectively applied in countries such as Canada. Canada's capital gains tax system is very similar to South Africa's capital gains tax system and it is submitted that South Africa should therefore follow Canada's approach. This will save resources for South Africa by not making it necessary to implement an entire new wealth transfer tax system (which is not guaranteed not to provide other problems), but by using the existing capital gains tax system already implemented in South Africa and by amending it based on the Canadian legislation.

CHAPTER 4
CONCLUSION

4.1 INTRODUCTION

The main purpose of this study was to analyse various alternative methods of wealth transfer tax critically from a South African estate duty point of view. This study entailed a literature review in order to identify alternative wealth transfer tax methods. The alternatives, including estate duty, were critically evaluated from a South African perspective to determine if estate duty should be abolished and replaced.

4.2 SUMMARY OF FINDINGS

Problems are experienced with the current estate duty system in South Africa. Because of the implementation of capital gains tax in 2001, the same amount is taxed in the hands of the same taxpayer at the time of death. The average estate duty revenue is a mere 0,14% of the total gross tax revenue, but it is accompanied by high administration and compliance costs.

Alternatives to estate duty that were identified include inheritance tax, accessions tax, inclusion-in-income approaches and a deemed realisation approach. Each approach comes with its own advantages and disadvantages.

4.3 PURPOSE STATEMENT AND OBJECTIVES

The main purpose of this study was to analyse various alternative methods of wealth transfer tax critically from a South African estate duty point of view. The main purpose was supported by the following research objectives:

- to analyse the literature on alternative methods of wealth transfer tax and estate duty in South Africa critically in order to establish a theoretical construct for this study. Alternative methods of wealth transfer tax were identified in Chapter 2 and include a deemed realisation approach, accessions tax, inheritance tax and an inclusion in

income approach. It was established that all of the identified approaches, except for the deemed realisation approach, is a tax on the transferee; and

- to analyse and compare the various alternative methods of wealth transfer tax critically from a South African estate duty point of view using the theoretical construct as underpin, which was done in Chapter 3; and
- to make recommendations regarding an appropriate wealth transfer tax for South Africa. This was done in Chapter 3 after having analysed and compared the various alternative methods of wealth transfer tax.

4.4 SUMMARY OF CONTRIBUTIONS

This research identified various alternative wealth transfer tax methods such as a deemed realisation approach, accessions tax, inclusion-in-income approach and inheritance tax which can be applied in South Africa. Through the literature reviewed it was determined that there is an international trend to abolish estate duty since countries such as Canada, New Zealand, Australia and the United States have already abolished this tax. This finding, namely that first-world countries have abolished estate tax, highlighted the significance of a study like this from a South African point of view where estate duty has been applied since 1955 and has never since been replaced.

The results of simplified calculations revealed that the tax revenue raised from the current estate duty, together with the current capital gains tax, in comparison with the tax revenue raised by only applying the capital gains tax, result in the same tax revenue for certain estates. This finding indicates that currently, unnecessary compliance and administration costs might be incurred on collecting two different taxes (estate duty and capital gains tax). The same tax revenue could have been obtained by only applying capital gains tax at the time of death.

Furthermore, this research concluded that estate duty should be abolished and that only capital gains tax should be levied at the time of death.

4.5 SUGGESTIONS FOR FURTHER RESEARCH

Inquiry needs to be made as to how the tax revenues collected are applied and, even more so, as to how it can be applied and administered more effectively to support the Government's fiscal policy of wealth distribution.

If estate duty is abolished, the deemed disposal at market value at death might alter the behaviour of taxpayers while they are still alive. Taxpayers might dispose of their assets during their lifetime in order to pay capital gains tax on a lower market value. This might aid in the distribution of wealth at an earlier stage and not simply only at death. Further studies will, however, need to be performed on the possible change in behaviour to substantiate this statement.

4.6 CONCLUSIONS

Although some of the alternative methods might yield higher tax revenue, if adopted, an entire new wealth transfer tax method will have to be implemented for South Africa. This could impact the entire tax legislation and result in high compliance and administration costs, which are doubtful to be offset by increased revenue from any identified wealth transfer tax method.

Attention should rather be paid to the current, established capital gains tax system whereby taxable capital gains are included in taxable income. A capital gains tax on death, without another form of wealth transfer tax as well, is believed to be fairer. It was submitted that taxpayers perceive capital gains tax to be fairer than an estate tax since they understand the arguments for doing so. This is because it is the increase in the value of the asset that is taxed (a new source of revenue) and not the amount that had already been taxed when initially earned by the same taxpayer, as is the case with the other identified alternative wealth transfer tax methods.

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