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IN THE GAUTENG TAX COURT

DATE: 18 February 2005
CASE NO: 11410

IN THE MATTER BETWEEN:

The ABC Trust Appellant

and

The Commissioner for the South African Revenue Service Respondent

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JUDGMENT

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BERTELSMANN, J

INTRODUCTION

[1] The appellant, a family trust established by the testatrix, received a bequest in the 2003 tax year.

[2] The bequest consisted of the transfer by way of testamentary disposition by the testatrix, Mrs. A, to the family trust.

[3] The disposition in the duly drawn and executed last will and testament of Mrs. A reads as follows:

"1. Erfgename

Ek bemaak my boedel soos volg:

1.1 Enige bedrag wat die ABC Familie Trust onder leningsrekening aan my verskuldig mag wees, aan gemelde trust."

[4] The respondent regards this bequest as a discharge of a debt for no consideration.

[5] The respondent has adopted the attitude that this has created a capital gain in the hands of the trust.

[6] Consequently, the capital gain has been included in the appellant's taxable income as provided for in section 26A of the Income Tax Act, 58 of 1962 ("the Act") in the Income Tax assessment issued by respondent on 18 December 2003.

THE FACTS

[7] On 17 October 2000 the testatrix sold shares to the value of R2 628 340,00 to the trust.

[8] The trust became liable to the testatrix for the value of the shares, determined at their market value on 21 June 2000.

[9] The transaction was concluded in writing by a one page deed of sale and acknowledgement of liability. This document provides that the purchase price is regarded as a loan recorded in the trust's books as a loan account in favour of the testatrix. Interest on this loan was to be determined from time to time and payable on demand, whereas the capital of the loan was repayable also on demand.

[10] Mrs. A passed away on 15 March 2002.

[11] The bequest was duly executed by the executor of Mrs. A's estate.

[12] The executor, XYZ Trust, approached the South African Revenue Service for a ruling that the provisions of paragraph 12(5) of the Eighth Schedule to the Act do not apply to this bequest.

[13] The respondent is of the view that paragraph 12(5) of the Eighth Schedule to the Act does in fact apply and has consequently

included as capital gain half the value of the bequest in the appellant's taxable income for the 2003 tax year.

[14] The appellant appeals against this ruling.

THE GROUNDS OF APPEAL

[15] It is the appellant's contention that -

(a) Paragraph 12(5) of the Eighth Schedule to the Act only applies where a debt or liability is written off by agreement;

(b) The provisions of paragraph 12(5) do not apply to testamentary dispositions, at least not to legacies or heirs.

(c) Paragraph 41 of the Eighth Schedule to the Act does not mention heirs or legatees.

(d) If the provisions of paragraph 12(5) of the Eighth Schedule do apply, the present instance does not represent a case where the debt has been discharged for no consideration. This is so, according to appellant, because the testamentary

legacy left by the testatrix to the trust created a claim in the hands of the trust which was liquid and enforceable and which cancelled out the liability which the trust had against the testatrix or her estate. Consequently, there was no disposition without value, but a set-off which automatically operated as a matter of law. Consequently, paragraph 12(5) does not apply.

THE LAW

[16] Section 26A of Act 58 of 1962 provides as follows:

> "There shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule."

[17] The Eighth Schedule to the Act deals with the manner in which taxable capital gains and assessed capital losses are calculated and determined.

[18] Critical to the determination of the question whether a taxable gain or loss has been created is the disposal of an asset. Paragraph 1 of the Eighth Schedule defines "disposal" as:

> "… an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act, forbearance, operation of law which is in terms of this Schedule treated as the disposal of an asset, and 'disposed' must be construed accordingly."

[19] Paragraph 11 of the Eighth Schedule defines disposals and includes, in sub-paragraph (1)(b) thereof:

> "the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset;"

[20] In paragraph 11(1)(g) the following is also defined as a disposal:

> "the decrease in value of a person's interest in a company, trust or partnership as a result of a value shifting arrangement."

[21] Not satisfied with the extensive and wide definition of "disposal", the legislature provides in paragraph 12 of the Eighth Schedule that certain events will be regarded as disposals, even though they may otherwise not readily qualify as such.

[22] Paragraph 12(5)(a) reads as follows:

> "(a) Subject to paragraph 67, this sub-paragraph applies where a debt owed by a person to a creditor has been reduced or discharged by that creditor -
>
> i) for no consideration; or
>
> ii) for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged …
>
> (b) Where this sub-paragraph applies the person contemplated in item (a) (in other words the debtor) shall be treated as having -

i) acquired a claim to so much of the debt as was reduced or discharged for no consideration, or if a consideration was paid, to so much of the reduction or discharge of the debt as exceeds the consideration, which claim has a base cost of nil; and

ii) disposed of that claim for proceeds equal to that reduction or discharge."

[23] This provision effectively renders the amount of the discharge taxable as a capital gain.

[24] The position of a deceased estate is dealt with in paragraph 40 of the Eighth Schedule. Paragraph 40(1) reads as follows:

"40(1) A deceased person must be treated as having disposed of his or her assets, other than –

(a) assets transferred to the surviving spouse of that deceased person as contemplated in paragraph 67(2)(a);

(b) assets bequeathed to an approved public benefit organisation as contemplated in paragraph 62;

(c) …

(d) …

to his or her deceased estate for proceeds equal to the market value of those assets at the date of that person's death, and that deceased estate must be treated as having acquired those assets at the cost equal to that market value, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a)."

(2) Subject to sub-paragraph 12(5), where an asset is disposed of by a deceased estate to an heir or legatee (other than the surviving spouse of the deceased person as contemplated in paragraph 67(2)(a) or an approved public benefit

organisation as contemplated in 62) or a trustee of a trust -

(a) the deceased estate must be treated as having disposed of that asset for proceeds equal to the base cost of the deceased estate in respect of that asset; and

(b) the heir, legatee or trustee must be treated as having acquired that asset at a cost equal to the base cost of the deceased estate in respect of that asset, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a)."

[25] The words "subject to subparagraph 12(5)" were introduced into the Act by section 82(c) of Act 74 of 2002, which is deemed to have come into operation on 1 January 2003.

[26] In his submissions on behalf of the appellant, Mr Marais SC argued that the amendment to paragraph 40(2) was not introduced

retroactively. This point was of importance, so the argument ran, because the testatrix died on 15 March 2002. Consequently, the financial year in which her estate fell to be assessed ended on that date.

[27] Consequently, argued Mr Marais, the provisions of paragraph 12(5) could not apply to the trust, as the reduction or discharge by the creditor occurred in the tax year which ended prior to 1 January 2003.

[28] It is common cause that the appellant's tax year ended at 28 February 2003.

[29] This argument, interesting though it is, may be correct as far as the testatrix and her estate is concerned. That is not the issue *in casu,* however.

[30] Paragraph 12(5) of the Eighth Schedule decrees that the acquisition of the claim is deemed to have been disposed of by the legatee or heir for proceeds equal to the reduction or discharge of which the legatee or heir became the beneficiary through the largesse of the testator or testatrix. Paragraph 12(5) does not focus upon the date

of the transaction from the point of view of the testator or the estate. The aim of paragraph 12(5) of the Eighth Schedule is and remains the beneficiary of the transaction. Section 66(13)(a) provides that where a person dies, the return shall be made for the period commencing on the first day of the year of that year of assessment and ending on the date of death. The year of assessment of the beneficiary of the last will and testament of a person that dies is not included in the provisions of this subsection.

[31] Once this fact is appreciated, the date of actual occurrence of the transaction is for present purposes no longer relevant as long as it is certain that the occurrence took place in the year of assessment that ended after 1 January 2003 as far as the tax liability of the beneficiary, the appellant, is concerned.

[32] The provisions of paragraph 12(5) do consequently determine the operation of paragraph 40(2) of the Eighth Schedule in respect of the appellant.

[33] In the alternative, the appellant argued that the effect of the transaction, namely the discharge of the trust's obligation toward the testatrix by the testamentary disposition of the full claim to the

trust, did not amount to an event that ought to be regarded as a disposal by the estate or an acquisition by the trust, but as a set-off. This was so, ran the argument, because of the fact that an obligation was created in the estate towards the trust by the testamentary disposition, which equalled the liability which the trust had towards the estate, so that set-off took place. The exact date upon which the set-off took place could be the subject of a fascinating debate. It would probably be the date upon which the final liquidation and distribution account of the estate was confirmed or published by the Master, or the date fourteen days after such publication, when the liquidation and distribution account acquires the force of a judgment. This would obviously be subject to the estate's solvency and its ability to comply with the testator's wishes.

[34] Be that as it may, I am of the view that the argument cannot succeed for two reasons:

a) The situation through which set-off could occur was created by an act on the part of the testatrix, namely the discharge of the trust, the debtor. The creditor, the testatrix, disposed of an asset by discharging the trust's debt for no consideration.

This created the situation where the claim against the trust was extinguished by operation of law, by way of set-off between the estate and the beneficiary, the trust.

b) It is not the occurrence (or "act") of set-off which renders the result thereof in the hands of the debtor taxable, but the act which amounted to a discharge of the debt: The drawing up of the last will and testament and its coming into operation at the date of death.

[35] Paragraph 11(1) of the Eighth Schedule expressly includes any operation of law which results in the extinction of an asset. The estate's asset was extinguished by the operation of law, namely the set-off, which in turn was created by a disposition by the testatrix. This transaction consequently falls squarely within the provisions of paragraphs 12(5) and 40(2) of the Eighth Schedule to the Act.

[36] The appellant's challenge must fail. The appeal is dismissed.

E BERTELSMANN
JUDGE OF THE HIGH COURT

FOR THE APPLICANT: ADV P MARAIS
INSTRUCTED BY:
FOR THE RESPONDENT: ADV D (LALOR) CRESSWELL
INSTRUCTED BY:
DATE OF JUDGMENT: 24 March 2005
REPORTABLE: YES