Things you need to know when using the R3.5m abatement

The R3.5m abatement amount is a useful technique when structuring a client's will but should not be used blindly, without due consideration.

Estate planning involves building a strategy and putting the underlying structures in place to assist with the accumulation, preservation and distribution of a client's assets. Once the relevant structures have been established, implementation of the strategy takes place over time and is not a once-off event.

When setting up the strategy it is necessary to take into account both the assets in the client's estate as well as current legal and tax legislation.

A fairly common estate planning technique involves utilising the Section 4A abatement amount in conjunction with the Section 4(q) deduction. This technique enables the first-dying spouse to bequeath the first R3.5m of his/her estate to a discretionary trust, with the balance going to the surviving spouse. Being a discretionary trust, the assets do not form part of the second-dying spouse's estate. There is therefore no estate duty payable on the first-dying spouse's estate.

The second-dying spouse's estate also qualifies for the R3.5m abatement. The two estates together, benefit from a combined R7m estate duty exemption. While this technique uses concessions available in the tax and legal environment effectively (one can save up to R839 650 in estate duty and executor's fees, using the full R7m exemption), it cannot be successfully implemented without taking a holistic view of the client's circumstances.

This can be illustrated by the following example:
Assume that Mr & Mrs Smith are married subject to the accrual regime. For the purpose of this example, let's also assume that the husband is employed and builds the bigger estate.

If the wife's estate is made up mainly of the accrual claim and she bequeaths the first R3.5m to a discretionary trust – her surviving spouse will have to find R3.5m to settle the accrual claim against his estate and may find himself in the awkward position of having to sell off assets (with CGT consequences) or raise a bond with the attendant costs in order to settle the accrual claim.

If, when structuring the client's will, this issue is identified, proper planning can identify assets which can be used to settle the claim. Because the trust is a discretionary trust, it is not recommended that the primary residence be transferred to the trust. Life assurance is one possible solution that can be utilised to settle the claim against the survivor's estate.

Living Annuities and Trusts

The concern is often raised that - on the death of the recipient of a living annuity - his or her nominated beneficiary may be a spendthrift or not competent to manage his or her own affairs.

In this regard, Glacier does allow the annuitant to nominate a trust as a beneficiary on the living annuity. It is important, however, to take note of the tax consequences of such a nomination. There is no estate duty consequence as the annuity is not regarded as an asset in the deceased's estate in terms of Section 3(3)(a)(bis)(i) of the Estate Duty Act.

Private Bag X5 Tyger Valley 7536
Email client.services@glacier.co.za
Tel +27 21 917 9002 / 0860 GLA ENG
Fax +27 21 947 9210
Web www.glacier.co.za

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Reg No 1999/025360/07 Licensed Financial Services Provider
Directors AA Raath (Chairman and Chief Executive), A Banderker, MT Moller

In terms of the 4th Schedule to the Income Tax Act, Glacier is regarded as an employer, and as such is required to deduct employee's tax at a rate of 40% (without the benefits of any rebates) from the annuity paid to the trust.

Where the trust distributes the income to a trust beneficiary in the same tax year, the income will retain its identity as an annuity and will be taxed as such in the hands of the annuitant at his or her applicable tax rate (but including rebates).

As the "employer" in respect of the beneficiary - the trust will also be obliged to withhold tax from the annuities paid to the beneficiary. However, because the annuity payment to the beneficiary is always going to be taxed at a lower effective rate than the 40% payable by the trust (because the beneficiary qualifies for the rebate) it would be advisable for the trust to apply to SARS for a tax directive in terms of paragraph 11 of the 4th Schedule.

The trust will be able to recover the tax deducted by Glacier (or the difference) from SARS when the assessment is submitted. The annuity is therefore taxed at the beneficiary's rate and not at the trust's rate.

Where the annuity income is retained in the trust – distributions in subsequent tax years will be capital distributions (after the 40% tax paid by the trust) and will not be taxable in the hands of the beneficiary.

Finally, it is important to make the point that there is no tax saving involved in using a trust – the advantage is that the annuity is protected for the beneficiary.

Any queries may be directed to:
Eugene Ward (041) 365 1303