



SOUTH AFRICAN REVENUE SERVICE

INTERPRETATION NOTE NO. 12

DATE: 27 March 2003

ACT : INCOME TAX ACT, 1962 (the Act)
SECTION : SECTIONS 8(4)(a) AND 25(1)
SUBJECT : RECOUPMENTS: ASSETS IN A DECEASED ESTATE

1. Background

In the case where the assets of a deceased estate are disposed of by the executor and a depreciation allowance was claimed by the deceased, an amount equal to the depreciation allowances could be subject to tax in the hands of either the estate or the heirs or legatees. These amounts (recoupments) are not always returned as income in the hands of the estate or in the hands of the heir/legatee, as the case may be. This could lead to an under declaration of income and circumstances where the estate, heirs or legatees could be liable for additional tax and interest.

The purpose of this note is to provide clarity regarding the application of the relevant provisions of the Act where assets are sold by the executor in the winding up of the estate and to serve as a guide with regard to income that is taxable in the hands of the estate and in the hands of the heirs/legatees.

The focus of this note is on sections 8(4)(a) and 25(1) of the Act. Any Capital Gains Tax (CGT) implications on the disposal of assets by an estate are not dealt with in this note.

2. The law and application

2.1 Section 8(4)(a)

Section 8(4)(a) provides for an amount to be included in the taxpayer's income in respect of amounts previously allowed as deductions which have been recovered or recouped during the year of assessment. In terms of paragraph (n) of the definition of "gross income" in section 1 of the Act, such recoupments must be included in the taxpayer's gross income.

In *ITC 1435 (50 SATC 117)* it was held that with regard to an asset in respect of which a wear and tear allowance has been allowed, a recoupment can only arise if that asset is sold, destroyed or otherwise disposed of and as a result thereof the taxpayer receives payment in excess of the tax value of the asset. The tax value of an asset is the purchase price less any wear and tear or depreciation allowances allowed in respect of that asset.

Section 8(4)(a) should be applied by taking into account the provisions contained in sections 8(4)(b) to 8(4)(j).

2.2 Section 25(1)

Section 25(1) of the Act provides that:

"Any income received by or accrued to or in favour of any person in his capacity as the executor of the estate of a deceased person, and any amount so received or accrued which would have been income in the hands of the deceased person had it been received by or accrued to or in favour of such deceased person during his lifetime, shall, to the extent to which such income or amount has been derived for the immediate or future benefit of any ascertained heir or legatee of such deceased person, be deemed to be income received by or accrued to such heir or legatee, and shall, to the extent to which such income or amount is not so derived, be deemed to be income of the estate of such deceased person."

The purpose of section 25(1) is to deem income accruing to the estate of a deceased person (“the estate”), that will be used for the benefit of an heir or legatee, to be the income of the heirs and legatees. Where such income is not for their immediate or future benefit it is deemed to be income of the estate. In order for this section to apply (that is to tax the income that accrued to the estate in the hands of the heir or legatee), three requirements must be met, namely:

2.2.1 Income in the hands of the deceased person prior to death

The amount that accrued to the estate must represent an amount that would have been subject to income tax in the hands of the deceased person had that amount accrued to such person prior to his or her death.

This aspect needs to be considered on a factual basis. Assets of a private nature, for example, the private residence of the deceased person sold by an executor, would not be income in the hands of such deceased person. On the other hand, if trading stock of a business carried on by the deceased person prior to his/her death is sold, the proceeds from such a sale would be income.

Similarly where a business asset, for which an allowance was previously allowed in the determination of the taxable income of the deceased person, is disposed of by the executor, a recoupment of such allowance would have been income in the hands of the deceased if such asset was sold during his/her lifetime.

2.2.2 Ascertained heir or legatee

An ascertained heir or legatee must be present. An “ascertained heir or legatee” means a definite heir or legatee with vested rights. Heirs who have renounced their inheritance cannot be said to be “ascertained heirs or

legatees". Where the will provides for a bequest to children still to be born, it cannot be said that such heirs are ascertained heirs.

In the case of an estate where the deceased left no will, the heirs will be ascertainable in accordance with the principles laid down in the Intestate Succession Act, No 81 of 1987.

2.2.3 Immediate or future benefit

The heir must have a vested (unconditional) right in the asset or the proceeds, should the asset be sold. An heir or legatee does not have a vested right if the will makes the inheritance, and the income derived therefrom, contingent upon the happening of an event, such as a marriage. The marriage may never occur.

An immediate enjoyment of the benefit is not a requirement. The receipt of an inheritance and income therefrom can be postponed to a future date, for example, until the heir attains majority. The heir will have a vested right to the inheritance and income as it is accumulated for his/her benefit. However, it must be noted that the terms of each will must be considered in deciding whether an heir or legatee has a vested right or not.

If assets were sold to settle the debts of the estate, none of the proceeds from the disposal are derived for the immediate or future benefit of the heir or legatee and accordingly section 25(1) is not applicable [*ITC 1293 (41 SATC 166)*].

If all three of the above requirements have been met, the income is deemed to be the income of the heir or legatee. The income is taxable during the year in which the income accrues or is received by the executor; not the date of the actual receipt by the heir or legatee.

If the first requirement (paragraph 2.2.1) has been met, but not the second or third requirement, the income is deemed to be the income of the estate. The executor will then, as the representative of the deceased estate (see paragraph (e) of the definition of “representative taxpayer” in section 1 of the Act), be obliged to register the estate for income tax purposes as a separate taxpayer and to render returns of income for the periods until such time as the estate is wound up.

The definition of “person” in section 1 also includes the estate of the deceased person. The rates of tax applicable to persons (other than companies) will also apply to the estate. The estate, however, does not qualify for the primary rebate (section 6 of the Act) and the exemption in respect of investment income (section 10(1)(i)(xv) of the Act).

Section 25(1) also applies to income accruing after date of death, for example, interest earned on capital invested while the estate is being wound up. The section provides that to the extent to which such income is not derived for the benefit of an ascertained heir or legatee it will be deemed to be income of the estate.

3. Example

Mr X died on 1 May 2001 and left his whole estate to his daughter, Y. The only asset in the estate was a plant used by Mr X to operate a small manufacturing concern. The plant was purchased by him 10 years ago at a cost of R500 000. It has been fully depreciated in terms of section 12C of the Act. The value of the plant at the date of death is estimated to be R600 000.

The following tax consequences will arise as a result of the different ways in which the asset is dealt with in the winding up of the estate :

3.1 The executor of the estate sells the asset (proceeds less than the debts in the estate)

The executor had to sell the plant in order to ensure that the debts (in excess of R600 000) of the estate are settled. The plant was sold for R600 000.

Due to the fact that the asset was sold by the executor in the process of winding up of the estate the amount accrued to the estate. If Mr X had sold the plant during his lifetime, the depreciation allowances previously allowed would have been recouped and would have formed part of his income. In this case the proceeds will be used to pay off the debts of the estate and Y will, therefore, not receive any benefit from the estate.

The amount recouped (R500 000) will form part of the income of the estate. (The recoupment is limited to the amount of allowances claimed by Mr X.)

The executor will be obliged to ensure that the estate is registered for income tax purposes and render a tax return declaring the amount of the recoupment as taxable income in the year of assessment that the amount was recovered or recouped. Any assessed loss incurred by the deceased up to date of his death is forfeited and cannot be set off against the income of the estate. The loss does not constitute expenditure incurred by the estate in terms of section 25(2).

No amount will be subject to income tax in the hands of Y as she will not obtain any benefit from the estate.

3.2 The executor of the estate sells the asset (ascertained heir entitled to inheritance)

The will stipulates that the plant must be sold in the winding up of the estate. (There were no debts in the estate.) The plant was sold for R600 000 and upon finalisation of the estate the net proceeds (after deduction of normal estate administration costs) were distributed to Y. The recoupment would have been income in the hands of the deceased, there is an ascertained heir and it is for the heir's immediate or future benefit. The requirements of section 25(1) have, therefore, been met. Y must, therefore, include the amount of the recoupment in her taxable income in the year of assessment during

which the amount accrued to the estate and not when it is actually paid to her.

3.3 The executor of the deceased estate sells the asset (income not for immediate/future benefit)

In terms of the will the executor is required to sell the plant. However, the will stipulates that Y is entitled to the inheritance, but not before her marriage. It cannot therefore be said that the inheritance will be derived for her benefit (she may never receive the inheritance because she may not marry) and consequently the recoupment will be taxable in the hands of the estate and not in the hands of Y.

3.4 The executor of the deceased estate distributes the asset *in specie* to the heir or legatee

In terms of the will Y is the only heir. She is prepared to pay all the administration costs pertaining to the winding up of the estate. Upon finalisation of the estate the asset is transferred to her. Due to the fact that no amount accrues to the estate section 25 does not apply. No amount is therefore deemed to accrue to either the estate or the heir.