

**THE EFFECTIVENESS OF A TRUST AS A TAX PLANNING TOOL IN  
LIGHT OF OUR CURRENT LEGISLATION AND PROPOSED  
AMMENDMENTS**

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## **DECLARATION OF CANDIDATE**

I, Rajeev Harriparsad, hereby declare that the contents of this dissertation represent my own unaided work and that the dissertation has not previously been submitted for academic examination towards any qualification. Furthermore, it represents my own opinions and not necessarily those of the University of Kwa-Zulu Natal, Howard College Campus and it does not contain any other persons' writing, unless specifically acknowledged as being sourced from other researchers. Where other written sources have been quoted, then:

1. their words have been re-written but the general information attributed to them has been referenced; and
2. where their exact words have been used, their writing has been placed inside quotation marks and referenced.

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Due to length and time constraints, this dissertation will briefly examine and provide an overview of how recent proposed amendments may effect the use of a Trust as a tax avoidance tool. Trusts have recently been a source of debate following the proposals made by in our Budget Speeches and the proposals by the Davis Tax Committee. The abolition of the “Conduit Pipe Principle,” together with a stricter approach on income distributed and retained by a trust have been recommended. This dissertation will provide a historical overview on the increased taxation of trust income as evidenced by our legislation. The continuous amendments of our legislation has attempted to curb any avoidance by those adopting the use of a trust. The radical proposals made by the Davis Tax Committee in their First Interim Report seem to disregard our current economy and the need for incentives investment. The continued echo’s of reform in our annual Budget Speeches have fuelled concern that our government will eventually consider tightening the taxation of trusts. This discussion provides a historical background of the development of the legislation which currently governs the normal taxation of trusts. Tax practitioners have adopted the use of a trust to further tax avoidance. A brief discussion on our legislation commencing from the Act of 1941 to our current legislation will show that our government has taken steps to close every loophole as adopted in tax avoidance. An explanation on the deeming provisions and Section 25B of the Income Tax Act 58 of 1962 is required to understand the impact of the proposals by the Davis Tax Committee. An understanding of Practice Note 23 needed to comprehend the “Conduit Pipe Principle.” The repealing of Section 25B can only be understood after a detailed explanation of the principles as currently practised. A critique on the relevance of the current proposal will conclude the dissertation. This will be done in light of our current financial climate and based on the need to solidify our tax base as opposed to the need to reform.

## CHAPTER 1

### INTRODUCTION

This discussion attempts to provide an outline of the taxation of a Trust in light of the recent proposals by the Minister of Finance and the Davis Tax Committee.<sup>1</sup> It also provides a historical analysis of the continued increase in the taxation of Trusts and their income by setting out a background to the increase in taxable liability on income arising from Trusts.

A trust has evolved as an effective mode of tax avoidance over the years. This has been limited by legislation coupled with our sui generis common law, which has affected the favourable views that many have had of the use of a trust as a tax avoidance tool.<sup>2</sup> The concept of a trust may not have evolved as much as its use and the subsequent legislation regulating their taxation. In addition to their use as a tax avoidance tool, trusts have been utilised for estate planning and also in some cases to protect the disadvantaged by virtue of a 'special trust'.<sup>3</sup>

The taxation of a trust has been a cause for argument for many a year. In the 2013 Budget Speech, the Minister of Finance, Mr Pravin Gordhan intimated that reform into the taxation of trusts was required.<sup>4</sup> To date this reform has been the focus of the Davis Tax Committee. Although the subsequent proposals of the Davis Tax Committee have not been tabled as an amendment, there is still cause for concern. These proposals include an attack on the well-established 'conduit pipe principle'.<sup>4</sup> The practice of income splitting by the use of a Trust has long been a cause for concern for the South African Revenue Service<sup>5</sup> and the provisions of the Income Tax

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<sup>1</sup> Established on 17 July 2013 by Minister of Finance, Mr Pravin Gordhan. The first committee on taxation in South Africa since the KATZ Commission. The committee consists of the following members: Judge Dennis Davis chairs the Committee. The other members are: Professor Annet Oguttu, Professor Matthew Lester, Professor Ingrid Woolard, Dr. Nara Monkam, Ms. Tania Ajam, Professor Nirupa Padia, and Mr Vuyo Jack. Mr. Cecil Morden from the National Treasury, Mr. Kosie Louw, an official from the South African Revenue Service are ex-officio members.

<sup>2</sup> These include Transfer Duty as regulated by the Transfer Duty Act 40 of 1949 and Donations Tax as regulated by Chapter V of the Income Tax Act 58 of 1962.

<sup>3</sup> A special trust, is defined in section 1 of the Income Tax Act 58 of 1962 as a Trust created solely for the benefit of a person that suffers from a mental illness or any serious physical disability. The incapacity must be of such seriousness that the beneficiary must be incapable of earning an income and the Trust will cease to be assessed as a Special Trust once the beneficiary is deceased. A Special Trust can also be created in terms of a will in which the youngest of the beneficiaries is under the age of 21 years at the last day of the year of assessment of the Trust.

<sup>4</sup> See Chapter 8 below for a detailed discussion of the 'conduit pipe' principle.

<sup>5</sup> Hereinafter referred to as SARS

Act<sup>6</sup> has sought to limit this by deeming income to a person as will be shown in the following discussion and analysis of the applicable legislation. Trusts have also been seen to have favourable tax implications although they are currently taxed at a higher rate than individuals.<sup>7</sup>

The concept of a Trust as an effective method to avoid or reduce taxation has always been popular with those attempting to decrease the value of their estate or who are willing to divest themselves of their assets in order to avoid taxation.<sup>8</sup> This has continuously come under scrutiny as will be shown in the following discussion.<sup>9</sup> The legislation duly governing the taxation of individuals and corporate entities alike has been amended accordingly as the fiscus attempted to close any loopholes that may have been created by our case law or by taxpayers schemes.

This dissertation will firstly provide a synopsis of the historical development of Trusts and thereafter outline the applicable legislation and its gradual amendments. The general use of a Trust as a mechanism to avoid taxation will be clearly outlined by the stricter approach by our government. The continued increase in the rate of the taxation of income arising from a Trust and the applicable amendments which have been enacted to limit the taxable avoidance provided by as Trust will be evidenced in the discussion of the applicable legislation. The dissertation will firstly provide an introduction on trusts including their incorporation into our legal system in Chapters 1 and 2. This will provide the framework for one to understand their use in current practice. Thereafter Chapter 3 outlines the difference in taxation between individuals and trusts. The distinction in the taxation of individuals and trusts is required to understand the popularity of a trust. Chapter 4 will discuss in detail the provisions of the 1941 Income Tax Act as relating to trusts. An explanation of these provisions will provide a basis upon which the increase in taxation of trusts can be determined. The discussion following Chapter 4 will illustrate the gradual increase in the taxation of trusts through legislation and case law. Chapter 5 will provide a summary of the deeming provisions of the Act and its applicability to the taxation of trusts. Section 7 is discussed and is of vital importance when determining taxable liability. Chapter 6 discusses the Margo

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<sup>6</sup> Act 58 of 1962 hereinafter referred to as the Act.

<sup>7</sup> Trusts are currently taxed at a flat rate of 41% as opposed to the sliding scale based on the amount received by or accrued to a taxpayer, which is the approach adopted in assessing other taxpayers, such as individuals. The current SARS Income Tax Tables provides for an increasing scale of taxation based on a person's income.

<sup>8</sup> See Generally DM Davis, Estate Planning and FJ Dawson, Estate Planning. A Trust is usually used to freeze one's assets when attempting to carry out asset freezing. This procedure entails the freezing the value of one's assets to enable a lower calculation of estate duty. The Trust is commonly used in estate planning as a method of disposing of assets of a high value or those that are capable of increasing in value. These assets are transferred to a Trust by virtue of interest free loans and the donor subsequently decreases the value of their estate whilst retaining control of the future of the assets by virtue of the conditions in the Trust deed.

<sup>9</sup> See Chapter 10 below

Commission. The discussion of the proposals made by the Margo Commission is used as an example of our government's continuous need to reform the system of taxation of trusts. Practice Note 23 can be construed as an important milestone in the taxation of trusts. Chapter 7 provides an explanation including a summary of the case law which resulted in Practice Note 23. The "Conduit Pipe Principle" is the most important principle when discussing the taxation of a trust. The dissertation could not be complete without a clear understanding in light of the current proposals. Chapter 8 provides an analysis of the principle in detail. A summary of section 25B is provided in Chapter 9. Section 25B is the section of our Act which deals solely with the income of trusts. The applicability of section 25B will further highlight the stricter approach as adopted by our government. Chapter 10 discusses the comments of our fiscus in their budget speeches and the proposals as made by the Davis Tax Committee. These form the basis of the dissertation and are discussed in detail. A conclusion is provided in Chapter 11. These include the writer's opinions on the viability of amending our legislation. The opinion included in this final chapter is based on the impact of adopting the proposals. This Chapter will also highlight the difficulties of amending our legislation and provides a discussion on the success of our current system of taxation in light the preceding chapters. The advantages and disadvantages of proposed reform will be weighed to establish the viability of our current system of taxation as opposed a radical change in the rules of taxation of trusts. The Conduit Pipe principle will also be analysed in light of Practice Note 23<sup>10</sup> and thereafter the subsequent application of Section 25B of the Income Tax Act<sup>11</sup> will be discussed. Following the aforementioned discussion, the current proposals made by the fiscus and the Davis Tax Committee will be critically analysed with specific reference being made to their impact on current legislation, practice and use.<sup>12</sup> It will be concluded that a trust can still be seen as an effective method of use and tool in general tax avoidance. This is due to a trust's ability to permit a taxpayer to divest himself of ownership of high value assets. The rates of taxation of trust may be at a higher rate than that of other taxpayer but because the trust allows for immediate distribution to a number of nominated beneficiaries a taxpayers liability for normal tax is reduced The continued development of our legislation has subsequently affected the viability of a trust as a tax avoidance mechanism but a trust is still a unique concept that offers a form of ownership which is unprecedented. A discussion on the historical incorporation of a trust into our legal system has to be understood in order to further understand the concept of a Trust and the popularity associated with their use.

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<sup>10</sup> See Chapter 7 below

<sup>11</sup> Act 58 of 1962

<sup>12</sup> See Chapter 11 below



## CHAPTER 2

### BACKGROUND

Prior to assessing the feasibility of a Trust as a tool in anti-avoidance, a background on the concept of a Trust has to be discussed. This historical outline of a trust will provide an introduction into their incorporation and use in South Africa.

The trust is one of the more popular forms of enterprise adopted by legal practitioners and business persons alike. This is due to the general belief that a trust can be used to avoid taxation. Many also use a trust to divest themselves of their assets in times of distress. eg. prior to a possible sequestration. Complex transactions involving various corporate entities and the transfer of assets through various countries have been used by some to avoid or decrease the liability of taxation eg. The use of an offshore trust to dispose of a person's assets. A trust is also considered as one of the most viable tools to peg the value of an estate in the course of estate planning.<sup>13</sup> This discussion will display the increased burden of taxation on a trust. The general perception of a trust as a popular tax planning tool will also be discussed. Although regulated by the strict provisions of the Act and the Tax Administration Act,<sup>14</sup> many still believe that the trust is the most feasible option in protecting their income and assets.

The history of a Trust and its incorporation into South African law can be traced to the Germanic times and the English influence on our legal system.<sup>15</sup> The English disposed of their assets to early forms of trusts when called upon to take part in the crusades in mediaeval England. The English also used the trust to avoid tax liability on their land by also transferring their immovable property to a trust. The increased popularity has also led to the trust being incorporated in international law as a trust is currently defined by the Hague Convention.<sup>16</sup> This is due to the various commercial transactions overlapping through various borders which involve the use of

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<sup>13</sup> See generally DM Davis, *Estate Planning*, '2014.

<sup>14</sup> Act 28 of 2011. See Chapter 5 below for a discussion on section 7 of the Act and Chapter 9 below for a discussion on section 25B of the Act

<sup>15</sup> . See Generally Wills and Trusts, RR Pace and WM van der Westhuizen, B2

<sup>16</sup> <https://www.hcch.net/en/instruments/conventions/full-text/?cid=59>, The Hague Convention on the Law Applicable to Trusts and their Recognition.

trusts. In South Africa, the trust is generally regulated by the Trust Property Control Act, but the taxation of trusts is regulated by the Act.<sup>17</sup> The earliest mention of a Trust in our case law was in 1833.<sup>18</sup>

The concept of a trust was summarised in *Estate Kemp and Others v McDonald's Trustee*,<sup>19</sup>

The underlying conception in these and other cases is that while the legal dominium of property is vested in trustees, they have no beneficial interest in but are bound to hold and apply it for the benefit of some person or persons or for the accomplishment of some special purpose. The ideal is so firmly rooted in our practice, that it would be quite impossible to eradicate it or to seek to abolish the use of the expression trustee, nor indeed is there anything in our law which is inconsistent with the conception.

This clearly illustrates the concept of a trust and the unique form of ownership of property that it creates.

The taxation of income arising from a distribution by a trust to a beneficiary or income that remains undistributed is the basis for this discussion. The difference in taxation in the taxation of an individual and a trust is of vital importance. This difference in taxation will provide a basis upon which the viability of a trust as a tool for tax avoidance can be assessed and forms the reasoning for the disposal of an asset to a trust. This will be examined in the next chapter.

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<sup>17</sup> Act 57 of 1988. The preamble of the Trust Property Control states that the Act should be used to regulate the control of trust property and to provide for matters connected herewith. The Act does not provide mechanisms for the taxation of Trusts but does regulate the appointment and duties of the trustees.

<sup>18</sup> *Twentyman v Hewitt*

<sup>19</sup> 1915 AD 491

## CHAPTER 3

### THE DIFFERENCE IN THE TAXATION OF INCOME OF INDIVIDUALS AND TRUSTS

Prior to discussing the various methods of the taxation of a trust, the distinction between the treatment of a trust and a natural person has to be analysed.<sup>20</sup> It is generally accepted and applied that individuals and companies are duly liable for the payment of income tax upon the income they earn. It is also generally accepted that taxable income is calculated upon income earned during a year of assessment which is a 12 month cycle. Income earned is subject to the allowable deductions and allowances and income tax is levied upon the resultant figure.<sup>21</sup>

The taxation of a natural person and trust differs in many ways, each having their own set advantages and disadvantages. This provides a basis upon which the use of a trust for tax avoidance can be evaluated. The major discrepancy between the taxation of a natural person and a trust is in the increased rates applicable to a trust as opposed to that of a natural person and the rates of normal tax payable on such income accrued to or received by these parties.<sup>22</sup> This forms the basis to evaluate the advantages and disadvantages of forming a trust. This includes the rates payable in respect of Capital Gains Tax which is a major consideration when one makes provision for tax liability.<sup>23</sup> In normal circumstances a natural person is taxed upon the prevailing rates whilst the income of a trust is taxed at a higher flat rate. Liability is determined on the undistributed income of a Trust and therefore the distribution of income will decrease the liability of the Trust. Income and capital are treated differently and whilst large donations are still commonly practised to establish the Trust, most of these assets are in capital in nature and are assessed in accordance with the principles of capital gains tax.<sup>24</sup>

The rate of taxation on a trust has gradually increased through the years. As at 1995, the income of a trust was taxed at a rate of 17 percent on a gradually increasing scale. In 2002, that rate increased to the amount of 40

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<sup>20</sup> Section 1 of the Act. The definition of a person includes a Trust as per the Income Tax Act. The definition includes an insolvent estate, the estate of a deceased person, any trust and any portfolio of a collective investment scheme other than a portfolio of a collective investment scheme in property.

<sup>21</sup> Section 11 of the Act. Section 11 provides a basis upon which deductions and allowances can be utilised when calculating taxable income.

<sup>22</sup> See note 7 above.

<sup>23</sup> Schedule 8 of the Act

<sup>24</sup> See generally Chapter 8 of the Income Tax Act. Capital gains tax relates to the taxable liability on the profit of a capital asset which is disposed. Capital gains tax is regulated by chapter 8 of the income tax act and a Trust currently pays capital gains tax at a rate of 41%. See also generally, Legal and Policy -Taxation in South (2015/2016) as issued by SARS.

percent and is currently taxed at a rate of 41 percent.<sup>25</sup> A natural person is taxed at a sliding scale from 18% to 40%. The definition of a natural person will in most circumstances include a donor, trustee or beneficiary of a trust. There are however circumstances in which a party to a trust could be regarded as a business entity such as a special trust which has been nominated as a beneficiary to a trust mortis causa.<sup>26</sup>

A major factor is the determination as to whether income has accrued to a person/beneficiary. A beneficiary is duly taxed upon the income they earn as distributions from a trust whilst undistributed income in the trust is taxed in accordance with sections 7 and 25B.<sup>27</sup> The undistributed income of a trust is often taxed in the hands of the trust as a taxpayer at the flat rate of 41%. Income earned by the trust, that is paid out to the beneficiaries by the trust in the same year as the income is earned flows through the trust, which acts as a ‘conduit pipe’ in this respect.<sup>28</sup> The beneficiaries are thereafter taxed upon the income they earn from such distribution, with the ‘conduit pipe’ principle dictating that the income retains its identity in their hands. Losses and expenditure incurred by a trust are also not transferred to a beneficiary and therefore the beneficiary will only be able to avail themselves of the applicable deductions and allowances.<sup>29</sup> A beneficiary is therefore able to avail themselves of the applicable deductions and allowance as contained in the Act but will not be able to utilise the losses and expenditure of the trust as a deduction in the calculation of the taxable income. A donor will dispose of his property or make a pecuniary/gratuitous donation to the trust. This will result in the donor’s tax liability being decreased for the period in which he makes the donation due to the decrease in the value of the donor’s estate. In the past it has been practice for beneficiaries to only earn income that was below the taxable threshold as determined in an annual cycle. This has subsequently been negated by the anti-avoidance provisions of the Act.<sup>30</sup>

The concepts of a trustee, donor and beneficiary are also significant. As natural persons they will be taxed in accordance with the prevailing rates of taxation. The date at which they are taxed differs from person to person as some may not receive the benefits from the trust in the same year that the trust is formed. A trust may also be a taxpayer in its own right.

Unlike a natural person, the rate of taxation applicable to a trust does not increase with the income retained by the trust. A trustee, although a natural person, acts as a representative of the trust and is therefore liable for the

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<sup>25</sup> Paragraph 1(b), Schedule 1, The Taxation Laws Amendment Act, 30 of 2002

<sup>26</sup> A trust created by virtue of a provision in a deceased person’s will.

<sup>27</sup> See Chapter 9 below for a detailed discussion on the provisions of section 25B.

<sup>28</sup> This principle will be discussed in more detail in Chapter 8 below.

<sup>29</sup> Section 25B(3). This section of the Act will be discussed in Chapter 9 below.

<sup>30</sup> See Chapter 10 for a discussion on the anti-avoidance provisions of the Act.

payment of income tax from the income of the trust. The assessment is based on the undistributed income as retained by the trust. The undistributed income will in the normal course of events comprise of income or assets that have not been vested to a specific beneficiary due to the suspensive provisions of the trust deed or discretionary powers of the trustees.

A trust can be complicated to assess due to the deeming provisions that are contained in the Act.<sup>31</sup> An example of undistributed income in a trust where the trustee's have not exercised their discretionary powers as to distribute any income during a period of assessment, in a discretionary trust. Therefore, when assessing the importance of a trust one has to be acquainted with the principles of the calculation of the normal tax liability of a natural person as well as the deeming provisions of the Act. When dealing with the beneficiaries, one has to be aware of the general formula used to calculate taxable income and one has to be apprised of the principles of section 25B when calculating the gross income of a trust.<sup>32</sup> This is due to the somewhat and sometimes complicated calculation of gross income as regulated by the Act.

Income received is treated in different ways and therefore it is vital that a proper determination of the income is made at the beginning when one decides to plan for their taxation. After the recipient of the income is determined, a proper assessment can be made to calculate the taxable income of the trust. Some of the income that a person may receive from a trust will be included in their taxable income for the period of assessment. The deductions and allowances which are allowed in terms of section 11 are also applicable to a trust as the definition of a person is inclusive of a trust.<sup>33</sup> The income received by a beneficiary will form part of their gross income. The beneficiary will thereafter have to determine their taxable income after applying the abovementioned principles.<sup>34</sup> A natural person will be able to avail themselves to a greater amount of deductions and rebates as opposed to a trust, for example. Retirement annuity contributions made by such an individual. These deductions are not applicable to trusts.

It is clear that there may be an overlapping of income between a natural person in their capacity as a beneficiary and the trust. Therefore, the nature and status of the income has to be ascertained and thereafter the person liable for the payment of the income tax will be determined. The taxation of a trust is dependant on the

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<sup>31</sup> Section 7 of the Act. See generally Chapter 5 below.

<sup>32</sup> Section 1 of the Act. Taxable income is determined after apportioning all allowable deductions and allowances in Part I of Chapter II and including all amounts which are deemed income in terms of the Act.

<sup>33</sup> Section 11 of the Income Tax Act 58 of 1962. See generally section 11 of the Income Tax Act 58 of 1962. Any expenditure and loss actually expended in the production of the income is allowed as a deduction. The expenditure and loss will not qualify if characterised as capital in nature.

<sup>34</sup> See generally AP de Koker, RC Williams, Silke on Income Tax, 2016, Chapter 1

undistributed income whilst a natural person is taxed on income received. A discussion on the legislative framework which provide for this taxable liability is required to fully understand the advantages and disadvantages of the use of a trust. The earliest form of legislation has to be discussed to provide a framework upon which our current form of taxation has been founded. This discussion will outline the gradual increase in scrutiny on trusts by our fiscus and will also provide the reasoning for the major amendments to our legislation as dictated by those attempting to circumvent the principles of our legislation. This will be examined in subsequent chapters.

## CHAPTER 4

### A DISSCUSSION ON THE PRINCIPLES OF THE INCOME TAX ACT OF 1941 AS RELATING TO TRUST INCOME

The provisions of the Income Tax Act of 1941 and thereafter 1962 as amended clearly provide an indication of the gradual increase in the taxation of income which is either distributed or retained by a trust. The major principles as confirmed by the Act of 1941 will also be discussed in detail. Relevant case law will be included. A stricter approach by the fiscus towards trusts is also in evidence.

The first relevant piece of legislation for this discussion is the Act of 1941.<sup>35</sup> It set out the general rules and principles applicable to taxation of individuals and corporate entities alike. Although at this stage, the rates of taxation differed by province, the general principles that governed these rates were to be found in the Act. Thereafter the amended Acts will be discussed in detail to provide an outline of how the principles have been amended to address the increased popularity of a trust as a tax planning tool.

A mere disposal of one's assets at death increases the tax burden of the deceased. This made the trust an attractive option for those planning for after their death. A trust also aided in limiting the value of a person's wealth whilst still alive by decreasing the person's net worth and consequently their taxable income. Income tax was duly levied upon all taxable income which arose from any source within the respective territories and which was received or accrued to a person during a year of assessment ending the 30<sup>th</sup> of June, whether a resident locally or abroad.<sup>36</sup> All income which was received by or received in their favour was assessed for the calculation of income tax which was payable. In summary, all income "received by or accrued to" was subject to taxation. Certain deductions and allowances were applicable and debts were allowed to be deducted prior to determining a person's taxable income.<sup>37</sup> Income tax at this stage was levied at a national and provincial level and both were binding and had varied rates of taxation. The general principles in assessing income tax which was retained and distributed from a Trust was practised in uniformity throughout the various provinces.

The principles of the 1941 Act were replicated throughout the years and the main sections and principles have remained intact subject to some variations.

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<sup>35</sup> Act No.31 of 1941

<sup>36</sup> Percival and Frere-Smith, *Manual of SA Trust Law* – (1953) 117. The author makes general reference in the script to the Union and Southern Rhodesia when discussing the taxation of Trust Income.

<sup>37</sup> See note 29 above and Section 10 of the 1941 .

The 1941 Act contained many provisions relating to the taxation of Public Companies which were registered in the Republic and such companies were subject to Undistributed Profits Tax.<sup>38</sup> Undistributed Profits Tax relates to the taxation of income which has not yet been distributed to a beneficiary. This could occur if a beneficiary has not yet been determined or there had not yet been a vesting of a right to receive income by a beneficiary.<sup>39</sup> The 1941 Act attempted to collect all tax on income and therefore also had provisions relating to the taxation of a notional “representative taxpayer”. A trust was taxed in accordance with the deeming provisions and those relating to a representative taxpayer. The representative taxpayer was at this period deemed to be the trustee/s. The notional representative taxpayer was a person whom had income in their possession which was due to another person and as such had a fiduciary duty towards the nominated beneficiary. It should be noted that at this stage of the development of our system of taxation, due notice was given to the trust as a taxpayer albeit as represented by the trustee/s. They were subject to the same liability that they would incur if the income was their own.

Subject to Section 69, a trustee was a representative taxpayer of the trust. In the event that income tax could not be collected from a trustee, the beneficiary was still liable for any receipts or accruals of income in favour of such beneficiary.<sup>40</sup> As a representative taxpayer, a trustee had the onerous burden of being liable as if entitled to the income a beneficiary would receive. In this respect the trustee was liable for tax in his personal capacity as a representative taxpayer. In this regard, income tax would be recoverable from him although limited to the assets of the beneficiary which are under his/her possession, management, disposal or control as per sections 70(1); (3) and 45 (1) and (3). In terms of Section 72 and 47 a trustee will still be held liable for unpaid taxes in two circumstances: firstly, if he alienates, charges or disposes of the income or, secondly, he disposed of or parts with any fund or money in his possession coming to him after the tax is payable from which the tax could have been paid. The protection of the liability and strict compliance of the collection of income tax by the trustee were maintained by these sections.

Six classes of eventualities were provided for in respect of representative taxpayers in the Act of 1941.<sup>41</sup> Inclusive in these classes is the taxation of trusts and the circumstances in which a trustee is deemed a representative taxpayer on behalf of the trust. This included circumstances in which the trust retained an

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<sup>38</sup> Percival Frere-Smith (note 36 above) 118.

<sup>39</sup> Percival Frere-Smith, (note 36 above) 119.

<sup>40</sup> See generally Percival Frere-Smith, (note 36 above) 121. This section was drafted with the aim of securing the payment of Income Tax. Prior to distributing income to beneficiaries, such income would be liable for normal, super and provincial taxes in the hands of the trustee. It has to be noted that each province had their own differing rates of taxation.

<sup>41</sup> Percival Frere-Smith (note 36 above) 118. A representative taxpayer is provided for in each of these six eventualities.



undistributed profit. An example of such a situation is a popular clause in a trust which suspended a benefit until the happening of an event. This entailed the suspensive vesting of a right until the happening of a specified event. In these circumstances, the trustee/s would assume the role of the representative taxpayer and the subsequent liability for payment of income tax on behalf of the trust.

In terms of the definitions of the 1941 Act, the word ‘trustee’ included under its scope any person having the administration or control of any property subject to a trust or any person acting in any fiduciary/official capacity the possession, direction, control or management of any property of any person under a legal disability.<sup>42</sup> A trustee is treated as an agent for the transmission of income from its source to a beneficiary when such beneficiary is identifiable.<sup>43</sup> Therefore, no special provision was provided for those acting on behalf of a special trust as currently defined in the Act.<sup>44</sup>

This has been an established principle in our law as the ownership of an asset vests in a trust until distribution. This has also been one of the founding reasons for the popularity of the use of a trust as many use a trust to divest themselves of assets. The common perception is that a person may be able divest themselves of their liability by donating assets to a trust and therefore avoid liability by not having any property registered in their names. This could be useful in preventing creditors from attaching assets but any such transaction may be declared void.<sup>45</sup>

Every beneficiary was liable to pay tax upon income they earned from a trust. The income upon which tax is levied includes all amounts that could be calculated in terms of a monetary figure. When the income received by a beneficiary is derived from an investment by a trustee, a beneficiary would be liable on that portion that they receive from the investment. In simple terms, a beneficiary was liable for the income they received in full or any portion thereof. This is not dissimilar from the current form of taxation which will be discussed below. A person is liable to pay income tax on all the income they receive as a beneficiary.

In terms of the 1941 Act, a trustee may also be liable to pay income tax on undistributed profits. This may occur in circumstances in which a beneficiary cannot be determined or a right to such income has not been vested. It has to be noted that the trust on its own was not liable for any income tax. In the circumstances as stated above, the donor retained the liability on income earned. These circumstances dealt with matters in which a beneficiary

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<sup>42</sup> Section 1 of Act 31 of 1941.

<sup>43</sup> The trustee was the process used by the Commissioner when attempting to collect income tax. The commissioner used to attempt to collect such income tax from the Trustee as the representative taxpayer and as a Trust was not defined in the Income Tax Act of 1941 see generally Percival Frere-Smith Manual of SA Tax Law (note 36 above).

<sup>44</sup> Section 1 of the Act.

<sup>45</sup> See Chapter 10 below for a discussion on the anti-avoidance provisions of the Act.

held a contingent right to the income of the trust which more commonly arise in the administration of a discretionary trust. At this stage of the evolution in the laws of taxation of a trust, the trustee bore the burden as imposed by the settlor or donor's wishes. Income that was retained by the trust was taxable and the liability fell upon the trustee to ensure that such liability was extinguished and not the trust in its capacity as a legal person. This principle was eventually dismissed in *Phillip Frame Will Trust* but did play an important role in determining taxable liability under the Act of 1941.<sup>46</sup> Under the 1941 Act, a trustee may also be liable to pay income tax on undistributed profits. This meant that a trustee could be held liable under certain circumstances. In the case of *Estate Munro v Commissioner of Inland Revenue*,<sup>47</sup> it was found that although the trustees were liable for the income tax payable upon undistributed income in terms of their discretionary powers they were also allowed the deductions and exemptions as applicable to the beneficiaries.<sup>48</sup>

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<sup>46</sup> 53 SATC (166). See Chapter 7 below.

<sup>47</sup> 1925 TPD 693

<sup>48</sup> See Chapter 5 below for a discussion on deemed income and the provisions relating thereto.

#### 4.1 THE DONOR / SETTLOR'S LIABILITY

The settlor or donor also has a liability to pay income tax in certain circumstances. In terms of Section 9(5), if a trust deed provided that a beneficiary shall not receive income/benefit until the happening of a certain event, fixed or contingent, such income derived during the period of waiting shall be deemed to be that of the donor. This could take the form of a beneficiary attaining the age of majority or a beneficiary being married before they become entitled to earn any income from a trust. Therefore the income earned during this period until vesting occurred and the subsequent income tax payable on such income was payable by the donor. The contingent beneficiary is subsequently dealt with in the evolving legislation of income tax.<sup>49</sup> Section 9(5) regulates the trust created inter vivos and curtailed any intention by a donor to divest his property whilst still being in control without the relevant tax liability.<sup>50</sup> These principles were promulgated for application in an inter vivos trust.

In the event that the donor is deceased, such income would be deemed to be that of the trustees. This meant that the trustees would assume liability for the income earned in the trust although they did not have a pecuniary interest except for their remuneration. In my opinion this procedure was very strict in the circumstances as the trustees may not have had any distinct relationship to the donor. This provision dealt with a trust created inter vivos and an opposing argument would be that the trustees would have been apprised of all the risks of accepting their appointment prior to their appointment. The representative taxpayer (trustee) was liable for the taxation.

In terms of Section 9(6), if a settlor/donor retained powers under the settlement to revoke a beneficiary's right to receive income or to confer that right upon another, either receipts or accruals of income, actual or deemed to or in favour of the original beneficiary during the retention period as stated above, such income is deemed to be

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<sup>49</sup> Section (7) of the Act, provides for circumstances in which the vesting of a right is suspended until the happening of a certain event. Although the taxation of income arising from trusts is currently regulated by Section 25B of the Income Tax Act, the deeming provisions were applicable until Practice Note 23 and the subsequent insertion of Section 25B. See Chapter 5 below.

<sup>50</sup> See generally AS Silke, *Tax Avoidance and Tax Reductions* (1958) 135. Case law was used to interpret the statute and it was found that when income was received by a trustee and such trustee is obliged to pay over the income to the beneficiary, this income will be taxed in the hands of the beneficiary. In the case of ITC288 7 SATC 330 it was found that If a trustee has the power to nominate a beneficiary, such income will be taxed in the hands of the nominated beneficiary and in all other circumstances the trustee would be held liable for the income tax in their representative capacity.

income of the settlor.<sup>51</sup> A common clause in the formation of a trust was one in which donor retained the power to revoke a beneficiary or substitute a beneficiary. During this period of revocation or substitution, the income earned by the beneficiary was taxable in the hands of the donor. This related to all undistributed profits of the trust. This led to the beneficiary earning a tax free income from the trust whilst the donor was taxed upon income subsequently paid to the beneficiary.

This was an important provision for those who wished to create a trust and divest their property whilst still attempting to remain in control of the assets they previously owned. When assessing a trust *inter vivos*, this provision curtailed the circumstances in which in terms of section 9(6), if a settlor retained powers under the settlement to revoke a beneficiary's right or to receive income or to confer that right upon another, either receipts or accruals of income, actual or deemed to or in favour of the original beneficiary during the retention period as stipulated, such income will be deemed to be that of the donor.

Section 9(4) made provision for circumstances where there were receipts or accruals of income due to a minor by virtue of a donation, settlement or disposition which was made by a stranger. The parent of the minor child would become liable for the payment of income tax on such income received if the parent has made a donation, settlement, disposition or any other consideration to the stranger or their family. This can be interpreted as a *quid pro quo* situation in which a benefit is received by the minor child in exchange for a benefit from the minor child's parents. The parents make a donation to a stranger, and in exchange the stranger makes a donation to their minor child. This provision curtailed that practice.

Although utilised most commonly as a method to provide adequately for one's minor children or surviving spouses, the income received from the trusts were often the cause for litigation. In a broader sense, trusts were only taxed in terms of the provisions dealing with deemed accruals and income. There were no specific clauses in the 1941 Act to deal with the income of Trusts. Trusts were very much a viable option for estate planning and tax avoidance and their formation was popular.

In terms of tax avoidance, the 1941 Act was the first real test of a trust's viability as an effective mode of income tax avoidance. The provisions of the 1941 Act provided a basis which still persists that allows for a trust to be a viable vehicle in diminishing a deceased or natural person's tax liability. In term of the 1941 Act, income tax was imposed in varying degrees on *inter vivos* and testamentary trusts. Specific reference was also

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<sup>51</sup> Percival Frere-Smith, (note 36 above) 120. The author found that the language of the section to be in complicated language. The section has been transferred into the Income Act 58 of 1962 and has retained its use due to donors often retaining their rights after donating assets to a trust.

made to the taxation of undistributed profits which were retained by a trust.<sup>52</sup> These profits can be equated to the undistributed income of a trust. This occurred in both forms of trust. In a testamentary trust, this could occur when payment to a beneficiary was suspended due to the happening of a certain event. In an inter vivos trust this may occur when a trustee exercises their discretionary powers. As stated earlier, the trustees were liable for the income tax payable as a trust had not yet been included into the definition of a 'person'.

The liability for payment of income tax was placed upon a beneficiary when they received the income in whole or part. The trustees were the representative taxpayers for all other amounts retained in the trust. *Armstrong v Commissioner of Inland Revenue*<sup>53</sup> was still the precedent in dealing with trust income distributed to a beneficiary and although the deeming provisions controlled the taxation of trust income it was generally accepted that such income retained its identity when distributed to a beneficiary. Thus all exemptions of such income in the trust were also applicable to the beneficiary.

The major advantages of the Act of 1941 can now be discussed with the benefit of our current legislation. In this sense the absence of a provision to regulate the income distributed by a trust allowed for greater flexibility in the interpretation of the 1941 Act. The deeming provisions of section 9 were the only considerations when planning to utilise a trust as a vehicle to evade or avoid taxation. Trustees were held liable for the payment of income tax by a trust but the calculation of this income was not specified. There were no special regulations and the generally accepted deductions were allowed to be apportioned to the income of a trust to determine the taxable income. This enabled the trust to lower its taxable liability whilst still complying with section 9. When analysed in the context of the economic climate the Act of 1941, this practice was easily construed as being sufficient for the purposes of taxation. During this period there were no disputes relating to the payment of income tax by the trust and the fiscus easily determined taxable income using the provisions of the Act. The inclusion of ancillary taxes in addition to income tax, have subsequently complicated the determination of taxable income and so has the increased popularity of estate planning.<sup>54</sup> The use of a trust as a viable tool in tax avoidance has continuously evolved over the years concurrently with our legislation. Our current form of legislation can now be discussed whilst bearing in mind the principles of the 1941 Act. Section 9 was replaced by section 7 and an analysis of the principles of section 7 will clearly outline the deeming provisions of the Act

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<sup>52</sup>Percival Frere-Smith (note 36 above) 120. The trustee would be responsible for the payment of tax on behalf of the trust in these circumstances.

<sup>53</sup> 1938 AD 343

<sup>54</sup> Capital Gains Tax, Donations Tax and Transfer Duty are just some of the ancillary taxes that are considered. Capital gains tax and Donations tax are duly incorporated and regulated by the Income Tax Act 58 of 1962 whilst the transfer duty is currently levied in terms of the transfer Duty Act 40 of 1994.

as they currently relate to trusts. This will further provide a basis upon which income is deemed to be that of a trust and subsequently increase its liability for taxation.

## CHAPTER 5

### THE APPLICABILITY OF SECTION 7 OF THE INCOME TAX ACT 58 OF 1962 TO THE TAXATION OF TRUSTS

After the promulgation of the Income Tax Act of 1962, the taxation of income which was received and distributed by a trust was regulated by the deeming provisions of section 7. Section 9 was duly replaced by Section 7 which provided some clarity as to the treatment of income of a trust. An example of the applicability of section 7 to trust income would be where the terms of the will or deed under which the trust was created are such that the trustee or administrator is required to pay particular income to a beneficiary. This income accrued to the beneficiary and they are therefore taxed on such income received. It is therefore vital that an analysis of section 7 is provided in order to discuss the framework for the taxation of trust income at the inception of our current legislation.

Section 7 deals with the circumstances in which income is deemed to have been accrued to or been received. Section 7 of the Act has remained mostly unchanged following the various amendments which have affected the Act. The sections under the old 1941 Act also alluded to similar principles as stated in the current Section 7.

In terms of section 7 (1), income which has to be paid to a beneficiary, (but which has not yet been paid to such beneficiary) due to the terms of a trust created by a will, accrue to such beneficiary. This reinforced the conduit pipe principle of trusts in that the trust became a vehicle for which the income of the beneficiaries flowed through.<sup>55</sup> This subsection also indirectly confirms the principle that a trustee will not be liable for the payment of income tax in cases where a beneficiary has a clear right to receive such income, because the subsection places the liability for such tax at the door of the beneficiary. In terms of discretionary trusts in which the trustee has an election as to whom to pay the income from the trust, such income will become a vested right in the beneficiaries and they will become liable on the amount of income they earn upon receipt of such income.<sup>56</sup> This was clearly an improvement on the 1941 Act which failed to substantially deal with distributions as a result of the provisions of a testamentary trust.

Section 7(2) deems income to respective spouses. Section 7 (2)(a) states that The income has be derived from a donation, settlement or other disposition on or alternatively by virtue of a transaction, operation or scheme entered into or carried made with the sole reason the sole or main purpose of postponing or avoiding liability by the donor. Section 7(2)(b) deems income between spouse in which a spouse receives by virtue of being in

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<sup>55</sup> See Chapter 8 below.

<sup>56</sup>See generally Silke on Income Tax, 3<sup>rd</sup> Edition (1963) 393.As soon as a beneficiary receives a right from a Discretionary Trust, such beneficiary will be liable for income tax on such income received. The beneficiary will have a vested right to income.

partnership with the donor or wherein the donor the connected is connected to a trade by which such income is derived. The subsection also applies to circumstances in which the donor was the sole shareholder of a company of which such income is derived. In these circumstances the amount of income which exceeds the amount which would reasonably have been earned will also be deemed to be income of the recipient's spouse.

Section 7(2)(a) relates to the liability of spouses whom receive income which was derived by a donation, settlement or other disposition after 20 March 1991, with the sole purpose of reducing, postponing or avoiding tax liability. Such income would have be in normal circumstances be included in the taxation of the donor and the income would further be determined considering the recipients trade, participation in generating the income, services rendered by the recipient or any other factor which may be of relevance.

In ITC 269<sup>57</sup> it was held that

It seems to us this must entirely depend on whether this money has accrued to the appellant, even if it has not been paid over to her. If it has so accrued, notwithstanding such non-payment, she would be liable to tax.

Section 7 (2A) was inserted to deal with circumstances in which a trust received income in a certain year and subsequently disposes of such income in a following year after such income has already been transformed to capital and is no longer income in nature. In these circumstances the trust would receive the benefit of not being taxed upon such income. This subsection is similar to the previous section 9 (D).<sup>58</sup> A primary requirement of this subsection is that there has to be a causal link between the capital and the income that would arise from such capital prior to the date of assessment. The provisions of this subsection will only apply to circumstances in which the trust was a resident at the time of the receipt or accrual of income. It has to be noted that beneficiaries are allowed a rebate in terms of the Act if they are found to be liable for income tax in terms of section 7 (2A).<sup>59</sup>

Section 7(3) provides for the taxation of income which is distributed to a minor child by the trust. The disposition has to be gratuitous and all other transactions will follow the course of a transaction dealt at arm's length. Section 7(3) of the Act deals with circumstances in which neither the trustee nor beneficiary was to be liable for the payment of income tax on the income earned by the trust. This scenario could take place if a father had created a trust for the benefit of his minor child. In terms of this section, the parent of the child would become liable for the income tax payable on such income received. The parent would be the person liable as the

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<sup>57</sup> (1933) 7 SATC 164

<sup>58</sup> Section 9(D) of the Income Tax Act of 1941

<sup>59</sup> 6 *quat*(1)(f)(iii) of the Act



minor child did not have the legal capacity to be held liable for the amounts received in their favour. This would hinder and assist estate planning as the parent's estate would be decreased but they would be left with the tax burden upon the donated assets. If there is any surplus from income which is meant for the support of the minor children, such surplus would be taxed in the hands of the parents.<sup>60</sup>

Section 7(4) deals with the circumstances in which a minor child receives a benefit from a trust which was not formed by his or her parents. The parent of the minor child/beneficiary will be liable for income tax payable on the benefit received. The qualification is that the parent has to have also provided a form of consideration to the founder of the trust of which the income is received. The aim of this provision is to prevent the use of minor children to split income through a trust by dealing with dispositions made by a third party to a trust for the benefit of a minor child whom has received a benefit from the minor child's parent/s. This is similar to the provisions of section 9(4) of the 1941 act, the section aimed at curbing evasion of a person's taxable liability.

Section 7(5) provides for cases that suspended the receipt of the benefits from the trust pending the happening of a certain event. This event may be contingent<sup>61</sup> or fixed in nature.

ITC 76<sup>62</sup> stated the following about vested and contingent rights

A vested right was substantial; something that could be measured in money; something that could be valued and that could be attached. A contingent right was seen merely as a spes. This is an expectation which might never be realized.

These conditions can take the form of the beneficiary being required to reach a certain age or be married in normal circumstances. If such a condition is imposed on the distribution of income to the beneficiary, such income which is retained in the trust until the happening of this event will also be taxable in the hands of the creator/donor of the trust. Section 7(5) was identical to the former section 9(5) of the Income Tax Act of 1941. In the event that the beneficiary dies before the event takes place, section 7(5) would not apply. In these circumstances, the trust would become liable for the income tax based on the retained accumulated income. Section 7(5) applies to income of those that were resident and non-resident in the Republic.<sup>63</sup> This clause was also a common feature in the previous Act of 1941.

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<sup>60</sup>. The parent would be able to claim any excess surplus after distribution as their own absolute property and therefore, income tax would be payable on such income. See generally Silke on Income Tax, 5<sup>th</sup> Edition (note 21 above) 503

<sup>61</sup> A contingent right is one that is dependant on the happening of an event for vesting to occur. The beneficiary does not a right to the income and as such the income will not accrue to the beneficiary until the happening of a certain event eg. the attainment of the age of majority. See generally Wills and Trusts by RP Pace and WM van der Westhuizen 80.

<sup>62</sup> 1927 (3) SATC 68

<sup>63</sup> See AP de Koker, RC Williams, Silke on Income Tax, Chapter 5 for a discussion on the resident and source based system of taxation.

Section 7(6) of the Act provides for circumstances in which a donor/creator reserved powers to renounce a beneficiary's right to receive income from the trust. The stipulation must be expressly provided for in the founding document of the trust. The clause relating to the revocation of a beneficiary's right to receive income may also confer the power of a donor/creator to substitute the current beneficiary with another person. It is accepted that section 7(6) would not apply to circumstances in which the beneficiaries have a contingent right to receive the income from the trust. It would also not apply to circumstances in which the donor as a trustee required a fellow trustee to confirm his revocation. Therefore, the stipulation in the founding document of the trust has to be precise in its language to provide clear rights of revocation or substitution of a beneficiary solely on a donor or creator of a trust. Section 7(6) of the Act provides for circumstances in which a donor/creator reserved powers to renounce a beneficiary's right to receive income from the trust. The stipulation must be expressly stipulated in the founding document of the trust. A proper interpretation of this section allows for the person conferring the right to be taxed upon the interest they retain. The provisions of section 7(6) will apply to a scenario in which the person conferring the right retains the power to revoke such distribution of interest or confer upon another person such interest. This becomes applicable when dealing with a trust which provides for the donor to retain these powers in the trust deed. The section will be applied to any circumstances in which there is a donation, settlement or any other disposition.

Sections 7(5) and 7(6) make provision for the collection of income tax from the donor in the circumstances outlined above. Section 7(5) and (6) were aimed at dealing with Inter Vivos trusts. Their application was also aimed at curtailing the use of a Trust to divest ones assets but remain in control of them.

Section 91(4) provides for further relief in the circumstances in which a donor was just unable to fulfil his income tax obligations as enforced under section 7(5) and 7(6). In these circumstances, the Commissioner is given the power to recover the unpaid taxes from the assets which initially produced the income that gave rise to the tax liability.<sup>64</sup> An examination of this provision simply shows that the Commissioner was empowered to recover the outstanding income tax from the trust assets which provided the income for which the donor incurred tax liability. This could take various forms such as shares or income received from immovable property which was deemed to be the income of the donors in terms of sections 7(5) and 7(6). This would guarantee the Commissioner the opportunity to recover the income as in most cases the donors had divested themselves of any income earning assets.

Subsection (7) regulates circumstances in which a person confers their right to income by way of rent, dividend, interest, royalty or similar income. If the person reserves a right to revoke such authority, the income will be deemed to be that of the donor.

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<sup>64</sup> See Chapter 10 below for a discussion on section 91 of the Act.

Subsection (8) is aimed at offshore trusts and ensures that the income so distributed is taxed in South Africa. This subsection ensures that the residents are taxed upon the income they earn from distributions from an offshore trust.

In addition, subsections 9 and 10 were also added in 2000.<sup>65</sup> These sections deal with deemed donations and the administrative requirements. Subsection 9 provides for a disposal or consideration which is less than the market value of the asset. In these circumstances the difference in value is deemed a donation.<sup>66</sup> Sub-section 10 provides that a person will have to disclose any donation, settlement or any other disposition to the Commissioner when filing their returns.

In the scope of tax avoidance, the inclusion of a clause which provides for the formation of a trust in a person's will is very popular. Unfortunately, the trust was not a person for the purposes of income tax until the subsequent amendment of the Act due to the case of *Phillip Frame Will Trust v Commissioner of Inland Revenue*.<sup>67</sup> The trustees were accordingly held liable until Practice Note 23 was issued by SARS.<sup>68</sup> Most of these testamentary trusts provided for income to be paid to a beneficiary upon the happening of an event. This also aided the deceased's wishes in protecting their wealth for the beneficiaries. Most importantly, Capital Gains tax was not applicable. Therefore, people were free to donate their assets which had a high rate of growth to the trust without the concern of a later penalty.

In summary, the following rules are applicable when determining the identity of the person liable for income tax:

Donors:

- Where conditions required by Section 7(5) are present and when the entire amount of income from the trust is deemed the donors notwithstanding any discretionary payment to the beneficiaries by the trustees.
- When there is a stipulation that the vesting of the right shall be suspended until the happening of an event.

Beneficiaries:

- When income is paid to the beneficiaries or payment is withheld at the discretion of the trustees. This discretion by the trustees is not deemed an event as it follows that although the beneficiaries are in the discretion of the trustees as to when they receive payment, they can also benefit by receiving their income at an earlier date.

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<sup>65</sup> Section 5 of Act 59 of 2000.

<sup>66</sup> Section 55 of the Income Tax Act, 58 of 1962. A donation is defined as any gratuitous disposal of property including any gratuitous waiver or renunciation of a right. See generally Part V of the Act.

<sup>67</sup> 1992 (3) SA 340 (W)

<sup>68</sup> Number 23/1994. See Chapter 7 below for a discussion on Practice Note 23.

-In the circumstances in which it is not merely the happening of an event which suspends payment. This may occur when the beneficiaries are undetermined. In this case it cannot be said that payment is suspended merely due to the stipulation.

In ITC 1484<sup>69</sup> the following was stated,

We find, therefore, that the income in issue in the appeal had vested in the beneficiaries, *in esse*, and been paid over to them by crediting their account and that the assessment should have been raised against the beneficiaries and was wrongly raised against the trust.

This merely confirms the principle that trust income may be taxable in the hands of a beneficiary as long it has been vested in such beneficiary. There is no such requirement that the beneficiary need physically receive such income.

As the years passed, legislation also evolved through amendments that were made to the Act. Some of the principles did however remain the unchanged. Just prior to the insertion of Section 25B, in 1991, the principles enunciated as above still mainly govern the taxation of trust income.<sup>70</sup>

The higher degree of importance in transfer duty and later, capital gains tax has led to a negative impact on the use of trusts. The promulgation of the 1962 Act brought a clear indication that the fiscus was attempting to curb the benefits attributed to a trust. A person was still free to dispose of their assets to a trust to lower the net value of the estate upon their death, and subsequently fall within the abatement as provided for when calculating estate duty.<sup>71</sup> The Act, along with ancillary legislation, formulated the manner in which the trusts and their assets were taxed. Specific reference is made to the taxation of the donor in circumstances where they retain control over the assets they donated to a trust.

At this stage of the development of the principles of taxation, there was still a chance for any of the donor, trustees or beneficiary to be held liable for income tax when the circumstances giving rise to the distribution of income were applied to the applicable legislation. The legislative framework of our country was still being developed and in an attempt to reform taxation many of the country's foremost experts in taxation were requested to provide a report into the system of taxation. An analysis of the recommendations which were made by the Margo Commission provides a further example of the concerns which were held by the Treasury on trusts and their use as a tool in tax avoidance.<sup>72</sup> This aspect will now be considered.

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<sup>69</sup> 52 SATC 312

<sup>70</sup> See Chapter 9 below

<sup>71</sup> Section 4A of the Estate Duty Act 44 of 1955. When calculating the value of a person's dutiable estate, an abatement of R3.5 million is allowed to be deducted from the net value of the estate.

<sup>72</sup> See Chapter 6 below.

## CHAPTER 6

### THE MARGO COMMISSION<sup>73</sup>

During the course of the current Act, the Treasury has continuously searched for methods of reforming the tax system and has formed commissions comprising of industry specialists and others to determine which changes are necessary. These included the Katz Commission<sup>74</sup> and the Davis Tax Committee.<sup>75</sup> One of the commissions which were established to assist in the reform of our system of taxation was the Margo Commission. In 1987, the Report of the Commission of Enquiry into the Tax Structure of the Republic of South Africa (The Margo Commission), a number of recommendations and statements relating to trusts were made.<sup>76</sup> The Commission was formed to provide feedback on creating a cohesive structure of income tax in South Africa, and to aid in the reform of taxation in the country. This was due to the continued perception that those adopting the use of Trusts were in a favourable position in comparison to others when dealing with taxation. The fact that Trusts were mentioned in their recommendation shows that they were of concern to the fiscus.

Among these recommendations were the following;

- The 'conduit pipe' principle was the appropriate method to adopt when dealing with the taxation of trusts.
- Appropriate action was required in preventing the splitting of income and subsequent tax evasion which followed.
- The Commission also recommended that in circumstances where a beneficiary was not defined, it would be appropriate to have the trustees pay the required tax at the rate as prescribed to for individuals.
- The commission also recommended that when Trust income did not accrue to a particular beneficiary at the end of a tax year, it should be taxed at the maximum rate applicable to individuals.
- It was also recommended that a business trust be taxed as if it were a company. It therefore follows that a trustee will be taxed as if they were in a similar position as a shareholder of the company.

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<sup>73</sup>Mr Justice CS Margo was the chairman of the Margo Commission.

<sup>74</sup> The Katz Commission was appointed on 22 June 1994 and submitted its first report on 18 November 1994. The Commission of Inquiry into the tax structure of South Africa was also known as the Katz Commission and included Judge Dennis Davis who is currently the chairperson of the Davis Tax Committee.

<sup>75</sup> See note 1 above.

<sup>76</sup> Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa. The Government Printer RP34/1987, Pretoria.

Recommendations such as confirming the ‘conduit pipe’ principle have since been incorporated in the legislation in terms of Section 25B.<sup>77</sup> The Margot Commission provides an example of the continuing evolution of our tax system and reform of the taxation of trusts. The recommendations were aimed at generation-skipping devices. A trust was included in this category and the Commission found that these forms of enterprise should be subject to Capital Transfer Tax every 15 years. This would entail the taxation of the assets in a trust which have not been transferred or vested to an ascertainable beneficiary every 15 years. This recommendation was not adopted by the fiscus but legislation providing a stricter approach has been subsequently adopted. These include capital gains tax<sup>78</sup> and the amendment of the act to include a trust as a person.<sup>79</sup> The very idea of the taxation of the trust’s assets in a 15 year cycle may seem impractical in light of our current legislation and the proposals that have been made by the fiscus and their committees. The Margot Commission was however mandated prior to Practice Note 23 and therefore their recommendations have to be analysed in the context of the financial climate in 1987. Practice Note 23 has had a hugely profound effect in the taxation of trusts. The circumstances leading to the necessity of Practice Note by SARS will be discussed in detail and will provide a basis for the subsequent amendment of legislation.

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<sup>77</sup> See generally chapter 10 below

<sup>78</sup> As governed by Schedule 8 of the Act.

<sup>79</sup> See Chapter 7 below for a discussion on Practice Note 23

CHAPTER 7  
PRACTICE NOTE 23<sup>80</sup>

Another important development in the treatment of trust income as relating to income tax was the introduction by SARS of Practice Note 23. A discussion on Practice Note 23 is imperative when analysing the taxation of a trust. In 1991, Section 25B was inserted into the Act.<sup>81</sup> The effect of the amendment was to confirm the long established 'conduit pipe' principle and more importantly to recognise the concept of a trust as a taxpayer.<sup>82</sup> Section 25B exclusively deals with the income derived from trusts. The 'conduit pipe' principle, was duly confirmed by the insertion of section 25B by deeming any income which has been vested to a specific beneficiary to be for their immediate or future benefit, to be income which has accrued to the specific beneficiary.<sup>83</sup> This income would thereafter be treated in the same manner as prior to distribution. This was a major deviation from prior legislation which relied upon the deeming sections for assessing liability for the taxation of trust income. Although the 'conduit pipe' principle was a commonly accepted principle, the insertion of section 25B provided the legislative framework upon which the income as distributed by a trust could be assessed. This is also an indicator of the prevalence of the use of trusts and confirmed that income would retain its identity as it passes through the trust and is distributed to the beneficiaries.

Practice Note 23 can be seen as a consequence of *Phillip Frame Will Trust v Commissioner of Inland Revenue*.<sup>84</sup> Following, this judgment, the Act was amended to include a trust in the scope of the definition of a person.

In this case, the trustees sought an order declaring that the trust was not a legal persona. The trustees were challenging the Commissioner's power to tax the trust on undistributed income. The court found that a trust was not a legal person and thereafter the Act was amend to incorporate a trust as a legal person. In its judgment the court said<sup>85</sup>

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<sup>80</sup> See Note 41 above. Issued on the 17th June 1994 and withdrawn on the 18th August 2015. Section 25B had been substituted by section 27(1) of Revenue Laws Amendment Act No. 32 of 2004 with effect from the years of assessment ending on or after 24 January 2005.

<sup>81</sup> Section 27(1) of Act 129 of 1991

<sup>82</sup> Section 2(f) of Act 141 of 1992

<sup>83</sup> Section 25B(1) of the Act.

<sup>84</sup> Note 67 above.

<sup>85</sup> Note 67 above, 12.

In short, in the absence of any express provision in the Act constituting a trust a ‘person’ or taxable entity for purposes of the Act, I do not consider that any liability for tax in respect of the undistributed income of a trust is created by the Act. If this is a *lacuna* in the Act it is a matter which can obviously only be cured by legislation.

This amendment made special provision for undistributed income. Undistributed income was income that had not yet been vested in a beneficiary and that had been undistributed. In these cases it was argued that the trust became liable for such tax with the trustee becoming the representative taxpayer. This brought to an end the dispute relating to undistributed income as it gave the Commissioner authority to levy tax upon the trust. Prior to the Treasury’s decision to amend the Act, the treatment of undistributed income was left open to debate.

The case had such a profound effect that the fiscus did not await the appeal decision and immediately amended the Act with retrospective effect from March 1986.<sup>86</sup> In addition to making the trust a taxpayer, the amendment also provided that the ‘conduit pipe’ principle,<sup>87</sup> may end after a certain period if distribution to a beneficiary does not take place within the year of assessment.<sup>87</sup> The trustee has a relationship with the trust where they act as a conduit pipe to transfer income to a beneficiary. If the income is not distributed to a beneficiary within a year, such income is retained in the trust and taxed in according to the prevailing rates applicable to the taxation of trusts.

In ITC 1864,<sup>88</sup> the appellant was the sole trustee of an inter vivos trust. The appellant/trustee was a technician and in 1997 formed the trust and provided services to various companies through the trust. The trust received the income for the appellant’s service. The beneficiaries of the trust were the appellant, his wife and children. The trustee merely worked as an independent contractor with all the proceeds of his employment being paid to the trust. Thereafter the appellant declared almost no income and the trust wrote off most income with expenses. The Commissioner performed an audit and found that the income received by the trust should be taxed in the hands of the appellant. In reaching a decision the court examined the provisions of Section 103 and the avoidance of taxation that it enforces. It was held that the appellant’s actions constituted a scheme for tax avoidance. In reaching judgment it was found that the taxpayer’s state of affairs was abnormal and that such transactions between the taxpayer and the trust gave rise to abnormal rights and obligations between the parties. It was held that the transaction was not concluded at arm’s length.<sup>89</sup> It was clear from the facts that the appellant

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<sup>86</sup> Income Tax Act no. 129 of 1991 at section 27.

<sup>87</sup> In terms of Section 25B such amount must be derived by the beneficiary in the year of assessment as received by the Trust. This leads to the income retaining its value of distributed to a beneficiary in the year that same becomes available for distribution. See Chapter 9 below.

<sup>88</sup> 2012 (75) SATC

<sup>89</sup> Ibid 247



would be liable for income tax. Following *Phillip Frame Will Trust*, the limited capability to avoid taxation grew as the moot point surrounding the taxation of a trust as a taxpayer had been answered.

Prior to the aforementioned amendments, a trust was taxed at the rate of an unmarried person. The Commissioner characterised a trust as a taxpayer even though not confirmed by legislation. The trust was taxed as an unmarried person on income which accrued to it. The trust could also claim the applicable rebate from its taxable income and the trustees were responsible for settling any outstanding taxes from the funds of the trust.<sup>90</sup> The applicable rebate was apportioned in the case of a new appointment of a trustee during a year of assessment.<sup>91</sup>

Prior to the amendment of the Act in 1991, it was argued that a trust could not be assessed for the purposes of income tax.<sup>92</sup> The basis of this argument was, firstly, that a trust was not defined as a person in the Act. Secondly, it was argued that income could not accrue to a trust because of the restrictions imposed on that income. The trustees were the ones whom were released of their burden as representative taxpayers after the amendment of the Act. They were accordingly not held liable for any undistributed income in the trust. The judgment did however have the effect on leaving undistributed income out of reach from the Commissioner. Practice Note 23 also dealt with section 25B. This was done with the intention of finally providing for the taxation of trusts in the Act and not relying solely on the deeming provisions of the Act.

The effect of the change in legislation brought some relief to trustees. They were no longer the representative tax payers of the undistributed income of the trust.<sup>93</sup> There was now a clear understanding of the treatment of trust income. The effect of the amendment of the act also brought to light the relationship between the trustee and the trust. If income remains undistributed at the end of a tax year, the trustee will become a conduit pipe for the Trust in respect of such income. The trustee merely retains the income on behalf of the trust.

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<sup>90</sup> Standard Trust Income Tax Guide, (1988-1989) 156.

<sup>91</sup> See generally, RC Williams, *Income Tax in South Africa* 384. An apportionment of the primary rebate is applicable if a trustee is discharged from office or appointed during the year of assessment. The trustee is the representative taxpayer and is allowed to deduct expenditure incurred in relation to income received or accrued to him in the capacity of a trustee. This expenditure includes the charges in relation to the administration of the Trust and the author cites the trustee's remuneration and premiums of a fidelity bond as examples of expenditure that would be allowed as deductions during this period.

<sup>92</sup> The argument surrounded the undistributed income as retained by a Trust. As a Trust was not included in the definition of a person, the argument arose that the Trust could not be held liable for undistributed profits which were retained.

<sup>93</sup> A trustee was held liable for the payment of the trust's income tax. This was due to the legislature which had not recognised a trust for the purposes of income tax.

The expenditure expended by a trustee on behalf of the trust will also in terms of Section 25B, constitute a deduction in the calculation of the trust's taxable income in terms of section 25B.<sup>94</sup> As a taxpayer, the trust will manage its own estate and therefore all income and expenses incurred during the year of assessment will have to be taken into account when determining taxable income. If the trustee manages such expenditure and if the assets to which the expenditure relates are not vested in a beneficiary, it cannot be deducted from that said beneficiary's income. Prior to the insertion of section 25B in the Act, the losses were proportionally afforded to the beneficiaries after taking into account the income they had received from the trust.

In terms of tax avoidance, the abovementioned amendments had a profound effect on the use of a trust. The addition of section 25B provided clarity on income flowing through a trust. The conduit pipe principle was also reinforced. The flow through mechanism of income in a trust is a major factor which has encouraged people to use trusts. The income retains its nature and the beneficiaries receive the income without any change. Therefore, one could now determine the nature of the income their beneficiaries were to own from the trust with more clarity.

The amendment of the Act to include the trust as a taxpayer had an opposing effect. The taxable burden on the undistributed income would gradually decrease the equity in the trust. The trust was now liable for taxation and had to follow the normal procedures eg. the filing of income tax returns. Increased thought had to go into the formation of a trust and also the proposed contingent rights to income. The higher rate of tax paid by a trust as opposed to a natural person is also a determining factor.

Section 25B confirmed the flow through principle of a trust as it provides for the treatment of income which is distributed by the trust.<sup>95</sup> Income which is distributed to a beneficiary retains its identity and the beneficiary is taxed upon the income they have received. The provisions of section 25B duly regulate the distribution and subsequent taxation of the income a trust receives and distributes. The conduit pipe principle has many advantages when used correctly after considering all of the factors such as the higher rate of taxation of trust income.<sup>96</sup> This rate of taxation is applicable to income arising from assets that are retained by the trust and not distributed. A clear understanding of the conduit pipe principle is required to understand the importance of trust and will be discussed in detail in the following chapter.

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<sup>94</sup> Section 25B(3) of the Act. See Chapter 9 below for a discussion on section 25B. Paragraph 4 of the repealed Practice note 23 gave rise to the apportionment of allowances and deductions between a trust and the beneficiaries.

<sup>95</sup> See generally Chapter 9 below.

<sup>96</sup> See note 7 above.

## CHAPTER 8

### THE CONDUIT PIPE PRINCIPLE

Following the release of Practice Note 23 and the subsequent amendment to the Act, the conduit pipe principle drew more attention. This concept is discussed below. The conduit pipe principle may become the cause for many an argument over the next few years if the Legislature implements the proposed changes to the taxation of trusts. As confirmed in the Act by section 25B, the principle simply provides that the nature of any distribution does not alter in state as it passes through the trust to the beneficiaries.<sup>97</sup> Put another way, subject to some exceptions, income derived from a trust retains its identity as it flows through the trust and to the beneficiaries.<sup>98</sup> This is known as the conduit pipe principle.

In normal circumstances if an amount of money is passed from one person to another, the amount received must be taxed in the hands of each recipient. If a person receives R100 000-00 as a donation it is an amount of a capital nature in that person's hands. Once they begin using part of those funds, any proceeds generated by such use revenue and taxed accordingly.

The conduit pipe principle only applies to cases in which income is distributed in the same year as which it was derived. Income that is received by a trustee for beneficiaries that have a vested right to same, is treated as having accrued to these beneficiaries. The trustees or trust in these cases become a mere conduit pipe for the onward transmission of the income.

In *Rosen*<sup>99</sup>, the conduit pipe principle was duly confirmed. This case involved the taxation of vested beneficiaries. Mrs Rosen received income from a trust created for her benefit by her father. During the period under dispute she received income from the trust whilst resident in England. Initially the objection to the assessment was upheld by the special court on the basis that part of the income was made up of annuities and the rest of dividends which were exempt from taxation. In reaching a decision the court had to determine if the dividends paid to the trust were still dividends once paid to the beneficiary.

The court held as follows

In effect the Legislature in those provisions has adopted a principle that can be conveniently termed the conduit principle: the registered shareholder is regarded as a mere conduit-pipe for passing the dividends

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<sup>97</sup> See Chapter 9 below. Section 25B deems any amount which is received by a trust for the benefit of a beneficiary to be the beneficiary's income.

<sup>98</sup> The treatment of annuities as per section 10 of the Income Tax Act. Therefore an annuity paid from a Trust as arising from a dividend or stock is not exempt from Income Tax.

<sup>99</sup> 1971 (1) SA 173

on to the deemed shareholder, the true recipient of them, in whose hands they consequently retain their identity and character as dividends. The function of the principle is mostly apposite to trust cases, the mere interposition of the trustee between the dividend-paying companies and the beneficiary not being regarded as sufficient to change the character of the dividends as they pass to the latter.<sup>100</sup>

The principle rests upon sound and robust common sense; for, by treating the intervening trustee as a mere administrative conduit-pipe, it has regard to the substance rather than the form of the distribution and receipt of the dividends.

The conduit pipe principle was therefore confirmed by the case which also found that it was based upon sound principles and was applicable to South African law.

The approach of the court in *Rosen* is supported by other authorities. For example, Meyerowitz holds the view that income which passes to a beneficiary from a trust does not lose its identity.<sup>101</sup> The conduit pipe principle may also be subject to the terms of the trust deed and not only the applicable legal principles. It depends on the duty that the trustee may acquire along with powers relating to the use/distribution of the property of the trust. The trustees are sometimes conferred with varying powers to dispose of the trust property and this discretion will impact on the eventual treatment of the income. An example can be seen in the treatment of an annuity paid from a trust. This occurs when income is derived from dividends or interest on, for example, government stocks and the nominated trustee pays out an annuity (as defined in the Act) to a beneficiary of the trust. The conduit pipe principle does not apply as the payment does not retain its status as trust income. The exemption granted under Section 10(1)(h) and (k) does not apply to an annuity.<sup>102</sup> Hence a trust beneficiary is liable to pay tax on an annuity paid out of dividend income. In terms of the previous section 19(6) the conduit principle did not apply to cases in which the trust receives and distributes dividend income in the form of annuities.

It has been shown that in circumstances in which a beneficiary has a vested right to income, the trustee/s merely serve as a conduit vehicle for such income to be transferred and vest in the beneficiaries. It has to be noted that in terms of *Rosen*,<sup>103</sup> the conduit pipe principle applies to circumstances in which the beneficiary has a vested right to receive the income and to circumstances in which the beneficiary acquired such right to the income eg. as will be the case with discretionary trusts.

The rule that a beneficiary and not a trustee should be taxed only applies to circumstances in which a beneficiary has a clear right to the income. This is dependent on whether the beneficiary has a vested or contingent right to the income.

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<sup>100</sup> Ibid 187 - 189.

<sup>101</sup> See Generally, Meyerowitz on Income Tax, 2001.

<sup>102</sup> AP de Koker, RC Williams, Silke on Income Tax, 12.2.26

<sup>103</sup> Note 100 above.

In terms of a discretionary trust, the income will only vest in a specific beneficiary if and when the trustee distributes such income to a beneficiary. Once this occurs, the contingent right becomes a vested right.

Even at an early stage of development of our law of taxation, trust income was seen to retain its identity as it was distributed from the trust to the beneficiaries.<sup>104</sup> This was made clear from *Armstrong v Commissioner for Inland Revenue*.<sup>105</sup>

In *Armstrong* the widow of the deceased was entitled to the income of the estate which was vested in trustees. The assets which she received income included mortgages, shares and property. The question that arose was if income she received by virtue of dividends was still exempt from income tax.

The court held that it was exempt from taxation due to the conduit principle. Although not confirmed in legislation, the Learned Judge Stratford found that the dividends retained their identity and were exempt from taxation.<sup>106</sup> In attempting to explain the conduit pipe principle, the court stated as follows

In the simple case I am now examining, namely, that of a trio comprising a company, the intervening Trustee, and the beneficiary, it is manifest that in the trust since the beneficiary derives his income from the company, for that income fluctuates with the fortunes of the company and the trustee can neither increase nor diminish it, he is a mere "conduit pipe".

This extract provides an example of the conduit pipe as the court confirmed that the income can neither increase nor decrease in value but merely retains its original form when distributed to a beneficiary. The conduit pipe principle is of importance when attempting to ascertain the identity and taxation of income being distributed from a trust. A concise understanding of the principle is required to appraise a person of the advantages and disadvantages of utilising a trust. The taxation of trust income is however regulated by section 25B of the Act. Practice Note 23 also led to the inclusion of section 25B and an understanding of the provisions governing the taxation of trusts will be discussed in the following chapter. This will provide a clearer understanding of the gradual increase in the taxation of trusts in general. Section 25B read with section 7 of the Act are currently the main provisions which regulate income tax as applicable to trusts. The discussion thus far has provided a timeline which clearly shows an increase in the taxability of trust income as our fiscus has increased the regulating provisions of the Act in order to adequately provide for all circumstances in which a trust may be utilised for tax avoidance.

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<sup>104</sup> This can be evidenced by the case of *Armstrong v Commissioner for Inland Revenue* 1938 AD (343). Judgment was handed down in 1938 which clearly precedes Practice Note 23.

<sup>105</sup> Ibid 348

<sup>106</sup> Ibid 351

## CHAPTER 9

### A SUMMARY ON THE PRINCIPLES OF SECTION 25B OF THE INCOME TAX ACT, 58 OF 1962

Trusts and their subsequent taxation are currently regulated by Section 7 and Section 25B of the Act.<sup>107</sup> Section 25B deals with the treatment of trust income. The following is an explanation of the provisions of section 25B as an understanding of the section is required to outline the feasibility of a trust in general tax avoidance. The discussion on section 25B will be analysed in the context of the 1962 Act as amended throughout the years. Current trends dictate that there will be subsequent changes to this legislation as the fiscus continues to tighten the screws on those attempting to use a trust to avoid the payment of income tax. The insertion of section 25B, which specifically deals with Trust income highlights the importance and prominence of a Trust. Section 25B is a direct result of the continued use of a Trust in an attempt to avoid or defer the payment of income tax.

Section 25B (1) and (2) deals with the vested rights of a beneficiary.<sup>108</sup> These subsections are generally read together in determining the tax liability of a beneficiary. In terms of section 25B(2), an amount which becomes vested in a beneficiary is taxed in their hands. In terms of section 25B(1), If such amount is not vested in the beneficiary, such amount remains in the trust and will be liable to taxation in the hands of the trust. The undistributed income will therefore increase the taxable income of the trust. Section 25B is subject to section 7 which reinforces the principle that even though such amount is further invested and not specifically paid out, it will be included in the beneficiary's gross income.<sup>109</sup> Any other income so derived will be attributed to the trust. The provisions of subsection 2 can be applied in respect of a trust which has conferred discretionary powers on the trustees.

Subsection 1 applies to circumstances in which section 7 does not apply. It can be said that to the extent that subsection 1 applies to all income for an ascertained beneficiary, all other income will accrue to the trust. All such income will be assessed in the hands of the trust as a taxpayer

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<sup>107</sup>Section 25B was inserted into the Income Tax Act by Section 27(1) of the Income Tax Act No.129 of 1991. The 2013 Budget review and The Interim Report released by the Davis Tax Committee can be used as an example of the Treasury's thoughts on reforming the model of taxation as applicable to a Trust. A Trust is currently seen as an effective method of income tax avoidance and a useful tool in estate planning. See generally, DN Erasmus Changes in the Taxation of Trusts in South Africa, <http://taxriskmanagement.comn/changes-in-taxation-of-trusts-in0south-africa>. The author believes that a change in approach by the fiscus will also lead to a change in attitude by tax planners as they attempt to circumvent any proposals.

<sup>108</sup>A vested right relates to right to a property or asset which is unconditional. The vesting of a right does not automatically entitle a person to ownership of the asset. See generally Wills and Trusts by Pace and WM van der Westhuizen 80

<sup>109</sup> See Chapter 5 above for a discussion on section 7 of the Act.

Section 25B(2)A, deals with circumstances in which a resident taxpayer receives benefits from a non- resident trust. In terms of this subsection, a resident will have to include any income as received from a non resident trust. The income will be included in an individual's taxable income if such income would have constituted income if the trust was a resident during any previous year of assessment in which the recipient had a contingent right to such income or if the amount has not already been subject to tax in South Africa.

Section 25B (3), deals, with expenditure allowed in the calculation of trust income. It has to be noted that such expenditure is only that which falls within the ambit of the general deduction formula.<sup>110</sup> All other expenses will be after-tax expenditure. Expenditure will also be apportioned to the beneficiaries depending on the amount of the accrual that they receive during the year of assessment.

Section 25B (3) qualifies any deduction that one may wish to make from income that they receive in terms of Section 25B (1). The subsection provides that such deduction must apply to an amount in the following circumstances:

- a) a beneficiary, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary; and
- b) the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that trust.

Expenses and allowances that are not apportioned to a beneficiary are subsequently apportioned to a trust. The principle that provides that an expense can only be deducted by a person bearing the expense is ignored. In the usual course of events, a trustee normally vests income in a beneficiary after all expenses dealing with such income are deducted.

Subsection 4 further limits the deduction a beneficiary can claim in terms of subsection 3 to the amount they receive from the trust in terms of section 25B(1). Subsections (4), (5) and (6) all deal with the limits of deductions and allowances allowable in terms of section 25B (3). Subsection (4) can be said to be a ring-fencing provision relating to the applicable deductions and allowances.<sup>111</sup> This provision prevents a trust from incurring an assessed loss.<sup>112</sup> It has to be noted that subsections (4), (5) and (6) are only applicable to trusts which were registered from the 1<sup>st</sup> January 1999.

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<sup>110</sup> Note 33 above.

<sup>111</sup> The deductions and allowances allowed when calculating taxable income is primarily regulated by Section 11 of the Income Tax Act of 1962. See generally A de Koker and RC Williams, *Silke on Income Tax* (2016) 7.

<sup>112</sup> Section 21 of the Act deals specifically with the aspect of assessed losses.

Subsection (5) provides for the excess allowances and deductions which are not allowable in terms of subsection (4). Cognisance has to be made that the limitation in subsection (5) is only applicable to the taxable income of the Trust and does not apply to the income that has been distributed to the beneficiaries.

Subsection (6) regulates the carrying forward of any excess deductions and allowance from a previous year of assessment. This subsection is qualified by the lapsing in the carrying forward of deductions which results in the break of the period in which such loss is carried forward.<sup>113</sup> A balancing act has to be established in which the amounts to be distributed to the beneficiary has to be assessed with reference to the income of the trust. Emphasis has to be placed on the dates of the vesting of the income when determining the amounts to be carried forward in the next subsequent period. The excess which is carried by a beneficiary ends with that very beneficiary. This means that upon the passing of a specific beneficiary, that 'beneficiary' excess cannot be transferred to another beneficiary.

Subsections (4), (5) and (6) do not apply in respect of any amount which is deemed to have accrued to any beneficiary in terms of subsection (1), where that beneficiary is not subject to tax in the Republic on that amount in terms of subsection 7.

Subsection (5) is applicable to deductions and allowances that are not regulated by subsection (4). The subsection provides that any deductions or allowances not allowed in terms of subsection (4) will revert back to the trust and that the income of the trust is in no way linked to that of the income of the beneficiaries.

Subsection (7) was introduced in 2000.<sup>114</sup> This subsection deals with the circumstances in which a beneficiary is not liable to pay income tax in South Africa. This is notwithstanding the status of the trust. Therefore, this subsection would apply although a trust may be subject to the laws of taxation in South Africa. In these circumstances, the rules of taxation will not apply. The subsection has an effect on those that are taxed in accordance with the source based system of income tax.<sup>115</sup> In the event that the subsection is applicable, the allowable deductions and allowances can be set-off against income that is not derived from or as a consequence of the trust. A further amendment was made by the Revenue Laws Amendment Act of 2004.<sup>116</sup> The word

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<sup>113</sup> Section 25B(6) states that the deductions and allowances must be borne during the 'immediately succeeding year of assessment.'

<sup>114</sup> Section 31, Revenue Laws Amendment Act, 59 of 2000

<sup>115</sup> Prior to 1 January 2001, taxpayers were taxed on income derived from within the Republic. This is in accordance with the source based system of taxation which provides that all income derived within the Republic should be taxed within the applicable legislation governing taxation in the republic. The source based system of taxation has subsequently been replaced by the residence based system of taxation. The residence based system provides that all residents of South Africa are taxed in accordance with the principles of Act notwithstanding the source of the income. Non-residents in South Africa will continue to be taxed in accordance with the source based principle of taxation. See generally, RC Williams, *Income Tax in South Africa, Law and Practice*, Fourth Edition 32

<sup>116</sup> Act No.32 of 2004.



‘income’ was replaced by the word ‘amounts’ in sections 25B.<sup>117</sup> This assisted in broadening the scope of the applicability of the section.

A trust is also liable for the normal penalties payable by taxpayers or the late filing of returns, which can include penalties for underestimating their income. This could occur in the circumstances in which a trustee attempts to apply the provisions of section 25B although the beneficiary has not accepted such benefit. It has to be noted that if the trustees fail to make the required resolution to pass the benefit to the beneficiary in the same year, the conduit pipe principle will not be applicable.<sup>118</sup> A trust also has its financial year end in February and if this is not applicable to the specific trust, it will be still compelled to abide by the regulations and file its returns by the end of its financial year.<sup>119</sup>

In summary, subsection (1) deals with the undistributed income of a trust whilst subsections 2(A) to (6) deals with the income as received by a beneficiary. Section 25B seeks to provide a platform on which the taxation of a trust can be assessed.

Section 25B is interpreted in accordance with the anti-avoidance principles of the Income Tax Act.<sup>120</sup> The provisions attempt to regulate schemes which are entered into for the purpose of tax avoidance and the decrease of a person’s taxable liability. A discussion on the legislation which governs the taxation of trusts requires an introduction into the anti-avoidance provisions and their applicability when determining the assessment of trust income. This clearly outlines our Legislature’s stance on limiting tax avoidance through impermissible schemes with the use of a trust.

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<sup>117</sup> Section 27 of the Revenue Laws Amendment Act 32 of 2004. In terms of the Explanatory Memorandum on the Revenue Laws Amendment Act of 2004, the amendment was required due to there being some confusion over the interpretation of the word income in section 25B. The word income may have been construed as relating to gross income less exempt income or income in its general form. The amendment allowed for the interpretation of income in its general form to be applied when dealing with section 25B.

<sup>118</sup> For the provisions of Section 25B(1) to apply, the distribution to a beneficiary has to take place within the same year. See generally Chapter 9 above.

<sup>119</sup> Paragraph 2.6, External Guide, SARS Comprehensive Guide to the ITR12T for Trusts,

<http://www.sars.gov.za/AllDocs/OpsDocs/Guides/IT-AE-36-G04%20->

[%20Comprehensive%20Guide%20to%20the%20ITR12T%20return%20for%20Trusts%20-%20External%20Guide.pdf](http://www.sars.gov.za/AllDocs/OpsDocs/Guides/IT-AE-36-G04%20-%20Comprehensive%20Guide%20to%20the%20ITR12T%20return%20for%20Trusts%20-%20External%20Guide.pdf)

<sup>120</sup> See generally chapter 10 below.

## CHAPTER 10

### THE ANTI-AVOIDANCE PROVISIONS OF THE INCOME TAX ACT, 58 OF 1962 AS RELATING TO TRUSTS

The Act contains many provisions which act as a deterrent or prohibitory obstacle to tax avoidance. These are of importance to trusts as they diminish the possibility of tax avoidance. They provide for circumstances which are not dealt with in sections 7 and 25B. Therefore, the discussion which follows provides a brief synopsis on the provisions which are applicable to the use of trusts.

Section 80A is the general anti avoidance section and deals with impermissible tax avoidance arrangements. This section allows the fiscus to impose tax if a particular transaction, operation or scheme had been entered into, if he was satisfied that it had the effect of avoiding or postponing any tax, duty or levy imposed by the Act. This section is still applicable and enforced for transactions entered to before the 2<sup>nd</sup> November 2006.

Section 103 (2)(b) makes specific reference to trusts as it cites the trustees or beneficiaries of any trust and is currently applicable. The provisions of section 103(2) are aimed at those whom wish to utilise an assessed loss, balance of an assessed loss, capital loss or an assessed capital loss to avoid liability or reduce the payment of income tax.<sup>121</sup> In these circumstances, the Commissioner is allowed to disallow any set-off with income and an assessed loss or balance of an assessed loss if an agreement was deemed to have been entered to on behalf of the Trust for the sole reason of avoiding the payment of tax.

Section 80A currently regulates arrangements which are deemed impermissible. The Commissioner is given the power to disregard any arrangements falling under the ambit of this provision of the Act. The Tax Administration Act also deals with reportable and excluded arrangements.<sup>122</sup> The Commissioner is empowered to exclude any such undue tax benefit. Section 80A replaced section 103(1) of the Act in 2006.<sup>123</sup> The repealed section 103(1) dealt with any transaction, operation or scheme which had the effect of avoiding or postponing the payment of tax and was not entered into for bona fide purpose of a business. Section 80A classifies which avoidance arrangements are deemed impermissible. These include arrangements which are not bona fide for the purpose of business<sup>124</sup> and in circumstances which are not business related, those transaction which are not

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<sup>121</sup> Section 20 of the Act. Section 20 allows for the carrying over of an assessed loss or balance of an assessed loss on condition that income can only be set-off against the specific trade which resulted in an assessed loss.

<sup>122</sup> Section 35 and section 36 of the Tax Administration Act

<sup>123</sup> Section 34(1) of Act 20 of 2006.

<sup>124</sup> Section 80A(a)

employed for a bona fide purpose.<sup>125</sup> Section 80A further qualifies any arrangement which creates obligation which would not be created when dealing at arm's length as impermissible.<sup>126</sup>

Section 9 of the Act is utilised by SARS in the collection of tax when dealing with a trust. Section 91 allows SARS to collect any outstanding income tax from the assets of the person deemed liable.

The deemed income of a donor is divided by the taxable income of a donor and thereafter multiplied by the total taxable income of the donor by SARS when determining the taxable income recoverable.<sup>127</sup>

The Tax Administration Act has assisted in the enforcement of the anti-avoidance provisions of the Act.<sup>128</sup> The Act provides for recourse against a representative taxpayer and also sets out the mechanisms whereby the revenue service may utilise for the collection of outstanding income tax.<sup>129</sup> The anti-avoidance provisions of the Income Tax Act have been brought to the fore by the Treasury in the Budget Speech of 2013 and the recommendations of the Davis Tax Committee.<sup>130</sup> The recommendations that have been tabled will assist SARS as it attempts to negate the need for such actions by the Commissioner as per the anti-avoidance provisions of the Act. These recommendations form the basis of the discussion and will be analysed in detail in the following chapter with reference to the applicable legislation as discussed in the preceding chapters.

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<sup>125</sup> Section 80A(b)

<sup>126</sup> Section 80A(c)

<sup>127</sup> Section 7 (5) and (6) of the Income Tax Act of 1962.

<sup>128</sup> No. 28 of 2011.

<sup>129</sup> See generally Part A, B and C of the Act.

<sup>130</sup> See Chapter 11 below.

## CHAPTER 11

### THE CURRENT PROPOSALS

#### 11.1 THE 2013 BUDGET SPEECH

During the 2013 Budget Speech, the Minister of Finance, Pravin Gordhan stated that the fiscus would be looking into the possibility of attempting to curb the tax avoidance opportunities afforded by a trust. The proposals have formed the basis of this discussion and are an example on the continued attack on a trust as an effective tool in tax avoidance. The mere mention of trusts in the Budget Speech is an example of the continued scrutiny that has fallen upon this popular entity. Once an opportunity for English citizens to protect their property when called upon to enlist with the army, a trust is now recognised as a popular method of ownership and this popularity has led to the fiscus rethinking their principles of taxation. The subsequent Budget Review contained the following with regards to these comments:

##### Reforming the taxation of trusts<sup>131</sup>

To curtail tax avoidance associated with trusts, government is proposing several legislative measures during 2013/14. Certain aspects of local and offshore trusts have long been a problem for global tax enforcement due to their flexibility and flow-through nature. Also of concern is the use of trusts to avoid estate duty, which will be reviewed. The proposals will not apply to trusts established to attend to the legitimate needs of minor children and people with disabilities. The proposals are as follows:

- Discretionary trusts should no longer act as flow-through vehicles. Taxable income and loss (including capital gains and losses) should be fully calculated at trust level with distributions acting as deductible payments to the extent of current taxable income. Beneficiaries will be eligible to receive tax-free distributions, except where they give rise to deductible payments (which will be included as ordinary revenue).
- Trading trusts will similarly be taxable at the entity level, with distributions acting as deductible payments to the extent of current taxable income. Trusts will be viewed as trading trusts if they either conduct a trade or if beneficial ownership interests in these trusts are freely transferable.
- Distributions from offshore foundations will be treated as ordinary revenue. This amendment targets schemes designed to shield income from global taxation.

Firstly the above passage makes it clear that any measures adopted will not affect or apply to the use of Special Trusts.<sup>132</sup>

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<sup>131</sup> The 2013 Budget Review 54.

The opening paragraph states that the fiscus is particularly concerned with the following:

- The flow through or conduit pipe principle
- The use of Offshore Trusts for tax avoidance
- The use of Trusts to avoid estate duty

It is common practice for people to transfer assets that do not have the opportunity to vastly increase in value to avoid estate duty. Such practice is done within the limitations of the prescribed legislation and any amendment would result in far reaching implications. Although it is an impossible task to guess what amendments may be proposed, any such amendments would have to be effected to both the Income Tax Act and Estate Duty Act.<sup>133</sup>

A person's freedom to dispose and deal with their property as per their own intentions may also be infringed.

With regards to Offshore Trusts, there seems to be a concentration by the treasury on offshore foundations. Our government will require those that receive distributions from these foundations to be taxed at the highest applicable rate.

Perhaps the greatest proposed amendment to the current taxation of Trusts is that the government intended to attack the conduit pipe principle.<sup>134</sup> In terms of discussions held between the private sector and those representing the National Treasury, it was found that the Treasurer was contemplating taking action against the powers given to Trustees in Discretionary Trusts and the manner in which distributions are made to beneficiaries.<sup>135</sup> The fiscus is attempting to tax all income that passes through the trust at the hands of the Trust at its applicable rate which currently stands at 41%. The distributions made to beneficiaries will be deductions and their income will thereafter be taxed. This does not seem like a major deviation from current practice as it is common accepted to tax beneficiaries on their distributions but the proposals will be totally against the conduit pipe principle as they do not recognise that the income will subsequently retain its identity. The Treasurer has been contemplating taking action against the powers given to Trustees in Discretionary Trusts and the manner in which distributions are made to beneficiaries in an attempt to prohibit trustees distributing an amount of income which will specifically fall under the taxable threshold.

It is common practice for people to allocate the entire income to a specific beneficiary or beneficiaries.<sup>136</sup> The Donor sells/loans to the Trust income or assets usually in the form of an interest free loan. The trustees

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<sup>132</sup> See Note 3 above. This is in accordance with the generally accepted principle that a Special Trust is created for those in need of special attention.

<sup>133</sup> Act 45 of 1955

<sup>134</sup> See chapter 8 above.

<sup>135</sup> <http://sentineltrust.co.za/Advisory/report-back-received-from-step-cape-town>

<sup>136</sup> DM Davis *ESTATE PLANNING* 14.1, 14.2.

thereafter have discretionary rights in distributing the income and capital of the Trust and in the process lower the eventual value of the estate of the Donor. This income is thereafter held in the account of the Trust and not paid over to the beneficiaries. The proposed amendments will affect how these schemes are adopted in practice. This is the sole reason for the proposed amendments as such proposals bring forth the taxation of undistributed income/capital gains into the taxable income of the Trust. The amount has to have been received or accrued to a person for it to be taxed upon.

The cases of *Lategan*<sup>137</sup> and *People Stores*<sup>138</sup> are authorities for the argument that the person has to have an unconditional right to the monies for it to be taxed upon. In the case of *Lategan* the presiding officer made the following comments, “accrued to or in favour of any person”, merely meant “to which he has become entitled.”

In *People Stores*, Hefer AF concurs with the judgment in *Lategan* and duly dismisses the argument that an amount that will be received in the future cannot be taxed in the present although it is due and payable because such amounts may be liable for taxation in two instances, namely the date at which it is deemed to be part of the person’s income and when they actually receive such amount.<sup>139</sup>

Therefore, it has to be determined if a person has an unconditional right to a certain amount of money, if such amount of money stays in the Trust and is subject to a condition of forfeiture. In certain circumstances the Trust Deed provides for the forfeiture of the beneficiary’s rights, eg. become insolvent or cede their rights under the Trust.

Some authors believe the problems of a discretionary Trust can easily be eliminated by more practical procedures.<sup>140</sup> These could include the lodgement of the Trust deed along with the income tax return. This could easily clear up any problems associated with resolute conditions or any further stipulations that effect the taxation of a Trust.

It is clear from the proposed amendments that the use of Trusts to lower tax liability will not be completely reduced. There are no pending proposals to prohibit the power a Trust has to distribute income to beneficiaries

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<sup>137</sup> 1926 CPD (203) 209.

<sup>138</sup> (1990) 4 ALL SA 594 AD.601(1),

<sup>139</sup> This deals with the issue of the date of vesting of a right. Income may vest in a person in a certain year but the recipient may only receive such income in a subsequent year. The year in which the person receives the income is the year in which the income accrues to the person. See generally Chapter 5 above for a discussion on the deeming provisions of section 7 of the Act.

<sup>140</sup> Taxing trusts effectively - there is no need to change the law by François van Gijsen. The author makes reference to a Protective Trust as defined in the Trust Property Control Act. The author suggests that the lodgement of the trusts tax return with the revenue service, the trustees certify that there are no resolute conditions which may affect the vesting of income to the beneficiaries. This will provide SARS with the opportunity to adequately assess the trust.

and more importantly the amounts they receive. A beneficiary can still receive income falling under the taxable threshold as confirmed by the terms of the Trust Deed.

## 11.2 THE FIRST INTERIM REPORT INTO ESTATE DUTY BY THE DAVIS TAX COMMITTEE<sup>141</sup>

The Davis Tax Committee has also added to the debate surrounding the current method of taxation of income deriving from Trusts.<sup>142</sup> Specific reference has been made to the Attribution Principle,<sup>143</sup> as confirmed by sections 7 and 25B. The Davis Tax Committee has made these proposals in reference to establishing a revised approach in Estate Duty. The proposals do not only expand on the 2013 Budget recommendations but also have greater implications.

The committee made the following recommendations in their interim report on Estate Duty:<sup>144</sup>

- The flat rate of taxation for Trusts should be maintained at its existing levels.
- The deeming provisions of section 7 and 25B insofar as they apply to Republic of South Africa resident Trust arrangements should be repealed
- The deeming provisions of section 7 and 25B insofar as they apply to non-resident Trust arrangements should be retained
- Trusts should be taxed as separate taxpayers
- The only relief to the rule should be the “special trust definition” contained in section 1 to the Income Tax Act which allows a trust to be taxed at personal income tax rates in limited special circumstances. The definition should be revisited by National Treasury so as to make provision for the inclusion of selected trusts used in Broad Based Black Economic Empowerment Structures
- No attempt should be made to implement transfer pricing adjustments in the event of financial assistance or interest-free loans being advanced to trusts.

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<sup>141</sup> Released on 13<sup>th</sup> July 2015.

<sup>142</sup> See note 1 above.

<sup>143</sup> The ability for a trustee to vest assets and the subsequent taxation on those assets on a beneficiary. Qualified by the deeming provisions of section 7 and 25B of the Income Tax Act. The committee has found that these sections have acted as a concession to high net worth individuals at page 38. The committee has also found that Estate Duty will be affected as the property is deemed to vest in the Trust and therefore reduces the value of an estate.

<sup>144</sup> The First Interim Report on Estate Duty 39.



The abovementioned proposals can be seen as far reaching as they call for the repealing of sections 7 and 25B of the Income Tax Act. The committee attempted to address the apprehension of their far reaching effects and have also asked for the proposals to be implemented in 2016 although the proposals are far from being accepted and ratified as a part of our legislation. The abolition of the deeming provisions of section 7 and section 25B which confirms the conduit pipe principle are the most vital proposals relating to the discussion.

It should be noted that notwithstanding the absence of Section 25B, the Conduit Pipe Principle was the accepted method of practice prior to Practice Note 23.<sup>145</sup> The committee has provided guidance on the new legislation that has been suggested as replacement provisions.<sup>146</sup> The committee has specifically proposed that section 7 and 25B of the Act be retained in respect of non-resident Trusts. The proposed amendments are to only affect those Trusts that are resident in the Republic.<sup>147</sup> The presumed reasoning would be such proposals are intended at reforming the Estate Duty and the general taxation in the administration of a person's estate and therefore should be limited to affect those whom are resident in the Republic. It would be common practice to distribute a deceased's assets as per the laws regulating of the country in which such assets are located. This is in line with the resident based principle.

The commission makes the recommendations of an increase in estate duty and Capital Gains Tax in order to balance the repealing of the section 7 and 25B. They have also noted that a person will still be able suspend the payment of estate duty by transferring their assets to a Testamentary Trust but ask that the subsequent distribution of assets attract a higher rate of taxation thus negating the advantages of their use.

The recommendations also ask for the taxation of a Trust as a separate taxpayer, though this is not a major deviation from the current practice.<sup>148</sup> The rate of taxation for a Trust is currently 41% and is therefore much higher than the sliding scale utilised when determining a natural person's taxable liability. The commission focused on Estate Duty in their report and Trusts were scrutinized due to their ability to become income splitting devices. In terms of the recommendations, assets will still be able to be transferred to Trusts but will lose their viability as any sale will result in the income realised to be taxed at the rate of 41%. Currently any income arising from the sale of a Trust asset will be retained by the Trust and distributed to a specific or

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<sup>145</sup>See generally The Standard trust Income Tax Guide of 1988 – 1989 .The principles of this rule are identical to those of the Conduit Pipe Principle. The Conduit Pipe Principle was therefore the standard form of practise when dealing with income distributed to beneficiaries prior to Practice Note 23.

<sup>146</sup> The Interim Report on Estate Duty by The Davis Tax Committee 41.

<sup>147</sup> These apply to Trusts that are registered in South Africa. All income which accrues to these trusts are taxed in accordance with the legislation governing income tax in South Africa.

<sup>148</sup> See generally the discussion on Practice Note 23 in Chapter 7 above.

determinable beneficiary. This is subject to the terms of the trust deed. The beneficiary will thereafter be taxed on the income received, in accordance with the provisions of the Act. The abovementioned proposals seek to increase this rate of taxation upon receipt and distribution of income from the Trust. It has to be noted that the Interim Report has only provided us with recommendations that are open to comment and there is still wait to determine if these far reaching recommendations will be adopted by the fiscus.

The Report also made note of Offshore Trusts and recommended that the current legislation be amended to provide for criminal sanctions for those whom fail to disclose their interest in these entities. Offshore Trusts and the income derived from them are currently taxed in accordance with sections 7 and 25B. The recommendations were to be confirmed in the 2015 Budget Speech but this failed to materialise as the report was only released in July 2015. Although the application of these recommendations may be within the mandate of the Davis Tax Commission, it still needs to be determined if they will be incorporated into our legislation. The practical and legislative implications will have to be considered as well as public comment by mainly tax practitioners and estate planners. The removal of the conduit pipe principle would render the consensus that income distributed by Trust should retain its identity as invalid. All income distributed to a beneficiary would thereafter be taxed in accordance as a distribution from the Trust. This would essentially entail all income received by different beneficiaries being treated alike.

A common problem which may arise is that donors may take advantage of these provisions in order to defer taxation of a high value asset through a Trust. An example would be dividends earned on shares which are owned by a trust. In terms of the current legislation, such income would be still treated as rental income but should the proposals come to fruition, this income would merely be a distribution from the Trust. One has to look no further than the case of Phillip Frame Will Trust to realise the importance of section 25B.<sup>149</sup> Although recommendations have been made to curtail the abuse the repealing of section 25B and section 7 by an increase in the rate of taxation, such amendments may still be circumvented by tax practitioners. The methods of tax avoidance will be determined if the proposals are ratified and thereafter those in the tax industry will have sufficient opportunity to scrutinize and develop methods of avoidance. The Davis Tax Committee also made confirmed that taxpayers would still be able to lessen their estate duty liability but called for taxpayers to be prohibited in dissolving their Trusts.<sup>150</sup>

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<sup>149</sup> See generally Chapters 7 and 9 above

<sup>150</sup> The Interim Report on Estate Duty 44.

The rationale for opposing the dissolution of Trusts in light of their recommendations was the following:<sup>151</sup>

- The dissolution of a Trust arrangement must be achieved in terms of the provisions of the Trust Deed, irrespective of the tax implications.
- It would be inequitable to simply allow a Trust to “bank” its accumulated estate duty savings.
- It would be extremely complicated for both SARS and the taxpayer.

The basis upon which the committee has made the abovementioned comments can only be applied to taxpayers whom have formed Trusts without the sole intention of decreasing their estate duty liability but for the protection of their assets. The committee wants to allow the Trust to be deregistered if only permissible in terms of the Trust Deed. In most circumstances, the donors would find it difficult to use a clause in the trust deed to dissolve the Trust as they would be attempting to circumvent the implemented proposals. The committee is taking a rigid approach in dealing with those whom utilise a Trust solely for the purposes of tax avoidance through their recommendations.

The 2016 Budget speech has echoed those of previous years as the Minister of Finance has again specifically referred to Trusts and the need to reform their taxation.<sup>152</sup>

The 2016 budget reiterated the need to revisit the principles of taxation relating to Trusts and specifically made reference to Discretionary Trusts. The fiscus is seeking to limit the use of a Trust to split income and therefore lower the liability for the payment of income tax as per the tax thresholds.<sup>153</sup> If these proposals are aligned with the recommendations of the Davis Tax Committee, they could result in the abolition of the attribution principle. This in turn will result in a flat rate of 41% being levied upon all income from a Trust and not on an individual basis based upon the beneficiaries’ liability in terms of section 25B and 7 of the Income Tax Act. The Budget speech also included an increase in the inclusion rates for Capital Gains Tax as it relates to a Trust from 27.3% to 32.8%. The rates applicable to a Trust have therefore increased from 27.3% to 32.8% as effective from the 1<sup>st</sup> March 2016.<sup>154</sup> In addition to increasing the rates of capital gains for Trusts, the fiscus retained the current rate

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<sup>151</sup> See Note 150 above. The committee requests that any dissolution of a Trust only be allowed in terms of the provisions of the Trust Deed. Therefore, the committee does not want those utilising a trust for tax avoidance to simply dissolve their trusts in light of their recommendations as this would imply that the Trust was merely formed as an arrangement for tax avoidance and not for the benefit of the stipulated beneficiary/ies.

<sup>152</sup>The 2016 Budget Review 11. Under the subheading the “Measures to prevent Tax Avoidance through Trusts,” the fiscus states that their intention is to ensure that the assets transferred through a loan to a Trust are included in the estate of the founder at death, and to categorise in interest free loans to trusts as donations. Further measures to limit the use of discretionary trusts for income-splitting and other tax benefits will also be considered by the fiscus.

<sup>153</sup>See generally the 2016 Budget Tax Guide as published by SARS at [www.sars.gov.za/AllDocs/Documents/Budget/Budget 2016](http://www.sars.gov.za/AllDocs/Documents/Budget/Budget%2016)

<sup>154</sup> See generally, The 2016 Budget Review 9

of 41% on taxable income when assessing a Trust. The 2016 budget has also shown that our government has not settled on any specific amendments that have been proposed and is still considering the drastic changes as proposed by the Davis Tax Committee. Further proposals such as including assets transferred through a loan to a Trust to be included in the estate of the founder at death and treating interest free loans to Trusts as donations will in essence tighten the grip by our fiscus on Trust income.

This discussion has been compiled until the end of March 2016 and has not taken into consideration any changes to our law of taxation which may have occurred thereafter.

## CHAPTER 12

### CONCLUSION

It is clear from the abovementioned discussion that legislation has been continuously enacted and amended to diminish the value of a Trust in general tax avoidance. The provisions of the Income Tax Act as interpreted in conjunction with our case law has gradually led to a stricter approach in determining the taxable income which is retained or distributed by a Trust. Challenges in our courts by taxpayers or the revenue service have on occasion led to an amendment of the acts or a ruling by Sars as was shown by the release of Practice Note 23. Our government has annually reiterated their intention to adopt a stricter approach for the taxation of Trust income. These comments have been echoed by the fiscus in our budget speeches. If the current proposals are brought into effect, the taxable burden on income derived from a Trust would be drastically changed. This may seem no different in theory but the current proposals are much more radical than those that are currently practised. The current system of taxation as applicable to a Trust has been brought about after many years of consideration including case law that have adjudicated on disputes that have arose from the interpretation of section 25B and section 7. The current proposals ask for these legislative measures to be repealed and thereafter replaced by provisions which are untested in our legal system. Although section 25B may specifically refer to Trusts, section 7 is the deeming provision and their deletion may result in further changes and room for avoidance in other spheres of taxation.

The Davis Tax Committee comprises of some of the primary authorities in the field of income tax and therefore their findings have to be considered with due respect.<sup>155</sup> It also has to be noted that the proposals of the Davis Tax Committee have been directed towards reforming the rules regulating estate duty and not specifically to Trusts although their proposals do specifically report on Trusts due to their use in planning a person's estate.

A Trust in its simplest form is a business enterprise either as a Trading Trust, Special Trust, Trust Inter Vivos or Mortis Causa. It can be inferred from the discussion that there is no practical method of completely avoiding the payment of tax by virtue of transferring income through a Trust.

Although the maximum inclusion rates and maximum effective rates on Capital Gains Tax have gradually increased and the general rate of income tax is higher than that of individuals, the use of a Trust has remained popular.<sup>156</sup> This is due to the unique divestment of ownership offered to the donor and protection of assets for the stipulated beneficiaries. Trusts will continue to be utilised in light of the current proposals although a ratification of the drastic steps by the fiscus may call for a rethink of its benefits. The Davis Tax Committee may have made their proposals with the current and future outlook on the economy in mind but it is my opinion

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<sup>155</sup> See Note 1 above.

<sup>156</sup> The inclusion rate has increased from 50% in 2012 to the current rate of 66.6%. The maximum effective rate has increased from 20% in 2012 to the current rate of 26.7%. The 2016 Budget Review 50.

that any amendments to our current legislation would not be feasible in our economic climate. Our current legislation is entrenched in our practice and has been challenged at every level through our courts. The proposed changes will not only add to the complexity of a convoluted system of taxation but also bring about a pessimistic outlook on the future of Trusts. This is due to the fear that those which utilise a Trust may fall victim to a higher rate of taxation. The concept of a Trust may be universally accepted but each country regulates the income deriving from a Trust within the ambit of their legislation.<sup>157</sup>

It is understandable that the fiscus would look at different methods to reform our system of taxation in order to maximise the income base which contributes to the collection of income through income tax but it is my submission that a more pragmatic approach should be adopted. Our legal system has for a long period reached a state wherein we develop our law within our own parameters. Our legislation and common law has been developed and amended through constant challenges from those attempting to evade taxation. Therefore, the fiscus should base any proposed amendments on the need for change. One does not have to adopt the principles of our international counterparts for the sake of complying with the current international methods of taxation and uniformity. The proposals should be based on the need to increase the tax base but the complications in implementing same has to be borne in mind. It is currently impossible to determine the possible alternatives one may utilise to assist in tax avoidance in the event of the proposals being adopted<sup>158</sup>. These attempts will probably play out in our tax courts as many try to find loopholes in the new provisions. It is my submission that these proposals would not be appropriate in our current economic climate and will only lead to further expenditure on behalf of the treasury due to the numerous disputes which will take place in our courts.

The South African economy is currently valued at its lowest in years and any proposals to curb tax avoidance may seem justified in an attempt to increase our cash surplus. This may also act as deterrence to high net worth

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<sup>157</sup> The Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition. The preamble states the following, “Considering that the trust, as developed in courts of equity in common law jurisdictions and adopted with some modifications in other jurisdictions, is a unique legal institution,

Desiring to establish common provisions on the law applicable to trusts and to deal with the most important issues concerning the recognition of trusts,”

The preamble confirms the universal acceptance of a Trust as an acceptable business model and the articles as contained therein sets out the general principles of a trust. The Convention is applicable to all signatory states.

<sup>158</sup> The 2013 Budget review and The Interim Report released by the Davis Tax Committee can be used as an example of the Treasury’s thoughts on reforming the model of taxation as applicable to a Trust. A Trust is currently seen as an effective method of income tax avoidance and a useful tool in estate planning. See generally, DN Erasmus Changes in the Taxation of Trusts in South Africa, <http://taxriskmanagement.comn/changes-in-taxation-of-trusts-in0south-africa>. The author believes that a change in approach by the fiscus will also lead to a change in attitude by tax planners as they attempt to circumvent any proposals.

individuals that may believe it would be more prudent to invest their cash in offshore investments rather than utilise the protection as afforded by a Trust which is registered in South Africa. This may lead to an increase in the fears of potential investors in South Africa. Although a periodic look into the reforming of our method of taxation can only be a positive in order to maintain international standards and the highest possible tax base, this proposed amendments to the taxation of Trusts may also bring about negativity which may also affect the approach of potential investors.

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Electronic Resources:

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