

COLLEGE OF LAW AND MANAGEMENT STUDIES
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**THE TAXATION OF TRUSTS IN SOUTH AFRICA WITH EMPHASIS ON THE
CAPITAL GAINS TAX AND ESTATE PLANNING IMPLICATIONS OF VARIOUS
TRANSACTIONS CONCLUDED BY A TRUST.**

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15 DECEMBER 2014

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ABSTRACT

For years trusts have been at the fore front of speculation and scandal. As an effective tool in estate planning, trusts have allowed many to structure their estates in a way which is the most beneficial for themselves and also saves on taxation. In light of the continuous use of trust in estate planning, the taxation of trust have recently come under fire as a tool used by many to avoid tax and to hide assets. In the 2013 budget speech Treasury announced a desired to tighten the reins on the taxation of trust so as to weed out abuse and misuse. One proposed way to achieve this is the doing away of the conduit principle. This has both normal tax and capital gains tax implications.

The aim of this dissertation is to investigate how trusts are taxed in South Africa, more specifically the capital gains tax implications of transactions concluded by a trust, when a trust is used as an estate planning tool. This will enable us to identify the most viable way to structure one's estate and to hold assets, from both a normal tax and capital gains tax perspective.

In conducting my research the relevant sections of the Income Tax Act 58 of 1962 will be examined. The implications of those sections on transactions concluded by a trust will also be discussed. On account of the fact that South Africa has developed its capital gains tax legislation based on the legislation used in Australia, an analysis of the recent development of the taxation of trusts in Australia will be looked. This will be done in order to identify any possible lessons South Africa may take away from these developments in Australia.

What the research has shown is that despite Treasury's push to impose stricter legislation in respect of the taxation of trusts, trusts will still have a place in estate planning. The advantages which the use of trusts offer seem to out way the consequences which come with Treasury's proposed change. As far as the lessons to be learnt from Australia. South Africa has currently followed in Australia's shoes with the implementation of the new detailed tax return for trusts. Alternatives to the doing away with estate duty and the conduit principle should also be looked at, for instance a more refined conduit principle which applies to specific tax types as Australia

has done. May be what needs to be looked at are the problems experienced by Australia and ways in which South Africa can avoid experiencing the same problems.

CONTENTS

Chapter 1 - Introduction	8
1.1 Introduction	8
1.2 Statement of Purpose	10
1.3 Rationale for the Study	10
1.4 Research Questions	12
1.5 Literature Review	14
1.6 Conceptual/Theoretical Framework	16
1.7 Research Methodology	17
1.8 Chapter Breakdown/Overview	17
Chapter 2 - Estate Planning and the Use of Trusts	19
2.1 Introduction	19
2.2 Estate Planning	19
2.2.1 Objectives	20
2.2.1.1 Flexibility	20
2.2.1.2 Provision of both capital and income with regard to the taxpayer's retirement	21
2.2.1.3 Protection of assets	21
2.2.1.4 Facilitating the administration of the estate	21
2.2.1.5 Disposal of asset	21
2.2.1.6 Liquidity	22
2.2.1.7 Minimisation of tax	22
2.3. Deductions	23
2.3.1. Section 4(q) of the Estate Duty Act No. 45 of 1955	23
2.3.2. Section 4A of the Estate Duty Act No. 45 of 1955	23
2.3.3. Section 56(1) of the Income Tax Act	23
2.3.4. Marital Regime	24
2.4. Estate Planning Vehicles and Tools	24
2.4.1. The Will	24

2.4.2. The Trust	24
2.5. Transferring Assets to a Trust	26
2.5.1. Sale	26
2.5.2. Donation	27
2.5.3. Bequests	27
2.6 Summary	28
Chapter 3 - The General Impact of Holding Asset in a Trust	30
3.1. Introduction	30
3.2. Asset Protection	30
3.3. Reduction in the Cost of Administering the Estate of the Taxpayer	31
3.4. Confidentiality	31
3.5. Flexibility	31
3.6. Continuity and Succession	32
3.7. Use of the Annual Donation Tax Exemption	32
3.8. Taxation	33
3.9. Lack of Control	33
3.10. Costs of Setting Up	34
3.11. Estate Duty	34
3.12. Summary	35
Chapter 4 - The Taxation of Trusts in South Africa	36
4.1 Introduction	36
4.2. Income Tax and Trusts	37
4.2.1 The Beneficiary	37
4.2.2 The Trust	38
4.2.3 The Donor	38
4.3 Donations Tax and Trust	39
4.4 Summary	41

Chapter 5 - Effect of Capital Gains Tax on Trusts	42
5.1. Introduction	42
5.2. Capital Gains Tax Explained Briefly	42
5.3. Capital Gains Tax and Trusts	44
5.4. Provisions in the Eighth Schedule which Affect a Trust	44
5.4.1 Paragraph 1- Definition of Disposal	44
5.4.2 Paragraph 11– Disposals	45
5.4.3 Paragraph 12– Deemed disposals	46
5.4.4 Paragraph 68– Attribution of Capital Gain to Spouse	46
5.4.5 Paragraph 69 – Attribution of Capital Gain to Parent of Minor Child	46
5.4.6 Paragraph 70 – Attribution of Capital Gain Subject to Conditional Vesting	47
5.4.7 Paragraph 71 – Attribution of Capital Gain Subject to Revocable Vesting	47
5.4.8 Paragraph 72– Attribution of Capital Gain Vesting in Non-Resident	47
5.4.9 Paragraph 80– Capital Attributed to Beneficiaries	48
5.5. Vesting vs Contingent in the Context of the Eight Schedule	49
5.6. Impact of Capital Gains Tax When Using a Trust in Estate Planning	50
5.6.1 The Trust Sells Assets	51
5.6.2 The Trust Distributes Assets to a Beneficiary	51
5.6.3 Spouses	51
5.6.4 Minor Child	51
5.6.5 Third Party Donations	52
5.6.6 Conditional Vesting	52
5.6.7 Revocation Clause in Deed of Donation	52
5.7. The Conduit Pipe Principle and its Future in South African Law	52
5.7.1 What is the Conduit Pipe Principle	52
5.7.2 The Future of the Conduit Pipe Principle in South Africa	54
5.8. Capital Gains Tax and Estate Duty	57
5.9. Summary	60

Chapter 6 - The Australian Model	62
6.1 Introduction	62
6.2 Capital Gains Tax and Trusts	62
6.3 The Law Before the Change	64
6.4 Changes in the Law	66
Chapter 7 - The Possible Future Direction for South Africa	70
Chapter 8 – Conclusion	74
Bibliography	78

CHAPTER 1

INTRODUCTION

1.1 Introduction

Trusts have for some time been an increasingly favoured vehicle through which people indirectly own assets as effective estate planning and in certain cases, for the protection of assets from creditors. There are two types of trusts that one can have, an inter vivos trust and a testamentary trust.¹

A testamentary trust is created by the provisions contained in a person's will.² This trust, in essence, inherits from the deceased's estate in terms of the will, in this case, the will itself will be the trust document (trust deed).

Inter vivos trusts are trusts that are created while the founder is alive.³ Although these trusts can be created verbally or by court order, they are generally created in terms of an agreement called a trust deed. There are a number of categories of inter vivos trusts, for example, the trust may be a family trust or a charitable trust, to name a few. There are a number of ways in which a trust can acquire assets. Assets may be donated to the trust or sold to the trust; a sum of money may be donated to a trust or loaned to the trust to enable the trust to purchase the required assets. Assets may also be bequeathed to an existing inter vivos trust in terms of a will.⁴ Each of these options will trigger different tax liabilities, such as donations tax or capital gains tax, for the parties involved.

¹ RP Pace & WN Van Der Westhuizen *Wills and Trusts, Division B: Trusts*, Service Issue 17, Last Updated October 2013, available at <http://www.mylexisnexis.co.za/Index.aspx?linkid=RG12IEIkMzM1MzkkNyRMaWJyYXJ5JEpEJExpYnJhcnk>, accessed on 14 February 2014, B3.

² Ibid.

³ P Haupt *Notes on Income Tax* 33rd ed (2014) 804.

⁴ AP De Koker & RC Williams *Silke on South African Income Tax*, ch 12, last update on May 2014, available at <http://www.mylexisnexis.co.za/Index.aspx?linkid=Q2ggMTIkNjQ1NSQ3JExpYnJhcnkkSkQkTGlicmFyeQ>, accessed on 10 April 2014.

For normal tax purposes, a trust is seen as a legal entity capable of owning assets and earning income, and is therefore a taxpayer.⁵ A trust is taxed at a rate of 40% of its income and at an inclusion rate of 66.6% of any capital gain it makes on the disposal of an asset, whereas individuals are taxed at the marginal rates of between 18% – 40%, depending on their income earnings and at an inclusion rate of 33, 33% of any capital gain they make on the disposal of an asset.⁶ There are certain deductions against the taxable capital gains e.g. individuals and special trusts are entitled to an exclusion of R30 000 a year of the total gain which they have made on the disposal of assets and natural persons are entitled to an annual exclusion of R300 000 in the year of their death.⁷ The deduction does not apply to any other trusts except a special trust.

One of the key factors which will indicate whether capital gains tax is applicable will be whether the transaction involving the particular asset in question is considered to be a disposal or deemed disposal of that asset in terms of the eighth schedule of Income Tax Act 58 of 1962 (the Act).⁸ Paragraph 11 of the eighth schedule of the Act⁹ sets out the transactions which will be considered a disposal. Paragraph 12 of the eighth schedule of the Act¹⁰ then goes on to deal with deemed disposals. With regard to a trust, a vesting of an asset or an interest in an asset in a beneficiary is considered to be a disposal of that asset/interest and will trigger capital gains tax.¹¹

Over the years trusts have become the port of choice in estate planning as a tool to decrease the impact which capital gains tax, as well as the other taxes, have on the value of an estate. They have been used to ensure that the beneficiaries and the taxpayer himself obtain the most benefit from assets as is possible. It is for this reason that this dissertation will investigate the capital gains tax implications of trust transactions, in order to determine the best way to structure one's estate, it being clear that each case must be dealt with on a subjective basis.

⁵ Haupt (note 3 above) 803.

⁶ De Koker & Williams(note 4 above) ch 24.

⁷ Nexia Levitt Kirson, *Tax Guide 2014/2015*.

⁸ Haupt (note 3 above) 678.

⁹ 58 of 1962 as amended.

¹⁰ Ibid.

¹¹ De Koker & Williams(note 4 above) ch 24.

1.2 Statement of Purpose

The purpose of this dissertation is to investigate how a trust is taxed in South Africa, specifically the underlying capital gains tax implications of trust transactions when a trust is used in estate planning and how the trust is used in estate planning as a tool to mitigate the effect of relevant tax legislation.

1.3 Rationale for the Study

There are certain transactions which affect the taxation of a trust. My aim is to look at the way in which a trust is taxed in South Africa, more specifically from a capital gains tax viewpoint. I will attempt to analyse how capital gains tax applies to trusts and the impact which the use of a trust has in mitigating capital gains tax when a trust is used in estate planning.

With a trust, taking into account the relevant sections of the Act, income may be taxed in either the donor/founder's hands, the beneficiaries' hands or in the trust itself.¹² The need to understand how a trust will be taxed is of crucial importance, as it enables individuals to determine the best financial structure to follow for estate planning purposes. This is not only because of the potential income tax and capital gains tax implications for both the trust and the individuals concerned, but also because individuals and trusts incur tax, specifically capital gains tax, on different scales.

My dissertation will investigate the most financially viable way to hold one's assets, in respect of capital gains tax, by weighing the pros and cons of using a trust against those of holding assets personally. For instance, the conduit pipe principle allows any trust income generated by an asset held in the trust to simply flow through the trust to the beneficiaries, while retaining its character as income and hence taxable at a lower rate in the beneficiaries' hands.¹³ On the other hand selling this asset out of the trust would incur a higher capital gains tax than if the particular asset

¹² Ibid.

¹³ Pace(note 1 above)B21.2.1.

was held by an individual. All of these are important considerations which need to be taken into account when determining the best way to structure one's estate.

According to the South African Revenue Service (SARS), there are a number of very wealthy individuals who use trusts as a tool to mitigate the effects of taxation, specifically capital gains tax.¹⁴ SARS has announced that it will review its taxation policy in respect of trusts and increase its tax base, with particular focus on these very wealthy individuals. As part of this review, SARS has indicated the possibility of doing away with the conduit pipe principle, mentioned above. This will have drastic tax implications for trusts as a whole.¹⁵ This dissertation will investigate the role which the conduit pipe principle plays in mitigating taxation and the possible effects which may result should the conduit pipe principle be done away with.

In conducting my investigations with regard to the above, I will also be looking at the taxation of trusts from an Australian perspective. The reason for my analysis of the taxation of trusts in Australia is that when South Africa adopted its capital gains tax regime, the legislation that was implemented at the time used the same components of a 'disposal' and an 'asset' as the Australian legislation did.¹⁶

Through the years, after having experienced a number of problems with the legislation, Australia has amended its legislation and the approach it takes to the taxation of trusts. The most recent of these amendments took place in 2011.¹⁷ In that year, and since then, Australia has undergone drastic changes to its approach to the taxation of trust, by implementing amendments to the Tax Law Amendments (2011 Measures No.5) Act 2011. These amendments have the effect of streaming any capital gains from the trust straight through to the beneficiaries.¹⁸ This, in essence,

¹⁴ J Van der Walt "Reforming the taxation of trusts: a long time coming" (01 March 2013), *South African Institute of Tax Professionals (SAIT)*, available at <http://www.thesait.org.za/news/118202/Reforming-the-taxation-of-trusts-a-long-time-coming.htm>, accessed on 23 October 2014.

¹⁵ CM Holdstock "Trusts – Is the Conduit Principle In Peril?" (31 May 2013), *South African Institute of Tax Professionals (SAIT)*, available at <http://www.thesait.org.za/news/127167/Trusts---Is-the-Conduit-Principle-In-Peril-.htm>, accessed on 17 February 2014.

¹⁶ J Cassidy "Capital Gains Tax in South Africa: Lessons from Australia?" (2004) 16 SA Merc LJ 164,195.

¹⁷ Ibid.

¹⁸ "Guide to Capital Gains Tax" 2012-2013, available at <https://www.ato.gov.au/Individuals/Tax-return/2013/In-detail/Publications/Guide-to-capital-gains-tax-2012-13/?page=34>, accessed on 7 May 2014.

makes a capital gain which a beneficiary is entitled to from a trust taxable in the beneficiary's hands.¹⁹

One of the aspects of estate planning in Australia which I will be looking at, is the fact that Australia has no estate duty or death duties.²⁰ I will investigate the effect this has on the use of trusts as an estate planning tool and the possible outcomes South Africa may experience or encounter should we do away with estate duty, as proposed by the South African Institute of Chartered Accountants (SAICA).²¹ SAICA proposes to abolish estate duty due to the possible double tax implications, and the fact that South Africa is the only country which taxes the estate of an individual and the capital gain of an asset on the death of that individual.²²

Accordingly I will also investigate and analyse the amendments to the legislation and the approach used by Australia to see if South Africa's current approach to the use of trusts in estate planning, with regard to the taxation of trust, specifically capital gains tax, might be improved on or changed in any way (if any change is possible or practical) by implementing parts of the Australian model.

1.4 Research Questions

1) How is a trust taxed in South Africa?

In answering this question, I will be discussing the effect of taxation on trusts in South Africa with an introductory discussion on the different types of taxes which apply to a trust. My specific focus will however be on capital gains tax and the impact capital gains tax has on estate planning when a trust is used. To aid in a better and more complete

¹⁹ "Trusts : Technical Update", *Australian Government, Australian Taxation Office*, available at <https://www.ato.gov.au/General/Trusts/In-detail/Trust-tax-time-toolkit/Technical-update/?amp;page=14>, accessed on 27 October 2014.

²⁰ "Managing the tax affairs of someone who has died", available at [http://www.mcaaccountants.com.au/files/docs/managing%20the%20tax%20affairs%20of%20deceased%20\(ato\).pdf](http://www.mcaaccountants.com.au/files/docs/managing%20the%20tax%20affairs%20of%20deceased%20(ato).pdf), accessed on 20 May 2014.

²¹ M Hassan "SAICA submission proposals to National Treasury on abolishment of Estate Duty," 14 December 2011, reference 377562, received on 20 May 2014.

²² Ibid.

understanding of my topic, I will be discussing how capital gains tax as well as estate duty are important considerations in estate planning.

2) How are a trust's transactions affected by capital gains tax in South Africa?

This question will be answered by analysing the relevant sections in the Act which apply to trusts, in particular the eighth schedule of the Act. I will also look at the different parties involved in a trust and how each will incur capital gain tax in respect of trust Transactions.

3) How is a trust used in estate planning?

This question will be broken down into a few parts. Firstly, I will look at specific example of how a trust is used in estate planning especially to mitigate the impact of capital gains tax and the effect the use of a trust has on one's liability for estate duty. Secondly, I will look at an analysis of the advantages and disadvantages of using trusts in estate planning, specifically focusing on the conduit pipe principle.

4) Is it more viable to hold assets in a trust or individually, with regard to capital gains tax?

In answering this question, I will look at the advantages and disadvantages of holding assets individually and weigh these against the discussion above (question 3) in order to set out the most viable structure for an estate. I will also look at SARS' proposed changes to the law of taxation in respect of trusts.

5) How is a trust taxed in Australia?

Here I will look at how capital gains tax works in Australia, specifically in respect of trusts and the new changes which have been implemented in Australia with regard to the taxation of trusts. I will also include a discussion on the relevant legislation in place at the moment in Australia.

6) Are there any lessons to be learned from the Australian model?

Given the changes and the approach used by Australia towards the capital gains taxation of trusts, this section will analyse the possible improvements or additions to the current approach towards capital gains taxation and trust which South Africa can make, if any.

1.5. Literature Review

Having looked at some of the available literature on my topic I have noticed that each individual aspect of my topic has been dealt with by various authors throughout the years.

Van Der Westhuizen²³ looks at the general principles which relate to the administration of trusts, as well as the taxation of trusts. He identifies four factors which play a part in determining who is liable for taxation in respect of trusts, these are ‘the nature of the transaction, the provisions of the trust deed, whether the income/gain is distributed or retained by the trusts, and the age of the beneficiary (minor or major)’.²⁴ He also goes on to discuss estate planning opportunities using trusts and mentions that trusts offer additional protection which at times outweighs any tax savings a person may receive from holding assets themselves.

This point was also discussed by Sevenster²⁵ in his article relating to capital gains tax. He sets out some of the differences between individuals and trusts with regard to capital gains tax, and notes that due to the conduit pipe principle income or gains are taxed in the beneficiaries’ hands at the lower marginal rate of between 18% to 40% of taxable income (including the 33.3% of the gain).

²³ Pace(note 1 above)B21.

²⁴ Ibid, B21.2.2.

²⁵ R Sevenster “CGT : trusts vs. individuals: Capital Gains Tax”, *Tax Breaks Newsletter*, Issue 337, February 2014, available at http://search.sabinet.co.za.ezproxy.ukzn.ac.za:2048/WebZ/Authorize?sessionid=0&bad=ejour/ejour_badsearch.html&portal=ejournal&style=ejour&next=images/ejour/montb/montb_n337_a5.pdf&clientid=5450, accessed on 14 February 2014.

With capital gains tax, as with income tax, a trust is seen as a taxpayer, due to this, states Stein²⁶ there may be times in which the trust itself will be liable for the capital gains tax, instead of either the donor or the beneficiaries of the trust. He explains that a trust makes a gain when any asset or interest has vested in a beneficiary, this for capital gains tax purposes, will be a disposal of that asset or interest. Such a vesting could have occurred because of the trust deed or because of the trustees exercising their discretion. This discretion could have been afforded to the trustees through the wording of the deed itself and once exercised, by vesting a right to the gain in a beneficiary. This will make that gain taxable in that beneficiary's hands. With the thinking expressed by Stein, we see the factors mentioned by Van Der Westhuizen coming into play.

As mentioned by Sevenster, the conduit pipe principle allows income to retain its nature as income in the beneficiaries' hands. Holdstock²⁷ discusses the possibility of this principle being done away with due to it being used to split income of a trust. The effect of doing away with the conduit principle, as discussed by Du Preez,²⁸ is that a discretionary trust, for example, will become very tax inefficient. SARS has proposed that a trust's taxable income, including any capital gains or capital losses made by the trust, will be calculated in the trust itself before distribution and hence taxed in the trust at a higher rate.²⁹

The role of an inter vivos trust in estate planning was discussed in an article by Thulani Mhlongo.³⁰ He looked at whether a trust is still an effective estate planning tool given the capital gains tax implications of trusts. He discusses the fact that holding assets in a trust will result in an estate duty saving, in that the asset will not form part of the deceased's estate, but each estate

²⁶ M Stein "Capital Gains Tax", ch 10, Service Issue 30, last updated: May 2014, available at <http://www.mylexisnexis.co.za/Index.aspx?linkid=Q2ggMTAkMjU3NiQ3JExpYnJhcnkkSkQkTGlicmFyeQ>, accessed on 14 February 2014.

²⁷ Holdstock (note 15 above).

²⁸ L Du Preez "Plan to tax capital gains as income will kill discretionary trusts." (03 March 2013), available at <http://www.iol.co.za/business/personal-finance/tax/plan-to-tax-capital-gains-as-income-will-kill-discretionary-trusts-1.1479432>, accessed on 17 February 2014.

²⁹ National Treasury, *Budget Review 2013*, 27 February 2013 at 54, available at <http://www.treasury.gov.za/documents/national%2520budget/2013/review/FullReview.pdf>, accessed on 10 November 2014.

³⁰ T Mhlongo "Is there life for the intervivos trust as an estate planning tool after the advent of capital gains tax." (December 2001), *Insurance And Tax Journal*, available at <http://www.mylexisnexis.co.za/Index.aspx?linkid=RGVjZW1iZXIzMjU3NiQ3JExpYnJhcnkkSkQkTGlicmFyeQ>, accessed on 18 February 2014.

needs to be dealt with on its own merits as this benefit may not be available to everybody.³¹ He reaches the conclusion that even with the higher tax rates an inter vivos trust has a prominent place in estate planning.³² The use of trusts in estate planning as a way to avoid capital gains tax was touched on in a SAICA article by PricewaterhouseCoopers.³³ The article looks at a decision by the Tax Court³⁴ which dealt with the bequest by a testator to a trust which was the equivalent to the debt owed to him by the trust on loan account. The court held that this amounts to a disposal for capital gains tax purposes as it is a waiver of a debt, and hence the trust will be liable for capital gains tax on the amount of the extinguished debt. This judgement had an impact on the use of trust to structure estates in a more capital effective way, as the effect would be a shift from a bequest which would not attract capital gains to a situation which results in the creation of liability for capital gains tax.³⁵

Although the subjects of the taxation of trusts, estate planning and capital gains tax have been covered previously, my dissertation will attempt to analyse and collate the existing literature on the individual components of my topic. Taking all the different aspects which have been covered by the different authors, I hope to compile a single document. This document will include an analysis of the Australian approach, and the existing South African approach, in order to determine if South Africa can improve, in any way, on its approach towards the capital gains taxation of a trust when the trust is used in estate planning. And the possible effect which doing away with estate duty in South Africa will have on the use of trusts as estate planning tools.

1.6. Conceptual / Theoretical Framework

The theoretical framework which will underline my dissertation is that of legal positivism. My dissertation will be based on the legislation and the authoritative judgments which have been handed down by the courts through the years, together with the general implementation of capital

³¹ Ibid 4.2.2.

³² Ibid .

³³ PricewaterhouseCoopers, “Capital Gains Tax 1318, “ Safe –as –houses” way of avoiding CGT struck down”, August 2005, Issue 72, available at http://www.saica.co.za/integritax/2005/1318_Safe_as_houses_way_of_avoiding_CGT_struck_down.htm, accessed on 18 March 2014.

³⁴ ABC Trust v CSARS, ITC 1793.

³⁵ PricewaterhouseCoopers (note 33 above).

gains tax by SARS and an analysis of the applicable literature. My research is descriptive and will set out to explain the law and its implications, and as such, my research will be based on the rule of law as it stands, legislation, customs and the decisions handed down by the courts, dealing with the facts at hand, and applying these to my topic.

1.7. Research Methodology

My sources of data and the material which will be used, will be compiled from desktop research. I will make use of the relevant statutes, case law and articles which have been written about each aspect of my topic.

1.8. Chapter Breakdown/ Overview

Part I

Chapter 2 -The Use of Trusts in Estate Planning

This chapter will discuss estate planning, with a specific emphasis on how one uses a trust in estate planning.

Chapter 3 – The Impact of Holding Assets in a Trust.

This chapter will discuss the advantages and disadvantages of holding assets individually or in a trust. It will include a discussion on the estate duty implications of holding assets individually or in trusts.

Part II

Chapter 4 - The Taxation of Trusts in South Africa

This chapter will contain a general discussion on how trusts are taxed in South Africa, primarily income tax and donations tax.

Chapter 5 - Effect of Capital Gains Tax on Trusts

This chapter will form the emphasis of the dissertation and will analyse the effect that capital gains tax has when one uses a trust as an estate planning tool. It will discuss the impact of the conduit pipe principle on the taxation of a trust, South Africa's proposed changes to the taxation of trusts, and SAICA's proposal to abolish estate duty and the effect it may have on estate planning and the use of trusts in estate planning.

Part III

Chapter 6 - The Australian Model

This chapter will discuss the taxation of trusts in Australia, specifically capital gains tax, and recent changes to the Legislation.

Part V

Chapter 7 – Possible Future Direction for South Africa

This chapter will discuss the manner in which South Africa may be able to improve its approach towards the capital gains taxation of trusts.

Part IV

Chapter 8 - Conclusion

This chapter will summarise the areas focused on in the dissertation, in respect of the capital gains tax implications of using a trust in estate planning and the possible way forward for South Africa in this area of taxation.

CHAPTER 2
ESTATE PLANNING AND THE USE OF TRUSTS

2.1 Introduction

Although the emphasis of this mini-dissertation is the effect of capital gains tax on trusts, it is relevant to briefly discuss the use of trusts in estate planning as this will afford a general overview on trusts as an important tool in structuring one's estate and assets in a tax effective manner.

Estate planning using trusts involves a number of aspects which have to be considered, in order to determine the most effective structure of an estate for a specific taxpayer.

This chapter will deal with:

- Estate planning and the objectives of an effective estate plan;
- The deductions available to a taxpayer under the relevant legislation, which should be kept in mind when structuring an estate plan;
- The use of a trust as an estate planning tool; and
- The way in which one can transfer assets into a trust and the tax consequences of the various options available.

Each of the abovementioned aspects will be discussed in turn below.

The objective of this chapter is to highlight the aspects which require serious consideration and application to a taxpayer's situation, when deciding on a structure for his estate which will be the most efficient for him and those he wishes to benefit from his estate, in a manner which is also the most tax effective.

2.2. Estate Planning

A definition of estate planning is:

the arrangement, management and securement and disposition of a person's estate so that he, his family and other beneficiaries may enjoy and continue to enjoy the maximum from his estate and his assets during his lifetime and after his death, no matter when death may occur.³⁶

In essence, estate planning is the planning of one's estate in such a way that a taxpayer obtains the most benefit from his assets during his lifetime, and at the same time providing for the security of his dependants after his death.³⁷ It is done to ensure the efficient administration and growth of the estate. This planning has as an underlying principle that any structuring of a taxpayer's estate will be done in the most tax efficient manner.

It should be noted that every estate plan, and its resultant tax efficiency, will be different as the plan itself will depend on the individual's circumstances and needs. The plan and structure needs to be flexible and also takes into account the taxpayer's personal wishes on how he would like his assets to be dealt with.

2.2.1 Objectives

Some of the objectives of an effective estate plan are as follows:³⁸

2.2.1.1 Flexibility³⁹

Flexibility, with regard to estate planning, means the ability of the estate plan to adapt to changing circumstances and changing legislation.⁴⁰ Due to the fact that estate planning is done during the lifetime of the taxpayer, it is not possible to anticipate each and every event which may occur during one's life and after death. The estate plan must be able to be changed with

³⁶ DM Davis...et al *Estate Planning*, Section A, last updated on March 2014, available at <http://www.mylexisnexis.co.za/Index.aspx?linkid=Q2ggMSQxMjg1NSQ3JExpYnJhcnkkSkQkTGlicmFyeQ>, accessed on 08 August 2014, 1.1.

³⁷ R De Swardt "Estate Planning" in Stiglingh M ... et al (ed) *Silke on South African Income Tax*, LexisNexis(2014), 1025.

³⁸ Davis(note 36 above)1.2.

³⁹ Ibid,1.2.1.

⁴⁰ Ibid.

minimum impact and effect on the assets, the value of the estate and equally importantly the tax liability of the estate and taxpayer.

2.2.1.2. Provision of both capital and income with regard to the taxpayer's retirement⁴¹

This entails providing for sufficient funds to enable the taxpayer to live comfortably after he has retired. The object is to ensure the estate plan is such that the taxpayer is financially stable and independent once he has ceased to work.

2.2.1.3. Protection of assets⁴²

For an estate plan to be effective it should provide for the protection of all assets. This means that the assets should be preserved and protected from the likes of inflation, being attached by creditors. The protection of the assets should be done with a minimum impact on tax. Such protection should not only apply during the lifetime of the taxpayer but should also continue after his death, when the assets have been transferred to his heirs or spouse or to a trust created for their benefit.

2.2.1.4. Facilitating the administration of the estate⁴³

An estate plan must be one that is structured in such a way that makes the administration of the estate after the death of the taxpayer easy. It should be sufficiently complex to meet the needs of the taxpayer and still be simple enough to deal with in the winding up of his estate.

2.2.1.5. Disposal of assets⁴⁴

The disposal of assets in an estate plan can be catered for by using a will or trust. This will ensure that the assets will be transferred or disposed of as per the taxpayer's wishes, and again in the most tax efficient manner with regard to estate duty and capital gains tax.

⁴¹ Ibid 1.2.7.

⁴² Ibid 1.2.9.

⁴³ Ibid, 1.2.10.

⁴⁴ Ibid 1.2.9.

2.2.1.6. Liquidity⁴⁵

This objective entails an estate plan which provides for the needs of the taxpayer during his life. It also entails a plan under which after the death of the taxpayer, the estate itself has sufficient liquid capital with which to pay all the liabilities that may arise.⁴⁶ Such liabilities include estate duty and capital gains tax, which also comes into play upon death.

2.2.1.7. Minimisation of tax⁴⁷

Estate planning should not be purely driven by the need to reduce the impact of tax on one's estate. Whilst an estate should be structured in such a way that it ensures the protection of the entire estate and provides for liquidity before and after death, part of the exercise involves a person's tax choices and decisions with regard to how best to minimise the liability for tax during his lifetime and after his death.

If possible, the taxpayer's estate can and should be arranged in such a way that both the protection of the assets which make up the estate and, at the same time, the minimisation of tax liability are achieved. One needs to ensure that tax liability is not just simply rolled over to the heirs or spouse. When this occurs all that the estate plan has done is shifted liability from the estate planner to the heirs. Tax will still be payable but at a different time and by a different taxpayer. This defeats the purpose of an estate plan.

From a tax point of view, with regard to estate planning, one of the main considerations is the minimisation of estate duty. This can be done by planning one's estate in such a way so as to make the best of all the deductions and allowances which are available. This will also allow a taxpayer to also get the maximum benefit from his estate during his lifetime.⁴⁸

⁴⁵ Ibid, 1.2.5.

⁴⁶ Ibid.

⁴⁷ Ibid, 1.2.3 -1.2.4.

⁴⁸ Ibid.

2.3 Deductions

It is my view that the following deductions and allowances should be considered as part of an estate plan structure:

2.3.1. Section 4(q) of the Estate Duty Act No. 45 of 1955

Section 4(q) of the Estate Duty Act No 45 of 1955 (Estate Duty Act) provides for a deduction from the gross value of the estate, the total value of property which has accrued to a surviving spouse from the deceased's estate. This means that anything which has been bequeathed to a taxpayer's surviving spouse will fall under the provisions of section 4(q) and will not form part of the estate duty calculation when his estate is being wound up. It must be noted however that the deduction does not eliminate the estate duty but defers it, and there is a potential for the increase in the value of the surviving spouse's estate which will result in the estate duty liability simply being rolled over until the surviving spouse's death.

2.3.2. Section 4A of the Estate Duty Act

Section 4A of the Estate Duty Act establishes the primary rebate/abatement. This is a deduction which is allowed for every deceased person, from the net value of his estate. The rebate is currently at R3 500 000. If the taxpayer does not use the entire rebate the unused portion of the rebate will be rolled over as an additional deduction in the estate of his spouse. In essence if the taxpayer structures his estate in such a way that the dutiable value of the estate is less than R3 500 000, then there will be no estate duty payable and his/her spouse will be then be entitled to a R7 000 000 rebate when he/she dies.

2.3.3. Section 56(1) of the Act

Donations to spouses do not incur donations tax, in terms of section 56(1)(b) of the Act (discussed in Chapter 3). The said donation will also be exempt from capital gains tax. There is also an annual exemption of R100 000 which can be used. However, any donation to any other party made during the lifetime of the deceased will be subject to both donations tax and capital gains tax.

2.3.4. Marital Regime⁴⁹

One can take advantage of a taxpayer's marital regime as part of his estate plan structure. If the taxpayer is married in community of property for example, his spouse is entitled to half of his estate by virtue of the marital regime. This means that the both estates will be combined to form a joint estate. On his death half of the value of the joint estate (assets and liabilities) will belong to his spouse in terms of his marriage in community of property, which effectively decreases the value of his estate.

2.4. Estate Planning Vehicles and Tools

2.4.1 The Will⁵⁰

In order to minimise the impact that the different types of taxes have on a taxpayer's estate, it is essential that the taxpayer executes a valid will to ensure that the estate is disposed of according to the taxpayer's wishes. If the will is a valid one the provisions of the Intestate Succession Act 81 of 1987 will be bypassed, thereby ensuring that the deceased's estate is wound up in the manner in which he intended and in accordance with his general estate plan.

2.4.2. The Trust

A trust is another useful tool when it comes to estate planning. As discussed above, one of the principal aims of estate planning is to ensure that you minimise the burden which estate duty places on an estate. A way to do this would be to place assets in a trust. Placing one's assets in a trust is the most elementary form of estate planning there is. The two types of trusts commonly used as part of an estate plan structure are the inter vivos trust and the testamentary trust.

A testamentary trust is created in a person's will.⁵¹ This trust, in essence, inherits from the deceased's estate in terms of the will, and, the will and its provisions will serve as the trust document (trust deed).

⁴⁹ Davis(note 36 above) Section C, 10.2.

⁵⁰ Ibid, 9.4.

⁵¹ Pace(note 1 above)B3.

Inter vivos trusts are trusts that are created during the lifetime of the taxpayer.⁵² These trusts, although they can be created verbally or by court order, are generally created in terms of an agreement called a trust deed. There are a number of categories of inter vivos trusts, for example, the trust may be a family trust or a charitable trust, to name a few. The founder (a party initiating the trust) of an inter vivos trust makes an initial nominal donation to the trust and the trust thereafter acquires assets which are controlled and managed by the trustees of the trust for the benefit of the trust's beneficiaries.⁵³

With regard to estate planning the preferred type of trust to use would be a discretionary inter vivos trust.⁵⁴ With a discretionary trust, the trustees are given the authority to distribute the capital and/or the income of the trust as and when they see fit (i.e. the discretion).⁵⁵ The beneficiaries in this case will not acquire any vested right to the income or capital, as there is no defined time when they will receive the said income or capital.⁵⁶ The occurrence of such a receipt is uncertain. The income or capital retained by the trust will in turn not form part of any beneficiaries' estate and will, as a result of this, not be subject to estate duty.⁵⁷ The concept of a vested right versus a contingent right and the tax consequences of both will be discussed further in chapter 4.

By using a trust effectively, a taxpayer can protect his assets from the claims of creditors, which is an important consideration for taxpayers who conduct risky commercial enterprises as their normal businesses.

Trusts are also considered to be separate legal person for tax purposes and are hence liable for tax. Trusts are taxed at a different rate to a natural person. Trusts are taxed on all retained income at the rate of 40%. However, the trustees can elect not to retain the income but to distribute that income to a beneficiary of the trust who is taxed at a lower rate than the trust (less than 40%), thereby effectively reducing the tax payable on that income.

⁵² Haupt(note 3 above) 891.

⁵³ Pace(note 1 above) B3.

⁵⁴ Haupt (note 3 above) 891.

⁵⁵ Ibid.

⁵⁶ Pace(note 1 above)B3.

⁵⁷ Haupt(note 3 above)891.

One of the major issues with estate planning is the treatment of growth assets. When a growth asset is retained in the taxpayer's personal estate the actual growth of that asset will become part of his estate, thereby increasing the value of his estate as the years go by until the death of the taxpayer.⁵⁸ For instance, if a house is purchased and held as part of the taxpayer's personal estate, the amount by which the value of the house appreciates over time, until his death, will become part of the value of the estate on his death. Estate duty will then be levied on the value of the house at the date of his death, which will be this appreciated value of the house.⁵⁹

One of the ways in which a taxpayer can avoid the effect of growth assets held personally is by moving growth assets into a trust during the taxpayer's lifetime. By doing so the taxpayer essentially freezes the value of that growth asset in his estate at the value at which it was disposed of to the trust. Any growth in the value of the asset will therefore be captured in the trust and not form part of the taxpayer's estate.⁶⁰ As a spinoff advantage, and in addition to reducing estate duty, the costs of winding up the estate (normally based on a percentage of the gross value of the estate) will also be reduced.

2.5. Transferring Assets to a Trust

There are a number of ways in which a taxpayer can transfer assets into a trust. Each of these will be now be discussed below.

2.5.1. Sale⁶¹

An asset may be sold by the taxpayer to the trust in one of the following ways:

- 2.5.1.1 The asset may be sold to the trust and the trust will pay the purchase price for the assets.⁶² In these circumstances, if the asset is an immoveable asset the transfer will

⁵⁸ Ibid 890.

⁵⁹ Ibid.

⁶⁰ Ibid.

⁶¹ Ibid 897.

⁶² Ibid.

trigger transfer duty and capital gains tax.⁶³ If the asset is a movable asset only capital gains tax may be payable. It needs to be noted that if an asset is sold to the trust for less than market value this may constitute a donation and hence will attract donations tax.

2.5.1.2 If the trust does not possess sufficient funds with which to purchase the asset, the asset may be sold on loan account to the trust. In this instance the loan account would be an asset in the taxpayer's estate. This would incur capital gains tax and transfer duty (if the asset is immovable). The interest which has been charged on the loan will also generate a normal tax consequence in the hands of the taxpayer. The taxpayer then has the option to utilise the R100 000 exemption⁶⁴ from donations tax, by donating the said R100 000 per annum to the trust thereby decreasing his claim against the trust on loan account and effectively reducing the value of his estate by reducing his claim against the trust. Caution needs to be exercised in cases where the taxpayer waives all or part of the interest on the loan as this may be seen as a donation for donations tax purpose. Such a waiver falls with the definition of a donation.⁶⁵

2.5.2 Donation⁶⁶

The asset may be donated to the trust. The donation will attract donations tax and capital gains tax. Again if the asset is an immovable asset, transfer duty will be incurred. Caution has to be exercised when donating assets to a trust, as section 7 of the Act deems income back to the donor and hence taxable in his hands, under certain circumstances where there is an element of 'donation, settlement or other disposition'.⁶⁷ Section 7 of the Act will be discussed in more detail under chapter 4.

⁶³ Paragraph 11(1)(a) of the eighth schedule to the Income Tax Act 58 of 1962, as amended.

⁶⁴ Section 56(2)(b) of the Act.

⁶⁵ Section 55(1) of the Act.

⁶⁶ Haupt (note 3 above) 897.

⁶⁷ Section 7(2) to section 7(8) of the Act.

2.5.3 Bequests⁶⁸

Assets may be bequeathed to an existing trust in terms of a taxpayer's will. If the asset is an immovable asset, no transfer duty will be incurred as a transfer of immovable property as part of an inheritance is exempt from transfer duty. The down side of moving assets to a trust by way of a bequest in a will is that growth assets will continue increasing in value in the taxpayer's estate until death. The actual growth will form part of the value of the taxpayer's estate and hence increase the estate duty liability which will become payable on the death of the taxpayer.

2.6. Summary

The following table summarises how one could transfer assets into a trust and the type of tax triggered by each method:

	Transfer Duty	Capital Gains Tax	Donations Tax	Estate Duty
Sale – Immovable Asset	Yes	Yes	If purchased for less than market value	No
Sale- Movable Asset	No	Yes	If purchased for less than market value	No
Sale on loan account	Yes-If immovable asset	Yes	<ul style="list-style-type: none"> • If amount sold for is less than market value • If no interest is charged or less than the acceptable interest is charged, that shortfall 	No
Donation- Immovable Assets	Yes	Yes	Yes	No
Donation- Movable Assets	No	Yes	Yes	No
Bequest – Immovable Asset	No	Yes	No	No
Bequest – Movable Asset	No	Yes	No	No

⁶⁸ Haupt (note 3 above) 883.

What can be seen from the analysis above is that there are many aspects which need consideration when deciding on how to structure one's estate. The suitable structure will inevitably be dependent on the desired outcome and each structure will result in different tax consequences.

CHAPTER 3
THE GENERAL IMPACT OF HOLDING ASSETS IN A TRUST

3.1 Introduction

This chapter will overview the general advantages and disadvantages of holding assets in a trust.

These general advantages and disadvantages are:

- Asset protection;
- Reduction in the cost of administration of the estate of a taxpayer;
- Confidentiality;
- Flexibility;
- Continuity and succession;
- Use of the annual donation tax exemption;
- Taxation;
- Lack of control;
- Costs of setting up;
- Estate duty;

Each aspect will be discussed in turn below. The advantages and disadvantages which may flow from using a trust as a tool in one's estate plan will depend largely on the kind of estate the taxpayer has and the intended estate plan itself.

3.2. Asset Protection⁶⁹

Firstly, the most obvious advantage of using a trust is that a trust offers protection of the assets. By placing an asset in a trust, the asset falls outside the scope of the taxpayer's estate, and cannot

⁶⁹ Davis(note 36 above) Section C,14.3.

be attached by creditors, nor will the asset form part of the taxpayer's estate for the purpose of calculating any divorce settlement.⁷⁰

3.3. Reduction in the Cost of Administering the Estate of the Taxpayer⁷¹

Once an asset has been placed in the trust, ownership of that asset vests in the trustees, in their capacity as trustees. The value of the asset will not be taken into account for the purposes of determining the dutiable estate of the taxpayer for estate duty purposes on his death.⁷² Only that portion of the unpaid value at which the taxpayer disposed of the asset to the trust, i.e. the outstanding proceeds, will form part of the taxpayer's estate and will be dutiable. Any growth in the value of the asset after its disposal/transfer to the trust will be contained in the trust.

3.4. Confidentiality⁷³

The trust deed which creates a trust, although registered with the Master of the High Court, is a private and confidential document. It will not be subject to inspection by the public. Hence the assets held by a trust will not be public knowledge. This is unlike a liquidation and distribution account drawn up when administering a deceased estate. This account, which documents the assets and liabilities of the deceased, has to lie for inspection, open to the public for comment and/or objections, and as such is accessible by the public.

3.5. Flexibility⁷⁴

A trust offers the flexibility of being able to indirectly hold assets and still allow the taxpayer the benefit of the income those assets produce. This can be achieved by setting up a trust in which

⁷⁰ T Carroll "Using a trust as part of your retirement planning: 5 good reasons."(August 2012), available at http://www.sanlam.co.za/wps/wcm/connect/sanlam_en/sanlam/for+individuals/glacier+by+sanlam/market+information/retirement+matters./retirement+matters+-+aug+2012, accessed on 17 February 2014.

⁷¹ C Hill "Seven reasons to consider setting up a trust" (27 June 2012), *Moneyweb*, available at http://www.moneyweb.co.za/moneyweb-tax/seven-reasons-to-consider-setting-up-a-trust?sn=2009_detail, accessed on 17 February 2014.

⁷² Ibid.

⁷³ Davis (note 36 above) Section B, 5.5.

⁷⁴ Ibid Section C,14.3.

the taxpayer and/or members of his family are beneficiaries. Trustees have the discretion to award assets to the beneficiaries, in accordance with the taxpayer's wishes, and the trust deed itself may be amended to suit changes in the taxpayer's circumstances.⁷⁵

3.6. Continuity and Succession⁷⁶

A trust does not die and the trustees can continue to carry out their duties after the death of the taxpayer in accordance with the provisions of the trust deed, which will incorporate the taxpayer's requirements. In a sense the trust can also be used as a tool whereby the income generated by the assets held by the trust and any capital gain on the disposal by the trust of any of those assets can be distributed over generations to the taxpayer and his descendants.⁷⁷ The actual assets may be retained by the trust, thereby falling outside the ambit of a beneficiaries' estates until those assets are distributed to the beneficiaries at a later date. Trusts can survive generations before they are terminated and their asset distributed to beneficiaries, therefore they are ideal vehicles for the preservation of assets and growth in the value of those assets over lengthy periods of time.

3.7. Use of the Annual Donations Tax Exemption⁷⁸

A taxpayer may use this exemption to donate R100 000 annually to the trust, thereby moving assets to that value into the trust without having any donations tax implications. The R100 000 exemption may be donated by a taxpayer to the trust annually to reduce any claim on loan account which a taxpayer has against the trust arising from a disposal of assets by him to the trust, thereby reducing the value of the taxpayer's estate

⁷⁵ Ibid.

⁷⁶ Ibid,1.2.

⁷⁷ Ibid, 14.3.

⁷⁸ De Sward (note 37) 1033.

3.8. Taxation⁷⁹

Trusts offer a taxpayer a degree of flexibility with regard to taxation. It allows for income distribution to the beneficiaries, which would be taxed at a lower rate than if the income was retained by the trust. This is through the conduit pipe principle, discussed in chapter 5. In that instance the trust can avoid paying the higher rate of tax (40%) and capital gains tax (effective rate of 27%) than the individual beneficiary who could be taxed at a rate lower than 40% on income and an effective rate of 13.3% on capital gains.⁸⁰

3.9. Lack of Control⁸¹

The assets in a trust are controlled by the trustees. Once a taxpayer transfers assets to the trust he will no longer have ownership of the assets and he will also no longer have control over the management of those assets. This however is assuming that the trust is set up correctly and the trust deed does not give the taxpayer some veto power or appoints him as sole trustee.

Recently trusts have come under attack from creditors, spouses in a divorce and SARS, to expose the abuse of trusts by an individual where the affairs of the trust are conducted in such a manner that the trust clearly represents the alter ego of the taxpayer concerned.

It is crucial for the trust to retain its identity as an independent legal taxpayer. The structure of the trust requires that an independent trustee be appointed. An independent trustee is a trustee who is not related or connected to the remaining trustees, the founder or any of the beneficiaries, and is actively involved in the decision making of the trust, such that the trust is not the alter ego of the taxpayer.⁸² The independent trustee must be able to deal with trust matters at arms' length.⁸³

⁷⁹ Davis(note 36 above) Section A 1.2.

⁸⁰ Kirson (note 7above).

⁸¹ Davis(note 36 above) Section C 14.5.

⁸² Ibid.

⁸³ Ibid.

Other safeguards to ensure that the trust is not deemed to be the alter ego of the taxpayer are more in line with proper corporate governance issues, such as the keeping of a minute book recording all resolutions relating to the administration of the trust by the trustee, and proof regarding such administration to emphasise the trust's independence from the taxpayer concerned.

3.10. Costs of Setting Up⁸⁴

The cost of setting a trust up as well as administering a trust can be an expensive exercise dependent on the fee structure of the trustees and advisors.⁸⁵

3.11. Estate Duty

A trust is generally used as an estate planning tool to mitigate the impact which estate duty has on a taxpayer's estate. In South Africa estate duty is governed by the provisions contained in the Estate Duty Act.⁸⁶ Section 2(1) of the Estate Duty Act provides as follows:

‘there shall be charged, levied and collected in respect of the estate of every person who dies on or after the first day of April 1955, a duty to be known as estate duty.’

From the above we can see that it is a tax which is triggered by the death of the taxpayer. Estate duty is currently payable at a rate of 20% of what has been termed the ‘dutiable amount’ of your estate on your death.⁸⁷

The dutiable amount in this respect is calculated by taking the value of all the taxpayer's property, which forms part of his estate, as is defined in sections 3 of the Estate Duty Act, less

⁸⁴ T Cohen “Estate planning Essentials; Inter vivos Trusts – Advantages and disadvantages.” *Estate Planning Essentials, Glacier by Sanlam*, (28 October 2010) Volume 31, available at https://www.sanlam.co.za/wps/wcm/connect/sanlam_en/sanlam/newsletters/estate+planning+essentials/volume+31, accessed on 05 June 2014.

⁸⁵ Ibid.

⁸⁶ Estate Duty Act No. 45 of 1955, as amended.

⁸⁷ Section 3(2) of the Estate Duty Act No.45 of 1955.

certain allowable deductions in terms of section 4 of the Estate Duty Act. This will determine the net value of the taxpayer's estate. From this net value we then deducte the section 4A abatement. This abatement, which currently sits at R3 500 000, is a general abatement available to all estates and means that any estate which has a net value of below the R3 500 000 threshold will not have to pay estate duty.

What requires consideration therefore are the possible ways in which a taxpayer can structure his estate so as to take advantages of the Section 4A rebate. For example, if a taxpayer's estate includes assets to the value of R5 000 000, an option would be to place the assets with the greater growth potential in a trust and retain the remaining assets, the value of which does not exceed the R3 500 000, in the taxpayer's estate. The result would be that the value of his estate would be decreased due to major assets being moved to a trust prior to his death, reducing the value of his estate to an amount either equal to or less than the section 4A rebate, thus reducing his dutiable estate to NIL, with no estate duty payable.

The relationship between estate duty and capital gains tax will be discussed in Chapter 5.

3.12. Summary

From the discussion set out above it can be seen that there are a number of pros and cons to using a trust as an estate planning tool. A trust, although taxed at higher rates than individuals and having an element of a lack of control, offers greater protection of assets, flexibility, confidentiality and the possibility of an estate duty saving on death. It is however evident that the impact which the use of a trust has as an estate planning tool will inevitably depend on the circumstances of each taxpayer. And in turn the desired outcome of the structure will determine the tax liability of the parties involved.

CHAPTER 4
THE TAXATION OF TRUSTS IN SOUTH AFRICA

4.1 Introduction.

This chapter will highlight how a trust is treated with regard to income tax in South Africa.

Trusts have become an increasingly favoured vehicle which people use to plan their estates. Although a trust does not have a separate legal personality, for tax purposes it is seen as a taxpayer in its own right. This is separate from the trustees, the founder/settlor and the beneficiaries. As such the taxation of trusts needs to be looked at closely in order to determine if it is in fact the best tool to use in an estate plan. Weighing the tax consequences of using a trust against those one experiences when keeping assets in their estate, will help the taxpayer to not only make an informed decision but will also help in deciding on an estate structure which would be the most tax effective for himself, his estate and for his beneficiaries. Whether he donates or sells assets to the trust, each transaction will attract some form of taxation, as would any distribution by the trustees.

The imposition of normal tax in respect of a trust is governed by section 7 and section 25B of the Act. In terms of these sections one or more of three possible taxpayers will be liable for the tax payable on any income of the trust, viz. the trust itself, the donor, settlor or founder of the trust or the beneficiaries.

This chapter will examine the application of section 7 and section 25B, as well as the application of the relevant donations tax provisions so as to highlight the impact which income tax has on trust transactions and on the relevant parties involved in a trust. The aim of the chapter is to set out the instances in which either the trust, the beneficiaries or the donor himself will be liable for income tax in terms of the legislation and hence assist a taxpayer in identifying on whom the liability for tax may fall.

4.2. Income Tax and Trusts

4.2.1. The Beneficiary

The liability of a trust beneficiary to pay tax on income from a trust is dealt with in section 25B, read with section 7, of the Act.

In applying the provisions of section 7(1) of the Act a beneficiary will be taxed on any income received by or accrued to a trust if that beneficiary has a vested right to that income.⁸⁸ Over the years there has been some debate as to what constitutes a vested right. A vested right can be said to be a right under which the beneficiary will definitely receive an amount (regardless of any discretion of the trustees to decide on such receipt), even if the time of such receipt is unknown or not yet determined and could occur at some future date.⁸⁹ If such vested right exists, the section deems any amounts due to the beneficiary in terms of such right to have been received by the beneficiary and hence taxable in his hands.

The same principle applies in respect of section 25B(1) and 25B(5) of the Act which in essence provides that where such beneficiary has a vested right to trust income then that income will be taxable in the beneficiary's hands regardless of whether the amounts have been received by someone else on the beneficiary's behalf.⁹⁰ (vesting will be more fully discussed in chapter 5).

Section 25B(2) goes a step further and deems the beneficiary to have a vested right when a trustee exercises the discretion granted to him in terms of a trust deed or other instrument. Again in this instance, the income will be deemed to have been received by or accrued to the beneficiary and hence taxable in his hands.

⁸⁸ Section 7(1) of the Act.

⁸⁹ Pace(note 1 above)B21.5.

⁹⁰ Ibid.

4.2.2 The Trust

A trust will become liable for income tax by the application of section 25B(1) of the Act. This section provides that where a beneficiary does not have any vested right to the income, then the income retained by the trust is deemed to have accrued to the trust itself and hence is taxable in the trust's hands.

4.2.3. The Donor

A donor's liability for income tax is determined by the application of section 7 of the Act, specifically sections 7(2) to section 7(8). It is important to note at this stage that the abovementioned sections will only find application if a 'donation, settlement or other disposition' has been made.

Before we delve into the implications of these sections we need to understand the meaning of the phrase 'donation, settlement or other disposition'. The courts have on numerous occasions decided on the meaning of each aspect of the phrase.

In *Ovenstone*⁹¹ the court was of the view that for a donation to come into effect there 'must be a disposal made wholly gratuitously, out of liberality or generosity, and those (dispositions) which are for some consideration but also have an appreciable element of gratuitousness or generosity, must be apportioned. The term "other disposition" must be interpreted eiusdem generis with that of "donation" and "settlement".'

In *Joss*⁹² the court held that 'other disposition does not include transactions for full value and money or money's worth, there must be some element of liberality.'

From the above it is clear that in order for section 7 to apply the amount must have been donated or possess some element of a donation in that it must have been made gratuitously, out of generosity or with an element of liberality and not through or because of a bona fide commercial transaction.

⁹¹ *Overstone v SIR* 1980 2 SA 721(A) 740A-C.

⁹² *Joss v SIR* 1980 1 SA 674 (T) 680 – 681.

Once such an element is present, section 7 then provides that the tax liability of the donor is determined as follows:

- Income is deemed to be that of a spouse (the donor) if it has been received or has accrued to the other spouse due to a donation, settlement or other disposition by the spouse for the sole purpose of avoiding tax.⁹³
- Income is deemed to be that of the parent (the donor) of any minor if it has occurred because of a donation, settlement or other disposition by the parent for the benefit of his minor child.⁹⁴
- Income is deemed to be that of the parent (the donor) if that parent has made a donation, settlement or other disposition to another person who has made a donation, settlement or other disposition in favour of the donor's child.⁹⁵
- Income will be deemed to be that of the donor, if the trust deed gives him the right to revoke the beneficiaries' right to receive income or give the said right to another.⁹⁶
- Any receipt which has occurred due to the donor making a donation in the form of a right to any rentals, dividends, royalties or interest, will be deemed to have been received by the donor and taxable in his hands if he has retained ownership or if there is a stipulation which states that the receipt or gain will be his.⁹⁷

4.3. Donations Tax and Trusts

Donations tax is payable at a rate of 20% on the value of any gratuitous disposal of property.⁹⁸ It is a tax which is levied on capital and not on income. In terms of section 55(1) of the Act, a donation is defined as, 'Any gratuitous disposal of property including any gratuitous wavier or renunciation of a right.'⁹⁹

⁹³ Section 7(2) of the Act.

⁹⁴ Section 7(3) of the Act.

⁹⁵ Section 7(4) of the Act.

⁹⁶ Section 7(6) of the Act.

⁹⁷ Section 7(7) of the Act.

⁹⁸ Haupt (note 3 above)848.

⁹⁹ Section 55(1) of the Act.

In essence, a donation is something which is given ‘wholly gratuitously, out of liberality or generosity’,¹⁰⁰ as discussed above. It has the effect of diminishing the value of the donor’s estate and in turn increasing the value of the donee’s estate.¹⁰¹ The definition of a person in the Act includes a trust and hence in certain instances when assets are donated to a trust it will trigger donations tax.¹⁰²

Section 56(1) of the Act deals with specific transactions which will not attract donations tax. Amongst these is section 56(1)(l), which makes provision for the exclusion from donations tax of any transfer or disposal of trust property from a trust/trustees to any beneficiary of that trust.¹⁰³

Section 58 of the Act then goes on to make provision for a deemed donation in a situation where ‘inadequate consideration’ has been received for the disposal/transfer of an asset.¹⁰⁴ In such a case the difference between the market value of the asset and the consideration received is regarded as a donation and therefore subject to donations tax.¹⁰⁵

It needs to be noted that, there currently exists a general exemption under which a person is able to donate up to R100 000 per year, which will not be subject to donations tax.¹⁰⁶

The effect of the principles set out above is that if a donor wishes to move assets into a trust, for the benefit of the trust’s beneficiaries, without receiving any consideration in return for the assets, the transaction will be subject to donations tax.¹⁰⁷ The donations tax liability will only be to the extent that the market value of those assets exceeds the R100 000 exemption.¹⁰⁸ If a consideration is received for the assets, but is considered to be inadequate, the difference between the amount received and the market value of the assets will be subject to donations tax

¹⁰⁰ De Koker & Williams (note 4 above) 23.3.

¹⁰¹ Pace(note 1 above)B21.4.2.

¹⁰² Ibid.

¹⁰³ Section 56(1)(l) of the Act.

¹⁰⁴ Section 58 of the Act.

¹⁰⁵ De Koker & Williams (note 4 above)23.5.

¹⁰⁶ Section 56(2)(b) of the Act.

¹⁰⁷ Section 55(1) of the Act.

¹⁰⁸ Section 56(2)(b) of the Act.

to the extent that such differential exceeds the R100 000 exemption.¹⁰⁹ If the assets are then distributed to the trust beneficiaries, there will be no donations tax payable.¹¹⁰

4.4. Summary

From the above analysis of the taxation provisions we see that the liability for taxation will either fall on the donor/founder, the beneficiaries or the trust. What is crucial is the existence of vesting and the result achieved from any donation made, vis income accruing as a result of a donation. These elements will determine who will be liable for the taxation.

In essence if a beneficiary has a vested right to the trust income or a portion thereof, that beneficiary will be liable for the tax on that income or the relevant portion, as the case maybe. If the beneficiary does not have any vested right to the trust income then in terms of section 25B(1) the trust may be taxed on that income. Where the donor/founder has made a donation settlement or other disposition to the trust which has resulted in income which has accrued to his spouse or was for the benefit of his child, or where he retains the right to revoke the beneficiaries' right to receive the income, then it is the donor himself who will be liable for the tax on that income.

¹⁰⁹ Section 58 of the Act.

¹¹⁰ Section 56(1)(l) of the Act.

CHAPTER 5
EFFECT OF CAPITAL GAINS TAX ON TRUSTS

5.1. Introduction

This chapter will deal with a detailed discussion of the capital gains tax provisions of the Act as they apply to a trust and a trust's transactions. This will highlight the impact which capital gains tax has on trust transactions and will also indicate upon whom the liability for capital gains tax falls.

Chapter 4 dealt with the application of income tax and donations tax on a trust, with an analysis of the relevant sections of the Act and the tax consequence of each. An important consideration when deciding to use a trust is the impact which capital gains tax has when you transact with and through a trust. Due to the fact that a trust is taxed at a higher rate on all capital gains made, the impact of this versus the impact of capital gains tax experienced when you keep assets in your estate must be considered when embarking on estate planning, especially if the taxpayer is considering using a trust.

South Africa does not have separate capital gains tax legislation. Instead the provisions which deal with capital gains tax are contained in the eighth schedule to the Act. Many of these provisions mirror those relating to the normal tax implications of a trust, which were discussed under chapter 4.

5.2. Capital Gains Tax Explained Briefly

Capital gains tax is a tax which arises on the disposal of an asset at a value greater than its value at its acquisition.¹¹¹ It is in essence a tax which is levied on any gain which is received on the disposal of an asset.¹¹²

¹¹¹ Haupt (note 3 above) 870.

¹¹² Ibid.

When considering the possible capital gains tax implications of transactions reference must be made to the eighth schedule of the Income Tax Act. According to Silke¹¹³ there are four requirements which have to be present in order to determine the capital gain, namely:

1. There must be an asset;
2. There must have been a disposal or deemed disposal of that asset during the year of assessment;
3. The base cost of that asset must be determined according to the provisions of paragraph 3 of the eighth schedule; and
4. The proceeds on disposal must be determined.¹¹⁴

Using the information determined from the above requirements, a portion of the net gain (i.e. capital gain less various allowances /deductions) is included or added to the taxable income of the taxpayer where it will be subject to normal tax at the applicable rate for that taxpayer. Capital gains tax is not in fact a separate tax from that of normal tax.¹¹⁵

The basic calculation of capital gains tax on the disposal of any asset would be, the proceeds received from the disposal of the asset less the base cost of the asset (generally the amount paid for the asset on its acquisition), less any allowable exclusions or deductions, which will give you the net capital gain.¹¹⁶ The taxable capital gain will be either 66.6% of this net capital gain, in the case of a trust, or 33.33% of the net capital gain in the case of an individual.¹¹⁷ This percentage or portion of the net capital gain will then be included in the taxable income of the taxpayer and taxed at their applicable tax rate, hence capital gains tax is not considered a separate tax from income tax.¹¹⁸

¹¹³ A, Koekermoer “Capital gains tax (CGT)” in Stiglingh M ... et al (ed) *Silke on South African Income Tax*, LexisNexis(2014),869-986.

¹¹⁴ Ibid, 874.

¹¹⁵ Haupt (note 3 above) 872.

¹¹⁶ De Koker & Williams(note 4 above)24.12.

¹¹⁷ Ibid.

¹¹⁸ Ibid.

5.3. Capital Gains Tax and Trusts

The application of capital gains tax to a trust arises from the interpretation or definition of certain key concepts relating to trusts and the administration thereof.

In terms of section 1 of the Act a person is defined as including the following:

- a) an insolvent estate;
- b) the estate of a deceased person;
- c) any trust; and
- d) portfolio of collective investment schemes

As stated earlier a trust is seen as a legal person for tax purposes and is taxed at the higher rate of 66,6% of the net capital gain. This 66,6% is then included into the trust's taxable income and taxed at a rate of 40%.

Section 1 of the Act also defines a beneficiary as follows:

‘in relation to a trust, means a person who has a vested or contingent interest in all or a portion of the receipts or accrual or the assets of that trust.’

5.4. Provisions in the Eighth Schedule which Affect a Trust.

5.4.1 Paragraph 1¹¹⁹ – Definition of Disposal

The first paragraph of the eighth schedule defines a disposal as, ‘an event, act, forbearance or operation of law envisaged in paragraph 11 or an event, act forbearance or operation of law which is in terms of this schedule treated as the disposal of an asset, and “disposed” must be construed accordingly.’¹²⁰

¹¹⁹ Paragraph 1 of the eighth schedule to the Act.

¹²⁰ Ibid.

This definition sets out the acts which shall be considered a disposal under the legislation and makes specific reference to paragraph 11.

5.4.2 Paragraph 11¹²¹ – Disposals

Apart from the acts/events which constitutes a disposal, as is listed in this paragraph, paragraphs 11(1)(a), 11(1)(d) and 11(1)(g) specifically relates to trusts.

Under paragraph 11(1)(a) should the trust transfer assets according to the provisions set out in this sub paragraph (i.e. sell, donate, alienate, etc...) capital gains tax will be triggered. By the same token, should a taxpayer transfer an asset to the trust through one of the methods set out in the subparagraph that taxpayer will be liable for capital gains tax. This will be considered a disposal for capital gains purposes. The same would apply with a beneficiary who disposes of his interest in a trust.

Paragraph 11(1)(d) goes on to include as a disposal, ‘the vesting of an interest in an asset of a trust in a beneficiary’.

This means that should the trustees distribute any trust asset to a beneficiary, it will be considered a disposal for capital gains purposes and the trust could possibly then be subject to capital gains tax on any possible capital gain.

The paragraph also deals with ‘value shifting arrangements’. These are defined in paragraph 1 of the eighth schedule to the Act and are in essence, arrangements whereby the market value of a person’s interest in a trust has decreased by reason of a change of entitlement and there is a corresponding acquisition or increase in the value of interest held by a connected person.¹²²

¹²¹ Paragraph 11 of the eighth schedule to the Act.

¹²² Note 119 above.

5.4.3. Paragraph 12¹²³ – Deemed Disposals

This paragraph sets out events which will be considered to be deemed disposals and as such will attract capital gains tax.

5.4.4. Paragraph 68¹²⁴ – Attribution of Capital Gain to Spouse

This paragraph covers a situation in which a capital gain has vested in a spouse wholly as a result of a ‘donation, settlement or other disposition’ or ‘transaction, operation or scheme’ that was entered by the other spouse (donor spouse), purely to avoid that spouse’s liability or postponing the said spouse’s liability for tax. The provision will deem the gain to have been made by the donor spouse and hence taxable in his hands.

As a result of this provision, should a wife acquire a vested right to capital gain because her husband donated an asset to the trust in which she is a beneficiary, that gain will be deemed to have been made/acquired by the husband and taxable in his hands. The reason or motive for the donation must be to avoid the resultant tax liability.

5.4.5. Paragraph 69¹²⁵ – Attribution of Capital Gain to Parent of Minor Child.

Where a capital gain has been made due to a ‘donation, settlement or other disposition’ by a parent of a minor child and the gain vests in, is treated as vesting in a minor child or has been used for the benefit of that minor child. The capital gain will then be considered to have been made by the parent and hence taxable in the parent’s hands. The same principle will apply in a situation where the parent has made a ‘donation, settlement or other disposition’ to a third party in exchange for a ‘donation, settlement or other disposition’ in favour of his child.

Based on this provision, if a parent(Y) donates an asset to a trust for the benefit of X’s family and in return X donates an asset to a trust in which Y’s minor child is a beneficiary then should a capital gain vest in Y’s minor child as a result of the donation by X, that capital gain will be

¹²³ Paragraph 12 of the eighth schedule to the Act.

¹²⁴ Paragraph 68 of the eighth schedule to the Act.

¹²⁵ Paragraph 69 of the eighth schedule to the Act.

deemed to have been made by Y himself. Similarly, if the capital gain which vests in Y's minor child is as a result of a donation by Y, the capital gain will be deemed to have been made by Y.

5.4.6 Paragraph 70¹²⁶ – Attribution of Capital Gain Subject to Conditional Vesting

When a capital gain arises as a result of a 'donation, settlement or other disposition' and there is a condition attached to the vesting of that capital gain, that it shall not vest until the happening of some event (contingent or fixed), the capital gain will be taxable in the donor's hands.

The provisions of this paragraph will find application if the donation is made to a trust with a condition for example, that the beneficiary shall not be entitled to the capital gain until he reaches the age of 25. The condition does not have to be set by the donor but can actually be imposed by the founder in the trust deed.

5.4.7. Paragraph 71¹²⁷ – Attribution of Capital Gain Subject to Revocable Vesting –

Where the deed of donation contains a clause in terms of which the donor has the right to revoke the vesting of any capital gain in a beneficiary or confer the right to the vesting of the capital gain on someone else, the capital gain will then be taxable in the donor's hands.

It should be noted that this provision has the result of reducing the amount of tax which is payable by the trust, as the capital gain will be taxed in the hand of the donor at a lower rate than it would have been if taxed in the trust.

5.4.8. Paragraph 72¹²⁸ – Attribution of Capital Gain Vesting in Non-Resident

This paragraph is applicable when a capital gain which arises from a 'donation, settlement or other disposition' made by a resident, vests in a non-resident. The capital gain in this situation will be taxable in the hands of the resident (i.e. the donor) and not the non-resident.

¹²⁶ Paragraph 70 of the eighth schedule to the Act.

¹²⁷ Paragraph 71 of the eighth schedule to the Act.

¹²⁸ Paragraph 72 of the eighth schedule to the Act.

Based on the above, if a resident makes a donation to a trust, any capital gain which arises as a result of that donation which has vested in a non-resident beneficiary, will be taxable in the resident donor's hands.

The meaning of the phrase 'donation, settlement or other disposition' was discussed in chapter 4,¹²⁹ and is applicable to the interpretation of the abovementioned paragraphs.

As was discussed in chapter 4, a 'donation, settlement or other disposition' materialises out of generosity or contains an element of liberality, it does not form part of a commercial transaction. Basically to be considered a donation there must not be any form of a 'quid pro quo' of relative value.

If any element of a 'donation, settlement or other disposition' is present in the transaction, this will have an implication with regard to the party who is liable to pay the capital gains tax.

5.4.9. Paragraph 80¹³⁰ – Capital Attributed to Beneficiaries.

In terms of paragraph 80(1), when a gain is the result of an asset which vests in a beneficiary it will become taxable in that beneficiary's hands. This paragraph is however subject to the application of paragraphs 68, 69, 71 and 72. If the provisions of the aforesaid paragraphs are met then this would override the application of paragraph 80(1) and 80(2).

The paragraph also provides that the beneficiary needs be a resident. If the beneficiary is a non-resident then the gain will be taxed in the trust's hands. It should be noted that the vesting could occur due to a trustee exercising the discretion afforded to him under a trust deed or due to a clause in the trust deed itself.¹³¹

The paragraph envisages situations where a trust asset vests in a beneficiary, this vesting is seen as a disposal for capital gains purposes and hence any gain which results due to such vesting will

¹²⁹ See full discussion in chapter 4 at 4.2.3.

¹³⁰ Paragraph 80 of the eighth schedule to the Act.

¹³¹ De Koker & Williams(note 4 above) 24.131.

be taxable in the beneficiary's hands.¹³² The effect of this is that when the asset is finally distributed to the beneficiary it will not attract capital gains tax as this tax has already been incurred.

Paragraph 80(2) then goes on to provide that when a beneficiary has a vested right to capital gain but not to the asset itself, the capital gain will be taxable in the beneficiary's hands.¹³³

It should be noted at this point that the abovementioned provisions relate only to the capital gains implications of a trust. Any capital loss which has been realised will always remain with the trust in all instances.

The concept of vesting flows through to the provisions of the eighth schedule to the Act, which relate to trusts and although briefly touched on in chapter 4, warrants further discussion.

5.5. Vesting vs Contingent in the Context of the Eighth Schedule

Vesting or vested interest and contingent interest are not defined in the eighth schedule or section 1 of the Act, but it is assumed that the 'interest' contemplated in this context is a beneficiary's right to something.¹³⁴

Vested and contingent rights have been defined in case law.¹³⁵ In *ITC 76*¹³⁶ the court held that:

Vesting implied the transfer of dominium.... A vested right was something substantial, something which has a present value and could be attached. A contingent interest was merely a spes- an expectation which might never be realised. For its very nature could not

¹³² Ibid.

¹³³ Ibid.

¹³⁴ SARS- Comprehensive Guide to Capital Gains Tax(Issue4) at 439, available at <http://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20-%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax%20-%20External%20Guide.pdf>, accessed on 29 June 2014.

¹³⁵ Ibid.

¹³⁶ ITC 76 (1027) 3 SATC 68 (U) 70.

have a definite present value. In the income tax sense, therefore, a vested right is an accrued right.

In *Jewish Colonial Trust Ltd v Estate Nathan*,¹³⁷ the court went further and held that:

Unfortunately the word “vest” bears different meaning according to its context. When it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right- that he has all rights of ownership in such right including the right of enjoyment. If the word “vested” were used always in that sense, then to say that a man owned a vested right would mean no more than a man owned a right. But the word is also used in another sense, to draw a distinction between what is certain and what is conditional; a vested right is distinguished from a contingent or conditional right.

What can be taken from the findings of the courts, as stated above, is that a vested right is something more than just an intangible right. It is a right which accrues to the beneficiary and is measurable. A vested right can also be referred to as a personal right to the assets or income, until such time as that beneficiary obtains the real right to the said asset or income.¹³⁸

As was discussed in chapter 4, a contingent right will be a right which is not certain, the amount to be paid or the asset to be distributed to the beneficiary is purely at the discretion of the trustees.¹³⁹

5.6. The Impact of Capital Gains When Using Trusts in Estate Planning.

The impact which capital gains tax has on trust transactions may be summarised as follows:¹⁴⁰

¹³⁷ *Jewish Colonial Trust Ltd v Estate Nathan* 1940 AD 163 at 175 to 176.

¹³⁸ SARS (note 134 above) 439.

¹³⁹ *Ibid.*

¹⁴⁰ Haupt (note 3 above) 744.

5.6.1. The Trust Sells Assets

If a trust sells a trust asset, any gain which is made will be taxed in the trust's hands, as long as the beneficiaries do not have a vested right to the asset/gain.¹⁴¹ If the beneficiaries have a vested right then the gain is taxable in the beneficiaries' hands.¹⁴² If the beneficiaries have a contingent right to the asset the trust will be taxed on the gain, in which event a beneficiary will only be taxed on the gain if it is distributed to him.¹⁴³ Any capital loss on the sale of an assets will remain in the trust, the losses made cannot be distributed to the beneficiaries in cases where the beneficiaries have a contingent right.¹⁴⁴

5.6.2. The Trust Distributes Assets to a Beneficiary

If the trust distributes assets to a beneficiary, the beneficiary will be taxed on the gain made.¹⁴⁵ This is subject to the application of the anti-avoidance provisions, contained in paragraph 68 to 72. These provisions in essence provide for instances where although a beneficiary has received a distribution from the trust it is in fact the donor who is liable for the capital gains tax triggered by the distribution.

5.6.3. Spouses

If a husband donates an asset to a trust for the purposes of avoiding tax, and his wife obtains a vested right to any capital gains relating to the asset, such gain will be taxable in the husband's hands.¹⁴⁶

5.6.4. Minor Child

If a parent donates an asset to a trust for the benefit of his minor child, any gain which vests in the minor child, relating to that asset, will be taxable in the parent's hands.¹⁴⁷

¹⁴¹ Paragraph 80 of the eighth schedule to the Act.

¹⁴² Ibid.

¹⁴³ Koekermoer (note 113 above)951.

¹⁴⁴ Ibid.

¹⁴⁵ Paragraph 80 of the eighth schedule to the Act.

¹⁴⁶ Paragraph 68 of the eighth schedule to the Act.

¹⁴⁷ Paragraph 69 of the eighth schedule to the Act.

5.6.5. Third Party Donations

If a parent donates an asset to a trust for the benefit of a third party's family, and in turn that third party donates an asset to a trust for the benefit of the parent's minor child, any capital gain which vests in the minor child will be taxed in the parent's hands.¹⁴⁸

5.6.6. Conditional Vesting

If a donation is made subject to a condition relating to the vesting of capital gains, the capital gain will be taxed in the donor's hands.¹⁴⁹

5.6.7. Revocation Clause in Deed of Donation

If a deed of donation contains a clause which relates to the donor's right to revoke a vesting of capital gains in a beneficiary, the donor is then taxed on the capital gain.¹⁵⁰

5.7. The Conduit Pipe Principle and its Future in South African Law

5.7.1 What is the Conduit Pipe Principle?

In essence, this principle applies where any income, dividend or capital gain, which a trust has received and has paid out to the beneficiaries of that trust, in the same year of assessment in which the income, dividend or capital gain was received, then such income, dividend or capital gain will retain its nature as income, dividend or capital gain in the hands of those beneficiaries and will be taxed in their hands.¹⁵¹

The principle has been confirmed by our courts in a number of cases. It was held in *Armstrong*¹⁵² that, 'in a trio comprising a company, the intervening trustee and beneficiary, it is manifest that in the truest sense that beneficiary derives its income from the company and the trustee can neither increase nor diminish it, he is a mere conduit.'¹⁵³

¹⁴⁸ Paragraph 69 of the eighth schedule to the Act.

¹⁴⁹ Paragraph 70 of the eighth schedule to the Act.

¹⁵⁰ Paragraph 71 of the eighth schedule to the Act.

¹⁵¹ Pace (note 1 above)B21.2.1.

¹⁵² *Armstrong v CIR* 1939 AD 343,10 SATC 1,6-7 of 10 SATC 1.

¹⁵³ *Ibid.*

In *Rosen*¹⁵⁴ the court supported this conclusion and went a step further by holding that if a case would arise where the income was not paid out to the beneficiaries in the year of assessment in which it was received but in a subsequent year, then income would lose its nature of being income. In this situation the conduit principle would have no application.¹⁵⁵

What this means is that if the trust in fact distributes income which it receives to a beneficiary in the same year in which the income is received the income will be taxed at a lower rate depending on which tax bracket that beneficiary falls into. There is a possibility that this could be less than the 40% which would apply should the income be retained by the trust and not distributed in the year of assessment in which it was earned.

The same principle applies if the trust made a capital gain on the disposal of an asset. When distributed to the beneficiaries in the year of assessment in which the gain was made, that capital gain would retain its nature as a capital gain when a trust distributes the capital gain to a beneficiary, triggering the conduit pipe principle. The portion of the capital gain which is included in the beneficiary's taxable income is 33.33% of the capital gain, as opposed to the portion of any undistributed capital gain added to a trust's income which is 66.6% of the capital gain.¹⁵⁶ The beneficiary can also make use of the annual exclusion of R30 000 to reduce the amount of capital gain that is taxed.¹⁵⁷ This is most tax effective for the taxpayer, as the capital gains tax element payable by individuals is an effective rate of 13.3%, which is much lower than the effective rate applicable to a trust which is 26.67%

The eighth schedule has also provided for the conduit pipe principle by providing for instances where capital gain which is distributed to a beneficiary in the same year is in fact taxed in that beneficiary's hands.¹⁵⁸

¹⁵⁴ *SIR v Rosen* 1971(1)SA 173,32 SATC 249,269-270.

¹⁵⁵ Haupt (note 3 above) 814.

¹⁵⁶ Haupt (note 3 above)774.

¹⁵⁷ Kirson (note 7 above).

¹⁵⁸ Holdstock (note 15 above).

From the above it can be seen that there is a split of the conduit principle, namely the capital gains effect and the income effect. Where you move capital gains from the trust to the beneficiary, the beneficiary will end up paying tax at a rate of 13.3% and not 26.66%. Where you move income from the trust to a beneficiary and that beneficiary is taxed at a lower rate of tax, the beneficiary will pay less tax on the income than the trust would have paid.

It should be noted at this point that when it comes to income, the conduit pipe principle is likely to be the most effective for the reduction of the amount of tax payable where the beneficiaries are taxed at a lower tax rate. This is because if a beneficiary falls within a higher tax bracket (i.e. taxed at a rate of 40%) the reduction of the amount of tax payable would be insignificant, as the income of a trust is taxed at a rate of 40%.

5.7.2. The Future of the Conduit Pipe Principle in South Africa

In recent years trusts have fallen into SARS firing line due to its increasing popularity as a tool to minimise tax. One of its many advantages, which promotes the reduction of tax, is in fact the conduit pipe principle.

SARS has proposed doing away with this principle. The effect would be that any income or capital which is distributed to a beneficiary of a trust in the same year in which it was made by the trust, will not retain its nature in the hands of that beneficiary. Any capital gain, when received or made by the trust will be taxed in the trust at the inclusion rate of 66.6%. When the gain is eventually distributed to a beneficiary, it will be distributed as taxable income in that beneficiary's hands. The doing away with one of the much loved principle, in essence, results in a trust only being able to distribute taxable income to beneficiaries.¹⁵⁹

This means that all capital gains which a trust receives will be taxed as gains when the trust receives it. The gain in essence, may then be taxed again when it is distributed to the beneficiary but it will be taxed as taxable income. This results in the capital gain being taxed at a higher rate in the trust, thereby thwarting the advantage of the lower inclusion rate and possible lower tax

¹⁵⁹ National Treasury(note 29 above).

rate afforded to an individual. It may result in a much higher tax consequence for the recipient beneficiary.

If the conduit pipe principle were to be done away with one would not be able to move any capital gain made by the trust down to a beneficiary who is taxed at a lower tax rate. The effect will be that the capital gain will be taxed in the trust at a rate of 26.66%. Similarly one would not be able to move income in these instances to a beneficiary who is taxed at a lower tax rate, and the income will be taxed at 40% in the hands of the trust.

The result of doing away with the conduit pipe principle may possibly lead to a double taxation on the capital gain made by a trust. The same amount which was made in the form of a capital gain could in fact be taxed twice, once in the hands of the trust as capital gains and again in the hands of the beneficiary. Although the capital gain will be taxed as such in the trust's hands and then taxed as taxable income in the beneficiaries' hands once it is distributed by the trustees, it is effectively the imposition of tax on the same amount twice, just in the hands of different tax payers.

To address the double tax problem which might arise, it has been suggested by SARS/Treasury that the distributions made to a beneficiary will be tax free.¹⁶⁰ These distributions are likely to be treated as deductions in the trust itself.¹⁶¹ This will have the effect of the income or gain being taxed in the trust at a higher rate and when distributed to the beneficiary, the amount so distributed would not be taxed again.¹⁶²

Another possible alternative to the tax free distribution would be to follow the method of taxation applicable to companies in the past and at present which would be to either:

¹⁶⁰ Ibid.

¹⁶¹ K Malapela "Protecting the tax base through trust taxation reform", *EY*, available at <http://www.ey.com/ZA/en/Service/Tax/2013-Budget---Kabelo-Malapela---Protecting-the-tax-base-through-trust-taxation-reform>, accessed on 23 October 2014.

¹⁶² National Treasury(note 29 above).

- a. Use the previous company tax and secondary tax on companies (STC model, which has now been replaced by the re-institution of dividends tax). Here the total required rate of tax from the company was split between taxation on the company's taxable income (28%) and only if the company distributed that income to the shareholders, an additional STC at 10%, (resulting in a total tax rate of 38%);¹⁶³ or
- b. The present situation, again where the total required rate is split between company tax (28%) and if the company makes a distribution or pays a dividend to its shareholders, an additional dividend tax (15%) taxable in the hands of the shareholders but withheld and paid by the company before payment to the shareholder concerned (resulting in a total tax rate of 43%).¹⁶⁴

In both the instances, the additional portion (10% STC/ 15% dividend tax) is not paid if the company does not distribute the income.¹⁶⁵

If this method was applied to trusts, the split would be less onerous for the trust as it would allow the trust to pay a portion of the tax (28%) on the taxable income with the balance of the required rate only paid when that income is distributed to the beneficiary of the trust. In that way the trust will not pay the additional tax if it retains the income. This would give the trust the option to retain income without having to pay the entire tax in any tax year.

How SARS intends to achieve the doing away with the conduit principle this is unclear and Treasury has not addressed the issue as yet. It would require an amendment to the relevant sections and paragraphs of the Act, specifically section 7, section 25 and paragraphs 11,68,69,70,71,72,80 of the eighth schedule.

Although the doing away with the conduit principle will effect the use of trusts as one of the principal vehicle to structure one's estate, the absence of the conduit principle will reduce the

¹⁶³ De Koker & Williams(note 4 above) 9.3.

¹⁶⁴ Ibid 9.5.

¹⁶⁵ Ibid.

overall tax savings available for the individual taxpayer and it would also eliminate the flexibility of trusts, as trusts at present are able to choose the manner in which it distributes its income. The remaining benefits of a trust which include succession, the protection of assets from creditors and to some extent estate duty savings will continue to make trusts an essential vehicle in estate planning. Hence the basic nature of a trust and its importance in estate planning will invariably remain intact.

5.8. Capital Gains Tax and Estate Duty

Many see a trust as a means or vehicle to curb the impact which estate duty has on a taxpayer's estate, because holding assets in a trust reduces the value of the taxpayer's personal estate and consequently those assets will not be included in the calculation of the dutiable estate of the taxpayer for purposes of assessing the estate duty due on his death. However, there is also a reluctance to use a trust as a vehicle to hold assets for this purpose, due to the misguided general impression that one will end up paying more normal tax (through capital gains tax) on the disposal of the asset if it is held in a trust due to the higher inclusion rate of any capital gains (66,6%) in the trust's taxable income, than the tax payable via estate duty if the asset was retained in the name of the taxpayer(at 20% of the value of the asset as at the date of death).

Bearing in mind that upon death an individual is deemed to have disposed of his assets on the day prior to the date of his death, thus triggering capital gains ,resulting in both capital gains tax and estate duty payments, the aforesaid impression could be misguided. Furthermore¹⁶⁶ as your taxable capital gain is calculated only on the gain you receive at the date of disposal, and estate duty is based on the full value of the asset and not just the gain on its disposal the base value on which each of the taxes is calculated is totally different (total asset value for estate duty and 66.6% of the gain for capital gains tax), creating a possibility of more tax being payable by way of estate duty than capital gains tax on the same asset.

¹⁶⁶ Mhlongo (note 30 above).

For example if an asset which is valued at four million rand (R4 000 000) at the acquisition date and at the date of death is valued at five million rand (R5 000 000) there are two possible taxation outcomes - ¹⁶⁷

Firstly, if the taxpayer held the asset personally, (assuming this is the only asset he has in his estate and for the purposes of the illustration ignoring any other liabilities he may have), the taxpayer would initially need to account for capital gains tax because death is considered to be a deemed disposal for capital gains tax purposes.

The calculation for capital gains tax will be as follows (taking into account the annual exclusion of R300 000):

Proceeds	R 5 000 000
Less the base cost	4 000 000
Net capital gain	<u>1 000 000</u>
Less annual exclusion	300 000
	<u>700 000</u>
Inclusion rate	x 33,3%
Taxable capital gain	<u>233 100</u>
Effective rate	x 40%
Capital gains tax	<u>93 240</u> →

The taxpayer's liability for estate duty will therefore in essence be as follows:

Value of the asset as at the date of death	R 5 000 000
Less capital gains tax	(93 240)
Less the primary rebate	(3 500 000)
Dutiable amount of estate	<u>1 406 760</u>
Rate of estate duty	x 20%
Estate duty payable @ 20%	<u>281 352</u> →

¹⁶⁷ This example is drawn from and adapted from personal experience in dealing with the administration of estates in practice.

Total tax paid by the taxpayer's estate; capital gains tax R 93 240 + estate duty R281 352 being a total of R374 592

Alternatively, if the taxpayer placed the asset in a trust during his lifetime and then it is disposed of from the trust at the date of his death at the aforementioned values the capital gains tax would be as follows –

Proceeds	R 5 000 000
Less the base cost	4 000 000
Net capital gain	<u>1 000 000</u>
Inclusion rate	x 66,6%
Taxable capital gain	<u>666 000</u>
Effective tax rate	x 40 %
Tax payable on the Taxable Capital Gains	<u>266 400</u> →

With no estate duty consequence on the death of the testator which has no impact on the trust or its assets.

(For purposes of this illustration, it is assumed that the asset is not the deceased's primary residence and that there are no additional deductible liabilities in his estate).

As can be seen from the above illustration, there is a R108 192 tax saving if the taxpayer held the asset in a trust in the given example. This is because capital gains tax is calculated on the gain and not the entire value of the asset as is the case with estate duty, and a trust is unaffected by the death of the taxpayer insofar as taxation is concerned.

The important consequence of this is the value of the asset which will be available for distribution to the taxpayer's heirs or to the beneficiaries of the trust.

The value of the asset which is available for distribution on his death (i.e. when the asset forms part of his estate) to his heirs will effectively be as follows:

Value of the Asset as at the date of death	R 5 000 000
Less Capital Gains Tax	(93 240)
Less Estate Duty	(281 352)
Value available for distribution	<u>4 625 408</u>

The value of the taxpayer's asset available for distribution to the beneficiaries if the asset is disposed of from the trust (on the date of his date) will be as follows:

Value of the Asset as at the date of death	R 5 000 000
Less Capital Gains Tax	(266 400)
Value available for distribution	<u>4 733 600</u>

What this illustrates is that by holding his asset in a trust and then disposing of it from the trust, the value of the asset which is available to the taxpayer's beneficiaries will be significantly greater than the value of that asset which will be available to his heirs if the asset is held by him personally and distributed upon his death from his estate. This may even be so in cases where the total tax burden of the taxpayer's estate on his death (estate duty and capital gains tax) is less than the tax burden of the trust on disposal of the asset (capital gains tax).

5.9. Summary

As set out above, a trust's capital gains tax burden in some cases mirrors those imposed by section 7 of the Act. Again this burden will depend upon vesting. If the beneficiary has a vested interest in the trust then the capital gain will be taxable in that beneficiary's hands.¹⁶⁸ If the beneficiary does not have any vested right to the capital gain then the trust will be taxed on such gain.¹⁶⁹ In the case of a donation, where the donor/founder has made a donation settlement or other disposition to the trust which has resulted in a gain to which his spouse¹⁷⁰ or child¹⁷¹ has a vested right, the donor will be taxed on that gain. Where the donor/founder (donor A) makes a

¹⁶⁸ Paragraph 80 of the eighth schedule to the Act

¹⁶⁹ Ibid

¹⁷⁰ Paragraph 68 of the eighth schedule to the Act

¹⁷¹ Paragraph 69 of the eighth schedule to the Act

third party donation (to B) and B then donates any asset for the benefit of donor A's minor child and the second donation (from B) results in a capital gain which vests in that minor,¹⁷² then it is donor A himself who will be liable for the tax on that capital gain.

Many also see the possibility of doing away with estate duty and the conduit principle as diminishing the effectiveness of a trust as a tool to help mitigate the effect of capital gains tax and estate duty. A trust in many instances should serve the purpose of protecting the full value of an asset, thereby ensuring that the ultimate beneficiaries benefit the most. This is however case specific and the result will vary depending on the size of the taxpayer's estate.

¹⁷² Ibid.

CHAPTER 6

THE AUSTRALIAN MODEL

6.1. Introduction

The Australian model is in my view the most suitable model for comparative purposes, mainly because the South African model has been gleaned from the Australian model.¹⁷³ This chapter will highlight how capital gains tax is determined in Australia and the recent changes in their capital gains tax legislation, as it applies to the taxation of trusts.

6.2. Capital Gains Tax and Trusts

On the 20 September 1985 capital gains tax took effect in Australia.¹⁷⁴ In essence, as with South Africa, it is a tax which is levied on any gain made on the disposal of an asset. Currently, save for a few differences, our capital gains tax system is very similar to that of Australia.

Capital gains tax in Australia is levied on any gain made from the disposal of assets, applying to assets which are either intangible or tangible. It is triggered on the happening of what has been termed 'capital gains tax events'. These capital gains tax events are listed in Division 104 of the Australian Income Tax Assessment Act 1997 (ITAA). Capital gains tax is not a separate tax, it is part of a taxpayer's income tax. This means that the net capital gain for the year will be included in the taxpayer's taxable income and then taxed accordingly.¹⁷⁵

The calculation of net capital gains and losses is done in much the same way as in South Africa. The difference however is that, in Australia, where a taxpayer holds an asset for 12 months or longer that taxpayer becomes entitled to a reduction of their capital gain. In respect of trusts and individuals there is an allowance of a 50% reduction in the gain.¹⁷⁶

¹⁷³ Cassidy (note 16 above).

¹⁷⁴ Note 18 above.

¹⁷⁵ Ibid.

¹⁷⁶ Ibid.

What this means is that where an asset is held in a trust purely for investment purposes, when that asset is sold, if it has been held for 12 months or longer, then the trust will be eligible for an allowance of 50% of the gain made on the disposal of that asset.¹⁷⁷ If however the asset (say property) is developed in some way, shape or form, then this may be interpreted as the taxpayer, in essence, trading in that asset. The asset as a result, could be treated as trading stock and proceeds from the disposal of that asset will be taxed accordingly.¹⁷⁸ The reason for the implementation of the discount was to primarily encourage, entice investment in immovable property in Australia.

It should be noted that this allowance is no longer available for non-residents and temporary residents of Australia due to the fact that the Australian Treasury is of the view that the allowance is no longer needed for the purposes of enticing foreign residence to invest in Australia.¹⁷⁹

Hence in the Australian scenario your net capital gain will be calculated as follows¹⁸⁰:

Total Capital Gains¹⁸¹ for the year
Less 50% allowance, where assets are held for 12 months or longer,
Less Total capital losses for the year.

With regard to trust, any distribution of gains made to a beneficiary may trigger capital gains tax. Currently any distribution of capital gains made by a trust to a beneficiary will be streamed to that beneficiary if the beneficiary has a ‘specific entitlement’ to the capital gains or part

¹⁷⁷ “Capital Gains Made By Trusts”, modified on 07 June 2014, available at <https://www.ato.gov.au/General/Capital-gains-tax/In-detail/Trusts/Capital-gains-made-by-trusts/>, accessed on 22 October 2014.

¹⁷⁸ “CGT Treatment of trusts”(December 2000) available at <http://www.allens.com.au/pubs/tax/fotdec00.htm>, accessed on 27 October 2014.

¹⁷⁹ Note 177 above.

¹⁸⁰ “working out your capital gain”, modified on 12 June 2014, available at <http://www.ato.gov.au/General/Capital-gains-tax/Working-out-your-capital-gain-or-loss/Working-out-your-capital-gain/>, accessed on 07 August 2014, 2.1.

¹⁸¹ Capital gains is calculated by subtracting the base cost of the asset from the proceeds received on disposal. The total capital gains for the year will be the accumulation of all the gains received on all disposal for that year.

thereof.¹⁸² This means that the capital gain will be taxable as capital gains in the beneficiary's hands. This is a change from the previous treatment of capital gains in Australia, where the gain was simply added to the trust's taxable income and then distributed to a beneficiary as income in proportion to their entitlement.¹⁸³

6.3 The Law Before the Changes

Under the provisions of section 97(1) of the ITAA 1936 the beneficiaries of a trust:

who is not under any legal disability is presently entitled to a share of the income of the trust estate;

- a. The assessable income of the beneficiary shall include;
 - i. So much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was a resident ; and
 - ii. So much of that share of the net income of the trust estate as is attributable to a period when the beneficiary was not a resident and is also attributable to sources in Australia.¹⁸⁴

This extract of section 97(1)(a) highlights the fact that before the changes in the law were enacted, the liability of a beneficiary of a trust to pay tax was determined using the principle of 'present entitlement'. The present entitlement of the beneficiary was in turn based on the net income of the trust estate. Net income is defined under section 95 of the ITAA 1936 and in essence is the total assessable income of the trust estate less all allowable deductions.¹⁸⁵ What this means is that the trust's assessable income is not limited to receipts which take the form of income, it in fact includes all amounts which the trust has received. Accordingly, the net income of the trust will include any capital gain made by the trust in the relevant tax year.¹⁸⁶ And the

¹⁸² Note 19 above.

¹⁸³ C Brown "Taxation of Trusts – The Problem of Aligning Concepts of Income", *19 Asia-Pac. Tax Bull.* 5 (2013), Journals IBFD. Available at http://www.ibfd.org/IBFD-Products/Journal-Articles/Asia-Pacific-Tax-Bulletin/collections/aptb/html/aptb_2013_05_au_1.html, accessed on 22 October 2014.

¹⁸⁴ Section 97(1) of the Income Tax Assessment Act 1997, as amended

¹⁸⁵ Brown (note 183 above) 2.2.

¹⁸⁶ *Ibid.*

amount on which the beneficiary is taxed hence, will be that share of the net income of the trust to which the beneficiary is presently entitled to.¹⁸⁷

Present entitlement was defined by the Australian courts in a number of cases. The courts have held that present entitlement will exist in cases where:

- a) the beneficiary has an interest in the income which is both vested in interest and vested in possession; and
- b) the beneficiary has a present legal right to demand and receive payment of the income. Whether or not the precise entitlement can be ascertained before the end of the relevant year of income and whether or not the trustee has the funds available for immediate payment.¹⁸⁸

So basically, a beneficiary will have to pay tax on amounts to which they have such a present entitlement, if no such entitlement existed then it will fall on the trustees to pay the tax.¹⁸⁹ The beneficiary under the above definition would have to pay tax on an amount which would not match the amount which the trust is able to distribute.¹⁹⁰

However it should be noted that what caused some confusion in Australia was the application of parallel principles used to calculate the tax liability of the beneficiary. One such principle was termed the 'quantum approach'.¹⁹¹ The quantum approach calculated the tax liability based on the share of the distributable income to which a beneficiary was presently entitled.¹⁹²

¹⁸⁷ Ibid.

¹⁸⁸ Harmer v Federal Commissioner of Taxation (1991) 173 CLR 264 at 271.

¹⁸⁹ Brown(note 183above).

¹⁹⁰ Ibid.

¹⁹¹ Ibid.

¹⁹² Ibid.

6.4. Changes in the Law

On the 29 June 2011 the Australian legislation relating to the taxation of capital gains in respect of trusts was changed.¹⁹³ The reason for the changes stem from a number of underlying problems experienced throughout the years. In this chapter I will only focus on the change in the treatment of capital gains and income of a trust in Australia, in so far as it contrasts to the treatment of trusts in South Africa.

One of the significant problems experienced with the Australian legislation was the impact that the legislation had at the time on the tax liability of beneficiaries. As stated above, previously, any gain made would simply be added to the income of the trust and then distributed to the beneficiaries as income. This was seen as a significant problem.

Division 6 of the ITAA 1936 provides for a beneficiary's 'present entitlement' to a share of the income of a trust.¹⁹⁴ This share is then included in the taxable income of the beneficiary.¹⁹⁵ The result of this is that where a trust has a split between beneficiaries, *vis-à-vis*, separate capital beneficiaries and separate income beneficiaries, the beneficiaries who are entitled to a portion of the trust income will inevitably have to pay tax on capital gains made by the trust.¹⁹⁶ This is regardless of the beneficiary's 'present entitlement'.

What this mean is that there is a mismatch between the amount to which a beneficiary is entitled to and the amount on which the beneficiary's tax liability is calculated.¹⁹⁷

In essence, there will be an amount which comprises all the different types of gains and income of the trust which constitutes the taxable income of the trust. It was this amount, under the previous system, which was distributed to the beneficiaries and then taxed in their hands. So if a beneficiary was just an income beneficiary, that beneficiary would have been taxed on an

¹⁹³ Note 177 above.

¹⁹⁴ Brown(note 183 above)

¹⁹⁵ Ibid.

¹⁹⁶ Ibid.

¹⁹⁷ Ibid.

amount which was made up of both capital gains and income. This beneficiary would then be said to have acquired a tax liability on an amount from which he never really receives any benefit.

The problem mentioned above was highlighted in the Australian High Court case of *Commissioner of Taxation v Bamford (2010) HCA 10*.

Bamford essentially dealt with what can be considered to be the income of a trust and the exact share of the said trust income on which a beneficiary will be taxed.¹⁹⁸

At the time of the decision the law required the beneficiaries to include in their taxable incomes an amount equivalent to their share of the income of the trust. A problem arises when the income available for distribution and the income of a trust differ. In such cases the beneficiary is taxed on income which has not been distributed. Hence the amounts on which the beneficiary will be taxed do not correlate to the amount to which they are entitled.¹⁹⁹

The courts disagreed with the contention raised in the case that the beneficiary should only be assessed on the distribution of any income which was in accordance with the trust deed itself. The court was of the view that the actual terms of the trust deed were important in the determination of the income of the trust. The finding of the court was that the net taxable income of a trust should be allocated to a beneficiary in accordance with the share of income which is available for distribution from the trust.²⁰⁰

In response to the decision of the court and in an attempt to simplify how trust income is taxed the Australian ITAA was amended to provide that in instances where the trust deed allows a trustee to stream capital gains²⁰¹ to a beneficiary, then such capital gain will be streamed to a beneficiary and taxed in that beneficiary's hands, even if the beneficiary has not received

¹⁹⁸ Commissioner of Taxation v. Bamford [2010] HCA 10.

¹⁹⁹ Note 19 above.

²⁰⁰ Ibid.

²⁰¹ The new streaming provisions also apply to frank dividend, however I will only be dealing with how these provisions apply to capital gains.

anything. The streaming will only take effect if that beneficiary has acquired a ‘specific entitlement’ to the capital gain.²⁰²

In relation to this, ‘specific entitlement’ will exist when the following two requirements are met. Firstly the entitlement of the beneficiary must be documented in the accounts or records of the trust, as being an entitlement to an amount in relation to capital gain. Secondly there must exist a reasonable expectation on the behalf of the beneficiary to receive some financial benefit in respect of capital gain or the beneficiary must have in fact received it.²⁰³

In cases where there is no such ‘specific entitlement’ then the beneficiary will be taxed on the share of the gain equivalent to his present entitlement to the income of the trust.²⁰⁴ A trustee may also choose to be taxed on capital gain to which no beneficiary is entitled as long as there is no beneficiary which will benefit or has benefited from that gain.²⁰⁵

What should be noted is that one of the requirements for specific entitlement is the ‘recording condition’. What this entails is that any beneficiary who has a specific entitlement to the capital gain must be recorded as having such a specific entitlement in the trust deed, the accounts of the trust and any statements of distribution or resolution statements.²⁰⁶ This entitlement to the capital gain must be recorded in the trust’s records/accounts within two months from the year end in which that gain was actually made.²⁰⁷ Therefore, the starting point would be to establish if the trust deed itself allowed the trustees to stream capital gains, thereafter the trustees would have to ensure that the beneficiary so entitled to the capital gain is in fact specifically entitled to the gain by ensuring that all trust resolutions and records record that that beneficiary is entitled to receive the capital gain.²⁰⁸

²⁰² Note 18 above.

²⁰³ Brown (note 183 above).

²⁰⁴ Ibid.

²⁰⁵ Ibid.

²⁰⁶ Note 18 above.

²⁰⁷ Ibid.

²⁰⁸ Ibid.

This recording condition in essence imposes stricter control over the distribution of capital gains. It ensures that those beneficiaries who are entitled to the capital gain will receive that capital gain. It also makes sure that when distributions are made to beneficiaries, only those that should benefit from the gain receive that gain and the beneficiaries who are not entitled to the gain will only be taxed on their share of the trust income hence resolving the problem experienced previously where some beneficiaries were taxed on composite amounts of income that included capital gains. The trust's income in these instances would be calculated by excluding the capital gains (and frank dividend), and thereafter the beneficiaries who are liable for tax only on that income will be assessed as such.²⁰⁹

In my view the 50% allowance for gains on any asset held for over 12 months is something the South African fiscal authorities should look at adopting to reduce the harsh effect of capital gains tax where the intention of the taxpayer was to hold the asset over a long term.

²⁰⁹ Brown(note 183 above).

CHAPTER 7
THE POSSIBLE FUTURE DIRECTION FOR SOUTH AFRICA

As we have seen there have been drastic changes to the taxation of trusts in Australia and proposed changes to the taxation of trusts in South Africa.

When capital gains tax was implemented in South Africa, the legislation imposed mirrored that of Australia. Over the years Australia has amended its legislation to combat the problems faced with implementing its Act, such amendments, as identified in chapter 6, have changed the implementation of capital gains tax in Australia completely. But is this the route South Africa should follow as well?

When we look closely at the amendments imposed to the capital gains taxation of trusts in Australia, namely the 'streaming of capital gains', one cannot deny the similarity which streaming bears to our present 'conduit pipe principle'. As with South Africa's conduit pipe principle, the identity of the gain is retained after it is passed on to a beneficiary and taxed as capital gain in the beneficiary's hands. Furthermore the Australian taxpayer is taxed on gains to which they have a 'specific entitlement'. This 'specific entitlement' may be said to be similar to our 'vesting' requirement in terms of paragraph 80 of the eighth schedule to the Act which was discussed above. In essence, with both requirements the beneficiary must have an entitlement to the gain, the beneficiary must also have some expectation that he will receive the gain. The entitlement has to be more than an intangible right and must be a right which is certain to materialise (and vest in the beneficiary). Also with streaming and the conduit pipe principle the gain will retain its nature as such in the hands of the beneficiary.

In light of the fact that the amendments to the Australian legislation equates, to an extent, to our present legislation, the possible abolition of the conduit pipe principle which has been proposed by SARS may not be the right way to go for South Africa. There is a possibility that the problems faced by Australia prior to the amendments, which introduce the streaming principle, may in fact be those which South Africa will experience should the conduit pipe principle be done away with.

What should be looked at instead are possible improvements which can be made to our current conduit pipe principle. The imposition of stricter requirements for the application of the principle, such as those imposed by Australia, namely the entitlement and recording conditions. Although in some cases our legislation requires the vesting of a capital gain in order for the beneficiary to be taxed on it, implementing a requirement such as the Australia's recording condition, may combat any abuse of the conduit pipe principle that may be taking place in South Africa. This will also prevent the possible double taxation issue which may arise should the principle be done away with.

Recently South Africa has in a manner followed suit, with the stricter disclosure requirements for trusts. SARS has now issued a new income tax return for trusts (ITR12T), which took effect as from the 3 October 2014. What has change now is the increased and extremely intense disclosures which are required before one even begins to complete the ITR12T. The new form in essence has become customised to the situation which the trust finds itself in.

There are two steps to the process of completing the new trust tax return. Step one is where you will need to capture all the trust details. SARS now requires the trustees to divulge all information relating to the trust, the beneficiaries and trust transactions. The following information will now be required:²¹⁰

- Details of all parties benefiting from the trust, their id numbers and tax information;
- Capital and revenue distribution or vesting of non-taxable income;
- Distribution or vesting of capital or assets;
- Loans granted and received;
- Donations and contributions made or received;
- Distributions received from other trusts or foundations;
- Refunds of contributions made to the trust; and

²¹⁰ J Klein & D Beachen, "new income tax return introduced for trust" (29 October 2014) *ENS Africa*, available at <http://www.ensafrika.com/news/new-income-tax-return-introduced-for-trusts?Id=1613&STitle=private%20clients%20ENSight>, accessed on 30 October 2014.

- The right of use of assets granted.²¹¹

These stringent disclosure requirements will allow SARS to allocate and track all amounts received and distributed by a trust. It will also enable SARS to identify the beneficiaries and their exact tax liability in respect of all receipts from or vested interests in the trust. In this way SARS can monitor the activities of a trust closely so as to identify any misuse or abuse which may arise. Although the steps taken by SARS are stricter than the recording condition imposed by Australia, it can be said that the steps taken by both countries are aimed at achieving the same result.

As expressed in the previous chapter, in my view a positive improvement would be to introduce the Australian 50% allowance for gains on any asset held for over 12 months to reduce the harsh effect of capital gains tax where the intention of the taxpayer was to hold the asset over a long term. This will go a long way to reducing the resistance to capital gains tax which prevails when the taxpayer feels the system of capital gains tax is too harsh.

The intention to hold the asset as an investment and not to profit from a quick sale or disposal is examined, as well as the length of time the asset is held. Prior to the capital gains taxation system South Africa used to apply this 'intention test' to determine whether a profit made on a sale was income or capital.²¹² The test being that if the intention was to hold the asset (based on the period the asset was held) and not to turn over an immediate profit from a disposal of the asset, then any profit made would be deemed to be capital and not income.

The Australian model of reducing the capital gain by a percentage according to the length of time that the asset was owned by the trust may well be an incentive to encourage trusts to invest, which South Africa should consider.

Australia does not have the equivalent of our estate duty which taxes the dutiable estate of a deceased taxpayer. As mentioned above, in South Africa estate duty is levied on the dutiable

²¹¹ Ibid.

²¹² SARS (note 134 above).

value of a deceased taxpayer's estate. The absence of these death duties in Australia (estate duty) therefore allows the Australian fiscus a greater flexibility in legislating and changing existing legislation with regard to income and capital gains tax, without the need to monitor the legislation relating to these taxes to ensure that there is no conflict or double taxation through death duties, capital gains and income tax. Given that the total revenue generated by estate duty in South Africa forms a minor part of the total tax generated for the fiscus, it might also be an idea for South Africa to do away with estate duty and focus on generating extra revenue from income tax and capital gains tax without any fear of unfair or double taxation.

This unfair/double taxation which is inherent in our system of income tax, capital gains tax and estate duty can be seriously onerous on a taxpayer. As highlighted by Barry Ger there are three ways in which double tax may occur, namely:

Assets owned by a deceased person in an offshore jurisdiction could be subject to both estate duty locally as well as whatever death duty is imposed in the foreign country; the assets that form part of the dutiable estate comprise income or assets that were already subject to income tax during the deceased's lifetime; and estate duty overlaps in many ways with capital gains tax. In terms of current legislation both estate duty and capital gains tax are levied on death.²¹³

The doing away of estate duty will eliminate this potential problem of double tax on death in South Africa and hence will eliminate the effect which double tax has of overburdening the taxpayer.

²¹³ B Ger "Time for Estate Duty to go?" *De Rebus, The SA Attorneys Journal*, May 2012, Issue 519, 59.

CHAPTER 8

CONCLUSION

In this dissertation I have examined the many uses of trusts as an essential economic tool in the structuring of an individual's financial affairs and his assets. Trusts have been an important aspect of our commercial world since the concept was imported into South Africa during the 1800's by the British, and over the years trusts have evolved into a sophisticated legal entity with some of its core functions and effects outlined herein.

The use of these sophisticated commercial entities have ranged from providing protection of assets from creditors to the provision of a succession plan for the continuity of one's hard earned assets to secure their future benefit and enjoyment for oneself and one's descendants and successors in title. Among the many uses is the important use of trusts as a means to reduce the impact of taxation on one's income and assets, or in some instances, to simply avoid tax in one way or another.

This evolution of the early trusts and its legal and tax treatment in South Africa has resulted in the complex tax legislation discussed briefly in this dissertation, with an emphasis on the capital gains taxation of trusts. The application of the tax legislation of trusts is a dynamic process, as the various changes and proposed changes discussed herein indicate.

A trust for tax purposes is a taxpayer on its own right. As such the various applications of tax legislation are wide and far reaching. For example

- The provisions of section 7 read with section 25 of the Act determine who will be taxed on the income received by a trust.
- Section 7 sets out instances in which the donor will be liable for tax. Section 25 provides for instances in which the beneficiary acquires a vested right to the income of a trust or to a portion thereof, in such cases the beneficiary will be liable for the tax. In any other case it is the trust itself which will have to pay the tax on the income at a rate of 40% on the trust's taxable income.

With the advent of capital gains as part of our taxation legislation, the eighth schedule to the Act lays out how capital gains tax applies to the transactions of a trust. These provisions are similar to those set out in sections 7 and 25 of the Act and, as with income tax, it is either the donor, the beneficiary or the trust itself which will be liable for the capital gains tax. This would mean that the capital gain will either be taxed at an inclusion rate of 66.6% in the hands of the trust or 33.33% in the hands of the donor or beneficiary.

As discussed above, trusts are taxed on a higher rate than individuals. We have been through the relevant sections of the Act and the implications of those sections step by step. Both the capital gains and income tax consequences of using a trust have been highlighted. So given these tax consequences which impact on trusts, the question is whether, in an estate plan of an individual is it better to hold assets in a trust?

From my experience in estate administration and estate planning the answer to that question may in fact be case specific. What one hopes to achieve from the estate plan will play a large part in the impact that a trust has in minimising the impact of taxation and specifically capital gains tax, on the income and capital appreciation relating to assets held in a trust.

When it comes to capital gains tax the salient feature of holding an asset in a trust is that it contains or ring fences the increase in the value of a growth asset for as long as it is held in the trust. As the trust will not pay any estate duty on the death of the taxpayer concerned, the value of the asset held in the trust and the growth in that value since its transfer to the trust will have no impact on either the taxpayer's estate, or the trust. Similarly, the transfer of a growth asset from the individual into a trust at a low value lessens the impact of capital gains tax and estate duty for the taxpayer, as capital gains tax and estate duty will be levied on the lower value of the asset when it is transferred to the trust by the taxpayer, as opposed to a higher value in the future if he retained the asset at the date of his death and then transferred it to the trust after his death. Many individuals who have growth assets are invariably advised to take advantage of this by moving asset from their personal estates into a trust at an early stage.

Recently there have been regular reports and speculation around doing away with estate duty and the conduit pipe principle. However, it does not seem as though Treasury will go forward with any of the proposed plans to dispense with estate duty or the conduit pipe principle. The silence with regard to the doing away with the conduit pipe principle in the 2014 budget speech is evidence of this. Perhaps this is a positive omission with regard to changes in recent tax legislation. Research and studies of the Australian approach to these two aspects of taxation indicate that the main lesson to learn from Australia is not so much what they have done in recent years but rather the problems which they have experienced through these years which warranted corrective actions through a series of amendments to their initial approach. In light of the proposed changes to our treatment of trusts the stance to take may be one of asking ourselves whether the changes we want to make will also create similar problems for our system which will saddle us with a series of amendments and the uncertainty which goes along with that.

For instance, if South Africa does away with the conduit pipe principle, the effect would be the one experienced by Australia before the streaming of capital gains was implemented. The income which is eventually distributed to the beneficiaries will be a compilation of all the different types of receipts of a trust. Again, as stated above, the result might be that beneficiaries may be taxed on amounts which they do not benefit from (assuming that these distributions are not tax free).

What merits noting is that at present the benefit of using the conduit pipe principle for income is confined to its application to the lower income earning individuals by redirecting income from the beneficiary with the higher income who is taxed at a higher tax rate. This also avoids retaining the income in the trust at a similar high rate of taxation (40%). The doing away of the conduit pipe principle will therefore eliminate this avoidance of higher taxation on income retained by the trust by redirecting income to the beneficiaries on a lower rate of taxation.

Similarly with regard to capital gains, the redirecting of a capital gain in a trust to the individual beneficiary to benefit from the lower effective rate of 13.3% as opposed to the effective rate of capital gains tax in the hands of the trust (26.6%)

The likelihood of the proposed changes being implemented in the immediate future seems slim. However the recent implementation of the new tax return which requires more stringent administration of the trust and imposes greater control over the flow of receipts and accruals into a trust as well as the portion of these distributed to beneficiaries indicate that these additional disclosures are the forerunner of changes to come in the medium to long term. This element of increased control through requiring full disclosure seems to be SARS way of trying to curb the problems faced with the misuse of trusts and tax avoidance inherent in the existing system which includes the conduit pipe principle. This change is also similar to the recording condition imposed by Australia.

Similarly the proposed doing away with estate duty seems to be a medium to long term plan primarily because although estate duty makes up a very small portion of the contributions to the fiscus as a whole there is a possibility of the removal of estate duty causing a ripple effect, for instance the possibility of having to also look at doing away with donations tax. This may require a more cautious approach by SARS.

In this dissertation the use of trusts in estate planning was discussed with an emphasis on the taxation of trust at the present time. The proposed and potential changes in the taxation of trusts were discussed with an overview of the Australian model.

Until our current legislation is changed tax practitioners are obliged to plan and advise and structure the taxpayer's estate with regard to the current tax position on income and capital gains for trusts registered as South African trusts and taxpayers. However, given the dynamic position of tax legislation in South Africa it would be prudent for the advisor to take note of the potential and proposed changes and where possible to structure the estate plan with adequate flexibility so as to cater for the proposed changes in the structure when the changes come into effect.

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