The Common Law Conduit Pipe Principle: Should we retain this principle in our South African law?

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Submitted in partial fulfilment of the requirements for the degree of

Master of Laws (Taxation)

At the

University of KwaZulu-Natal

College of Law and Management Studies

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2018

DECLARATION

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ACKNOWLEDGEMENTS

"Reading furnishes the mind with the materials of knowledge; it is thinking that makes what we read ours." John Locke

- To my beloved son and daughter Minenhle and Sisanda Magasela, I dedicate this piece of work to you and wish that it inspires you to be the best at what you do for the rest of your lives. All is possible if you believe in yourself!

- I wish to extend my profound and sincere thanks to my supervisor Mr Christopher Schembri. I reserved special thanks for you because without your belief in me and your consistent patience I would never have successfully finished my journey. Once again, thank you!
- My thanks also go to Professor Shannon Bosch and Doctor Caroline Goodier for teaching me the valuable skills needed to both conducting and writing a meaningful legal research project. Without this knowledge I would also not have been able to successfully complete my research project.

- Last but not least, I thank everyone who had faith in me and encouraged me to soldier on in the face of all challenges I faced. It is because of your support that I was able to emerge victorious!

ABSTRACT

More than a decade has passed since the ‘common law conduit pipe principle’ was introduced into our South African law of taxation. Following this introduction in 1938, a trust has in some situations operated as a retainer or saver of the identity of certain types of amounts from the point the trust receives each amount type up until that amount exits the trust. Consequently these amounts are not exposed to normal tax even when they finally reach the hands of their beneficial owner. This principle was later incorporated into the Income Tax Act 58 of 1962 by the insertion of both section 25B and para 80 of the Eighth Schedule to that Act. With the passage of time and taxpayers becoming more and more knowledgeable and consistently strategizing new ways of avoiding triggers of certain types of taxes, they realised that the conduit pipe principle could easily be manipulated within a discretionary trust to obtain various tax benefits. As a result of these tax benefits the use of discretionary trusts in South Africa is constantly on the rise. However, their continued use was first brought into question after the 2013 National Budget speech in which it was indicated that these types of trusts would no longer operate as a conduit pipe. This suggested the repeal of section 25B and para 80 of the Eighth Schedule.

The doing away with the conduit pipe principle in our law of taxation has necessitated the imposition of the question whether its real purpose and value is properly understood. The National Treasury and SARS do not appear to fully comprehend this purpose – the purpose seems to be to facilitate the avoidance of normal tax. Hence the aim of this study is to attempt to determine the true purpose and value of this principle within our tax law system. This study realises this objective by embarking on an in-depth analysis of *Armstrong v Commissioner for Inland Revenue* 1938 AD 343 which introduced this principle into our South African law of taxation. This study successfully found that the true purpose of the ‘conduit pipe principle’ is to rule out the possibility of double taxing the amount which has already suffered the consequences of tax at its originating source when it subsequently lands in the hands of its beneficial owner. This means that through the conduit pipe operation of a trust there is assurance that each identity of amount is protected against being lost between the time that amount is paid to the trust and the time the

trust pays it over to the beneficiary who will also take advantage of the exempt status of that amount in his hands. This tax benefit is only available if the amount is paid over in the year of assessment during which the trust received it – otherwise it gets caught up in the normal tax net in the beneficiary's hands. Trustees successfully escape this trap by insisting on making this payment within the same tax period the trust received the amount.

The study also looked at the current normal tax treatment of the income that is inclusive of both local dividend(s) and interest from investment(s) and analysed the tax impact these types of amount have on reducing the taxable income of both a discretionary trust and its beneficiary. A comparison was made from a current income tax treatment point of view with the hypothetical time when the conduit pipe principle is finally abolished. It was discovered that beneficiaries of these types of trusts would be taxed more than they are currently being taxed as the dividends and basic interest exemption under the Income Tax Act 58 of 1962 would no longer be available to them. A discretionary trust would no longer be an ideal tool to use in a tax avoidance strategy but will still be a good shelter for the protection of assets. This study further concludes that the conduit pipe principle should be retained in our law because it abolition was apparently recommendation on the basis of its true purpose being misunderstood for tax avoidance rather than avoidance of imposing double tax on an amount that has already been taxed at its source.

KEYWORDS

Conduit pipe principle, discretionary inter *vivos* trusts, normal tax liability, tax avoidance, dividends, interest income, exempt income, beneficiaries, trust income, trusts liability, Income Tax Act, Davis Tax Committee**.**

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CHAPTER 1

1. Introduction and research overview

In South African law of taxation there is a common law principle called the conduit pipe principle.[1] This principle was introduced into our jurisdiction in 1938.[2] Since its introduction, it has received a lot of attention and provoked a lot of controversy. This principle was first mentioned in *Armstrong* which introduced it into South African law.[3] The court in that case held that in the event the trust income is derived from dividends received from companies charged with normal tax under the fiscal legislation, the fact that the trustee (as a representative taxpayer) intervenes between the beneficiary receiving such income of the trust and the companies paying that dividend is no bar to the beneficiary claiming a section 10(1)(k) exemption in terms of the Act when that dividend is later paid by the trust to that beneficiary.[4] The effect of the conduit pipe principle as expressed in *Armstrong* is that an exempt amount will not part with that status merely because that amount first passed through the trust before reaching the beneficiary and that status will remain even if the trust chooses to pay that amount out of its income, for example as an annuity – the exemption is still available.[5] Although *Armstrong* was decided in1938, the principle still applies today. The rationale of this principle seems to be that an amount should not lose its identity when passing through the trust to the beneficiary. If an amount is exempt from normal tax when paid to the trust it will, subject to certain exceptions, retain this identity when paid to the beneficiary. The fact that the beneficiary thereof received it through a trust does not convert it into a taxable receipt in his hands. Even though the amounts received by the trust may be composed of different sources of income, as long as each type of amount remains identifiable in the hands of the beneficiary, all the expenses that are associated with

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[1] *Armstrong v Commissioner for Inland Revenue* 1938 AD 343 (hereinafter referred as '*Armstrong*'). See also Cliffe Dekker Hofmeyr Capital Gains Tax 1951. Trusts conduit pipe principle May 2011 - Issue 141: Available at https://www.saica.co.za/integritax/2011/1951_Trusts_conduit_pipe_principle.htm (Accessed on: 29/07/2018).

[2] *Armstrong* 348-349.

[3] Ibid.

[4] Ibid.

[5] Stiglingh, M…et al *Silke: South African Income Tax* (2017) 831.

it may be claimed proportionately by the beneficiary when that income is later distributed to the same beneficiary - the principle will equally apply.[6]

As with all other principles, it was desirous that the conduit pipe nature of a trust be limited in the sense of imposing a qualification on its operation. Hence the original identity of the amount can only be preserved if the trustee(s) distribute it to the beneficial owner within the tax year it arose.[7] Thus If no distribution takes place within that tax year the principle will not apply and that amount will take on a new identity subjecting it to a different tax treatment. The reasoning of the court in *Armstrong* was followed in *Polonsky*[8] in 1942. In that case the court made mention of the purpose of the conduit pipe principle for the second time, remarking as follows:[9]

"In short, therefore, I rise from a perusal of the will and the facts of the stated case with a conviction that the balance of the income retained by the trustees belongs to the respondent's wife and to no one else; that the trustees are no more than a conduit pipe and have no material interest in her income."

This means the role and purpose of the trustee is, hypothetically speaking, like that of a bridge serving no other purpose other than allowing for the 'crossing over' of the income distributed from one side to the other. The operation of this principle enables taxpayers to pass on their normal tax liability to their beneficiaries who are often taxed at a low rate and enjoy a variety of tax exemptions.[10] Apparently, this is one of many other tax benefits inherent in the application of this principle which led to its eventual legislative incorporation into our law.[11] Although this principle has been strong enough to survive in our law of taxation which is characterized by its ever-

[6] *Armstrong* 349-351.
[7] Ibid, 832.
[8] *Commissioner for Inland Revenue v Polonsky* 1942 TPD 249 (hereinafter referred as *'Polonsky'*).
[9] See *Polonsky* supra at 248.
[10] Brink, S.M., 2017, 'An investigation into the future of discretionary trusts in South Africa: An income tax perspective: Part 2', *South African Journal of Economic and Management Sciences* 20(1), a1789. https://doi.org/10.4102/ sajems.v20i1.1789 6 (hereinafter referred as 'Brink'). See also R Swart *Tax benefits of discretionary trusts: abolishment of the conduit pipe principle* (Unpublished LLM Dissertation, North-West University, 2015) 2.
[11] Section 25B and Paragraph 80 of the Eighth Schedule to the Income Tax Act 58 of 1962, as amended (hereinafter referred as 'Act 58 of 1962'). See also R Swart *Tax benefits of discretionary trusts: abolishment of the conduit pipe principle* (Unpublished LLM Dissertation, North-West University, 2015) 23-36.

changing tendencies and complexities its future is unclear. The Davis Tax Committee[12] after having conducted an investigation into how taxpayers exploit discretionary trusts to achieve tax avoidance,[13] through the manipulation of both estate duty and donations tax, recommended that this principle should be abolished.[14] This abolition was recommended specifically in relation to 'discretionary trusts'. Many questions have subsequently arisen questioning the use of these trusts in future and their taxation in our law leading to academic research being undertaken with a view to answering these questions.[15] Before these studies[16] were done, an analysis[17] intending to clarify some of the crucial aspects regarding the then proposed amendments to the taxation of trusts was undertaken to investigate, among other issues, if without the conduit pipe principle, 'discretionary trusts' will still remain an effective estate planning tool in the future. By the 'future' it is meant the time when this principle is no longer part of our law. Brink's article was based on the 2013 National Budget Speech trust reform proposals[18] and it concluded that those proposals were to be interpreted to mean the scrapping of the conduit pipe principle in section 25B and para 80 of the Eighth Schedule in the Act and the attribution rules in section 7. Although the 2013 National Budget Speech on trust reform by the then Finance Minister Pravin Gordhan will not be analysed in this dissertation, reference to it remains relevant as it formed the background leading to the recommendations for the abolition of the conduit pipe principle by the DTC in 2015. Occasional reference thereto cannot be avoided in this dissertation.

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[12] On 17 July 2013 the Minister of Finance, Mr Pravin Gordhan, announced the members of the Tax Review Committee (the Committee) as well as the Committee's Terms of Reference. This gave effect to the Minister's previous announcement in February 2013 when he tabled the 2013/14 Budget that government will initiate a tax review this year "*to assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability*". It was decided at the inaugural meeting of the Committee on 25 July 2013 that the Committee will be known as The Davis Tax Committee (DTC).

[13] See M Loubser '*A Case Study Analysis of the Impact of the Davis Tax Committee's First Interim Report on Estate Duty on certain Trust and Estate Planning Structures Used by South African Residents'* (Unpublished M Com Dissertation, University of the Witwatersrand, Johannesburg, 2016) 2-3.

[14] Ibid.

[15] SM Brink & LC Willemse *'An Investigation into the Future of Discretionary Trusts in South Africa –An Income Tax Perspective'* Journal of Economic and Financial Sciences | JEF | October 2014 7(3), pp. 797-818 (hereinafter referred as 'Brink & Willemse'). See also M R Hussain *Taxation in South Africa and the use of Trusts as an Effective Estate Planning and Tax Saving Mechanism* (Unpublished LLM Dissertation, University of KwaZulu-Natal, 2015), see also R Swart *Tax benefits of discretionary trusts: abolishment of the conduit pipe principle* (Unpublished LLM Dissertation, North-West University, 2015).

[16] Ibid.

[17] Brink & Willemse *(supra*) 797-818.

[18] Brink (*supra*) 3.

Interestingly enough, on 24 August 2016 the Second and Final Report on Estate Duty by the DTC was released and whilst it relaxed certain of the initial recommendations made in its First Report, it still maintained the repeal of both section 7 and the conduit pipe principle embodied in the relevant section and paragraph.[19] The DTC's recommended tax treatment of discretionary trusts is summarized as follows:

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[19] See section 25B regarding the taxation of the income of trusts and beneficiaries of trusts. This section provides as follows:

(1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to the trust.

(2) Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant deed of trust, agreement or will of a deceased person, that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary.

(3) Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any amount referred to in subsection (1), must, to the extent to which that amount is under that subsection deemed to be an amount which has accrued to –
(a) a beneficiary, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary;
(b) the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that trust. See also paragraph 80 of the Eighth Schedule to the Act 58 of 1962. This paragraph deals with the taxation of capital gains of a trust and it provides as follows:
(1) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary (other than any person contemplated in paragraph 62(a) to (e)) who is a resident, that gain –
(a) must be disregarded for the purposes of calculating the aggregate capital gain or aggregate capital loss of the trust; and
(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of.
(2) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than any person contemplated in paragraph 62(a) to (e)) who is a resident has a vested interest or acquires a vested interest (including an interest caused by the exercise of a discretion) in that capital gain but not in the asset, the disposal of which gave rise to the capital gain, the whole or portion of the capital gain so vested-
(a) must be disregarded for the purposes of calculating the aggregate capital gain or aggregate capital loss of the trust; and
(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the gain vests.

(a) That the income of this type of trust must be assessable to tax in the hands of its beneficiary if it is clear from the provisions of the trust deed itself that the income as well as the capital is vested in the said beneficiary; and

(b) If it is also clear that both such income and capital are not so vested the definition of 'gross income' in section 1 of the Act must be used to identify the hands in which such income and capital is to be assessed for normal tax purposes.

The purpose of this dissertation is not to investigate the future of the discretionary trusts in South Africa. This dissertation will only examine the conduit pipe principle. It will attempt to answer the question whether this principle should be retained in our law or not by investigating its true purpose. It is clear that the abolition of this principle will, to a certain extent, limit the attractiveness that these types of trusts enjoy.

1.1 Purpose of the study

This dissertation will analyse *Armstrong* in depth with the main objective being the full comprehension of the purpose and value of this principle in the South African law. Then this dissertation will examine the link between this principle and the use of discretionary trusts. This link will be examined in order to determine if tax avoidance is incidental to the functioning of this principle or whether it is the main purpose that this principle is intended to serve, hence warranting the understanding that both the Fiscus and the Treasury have of it.

As far as the abolition of the conduit pipe principle is concerned the reasons advanced by the Fiscus and the National Treasury seem to support the conclusion that they have little apprehension of what the purpose of the conduit pipe principle is in our law. Thus the aim of this dissertation is to investigate this purpose. This purpose will then be used to answer the core question of this study – whether we should retain this principle in our law? Although the current tax treatment of discretionary trusts will be analysed in this dissertation, this will only be done in order

to clearly illustrate the hypothetical scenarios that will arise if the conduit pipe principle is done away with.

1.2 Research methodology

The research methodology that this dissertation will adopt is desk-based. It will be a purely qualitative analysis of tax cases in which the conduit pipe principle was applied by the courts of law, legislation to the extent that it deals with the conduit pipe principle and literature on the subject of the taxation of trusts.

1.3 Scope of the study

The analysis of case law, legislation and literature will only be limited to South African taxation law. Although the purpose of this study is not on the study of discretionary trusts and how they are taxed, these trusts will be examined only to the extent that it is necessary to demonstrate the application and functioning of the conduit pipe principle.

1.4 Chapter outline

This dissertation will consist of five chapters. Chapter one will be an introductory chapter. It will focus on the introduction and the general overview of the research problem. Chapter two will contain the historical development of the conduit pipe principle and examine its purpose in South African law as expressed in *Armstrong*. It is in this chapter that the true purpose of the conduit pipe principle will be examined and the answer to the research question in paragraph 1.1 (above) be provided.

Chapter three will look at what is a discretionary trust and what are the reasons for creating this trust. Chapter four will examine the current taxation treatment of this type of trust focusing on the current income tax benefits to beneficiary arising from the application of the conduit pipe principle. It will then examine if this trust will still retain those tax benefits should the conduit pipe principle be abolished in our law. Chapter five will contain the conclusion of this dissertation. This will be the conclusion from the discussions in the preceding chapters.

CHAPTER 2

2.1 Introduction

Chapter 1 gave a brief discussion of the introduction of the conduit pipe principle into our domestic law. It also gave a historical overview of how this principle developed through case law to what it is today. As was pointed out in that chapter this dissertation will attempt to provide clarity as to the real purpose of this principle in our law. This chapter will only be devoted to investigating this purpose. This purpose will be determined by discussing and analysing *Armstrong* in depth and focusing on the rationale behind the court's judgment in that case. This rationale will suggest the real purpose of this principle. As will appear from the following analysis of *Armstrong* only what is relevant for the purposes of this chapter is discussed and analysed.

2.2 Historical development of the Conduit Pipe Principle in South African Law

2.2.1 *Facts in Armstrong*:[20]

Mrs Armstrong survived her husband Mr G. S. Armstrong who died testate in 1934. Mr Armstrong's assets in his estate were a mortgage bond, share investment and landed property. His Will entitled Mrs Armstrong to receive the net income of the residue of his estate for her lifetime. This right to receive this amount was then ceded by her to her three daughters in undivided equal shares in July 1935. On this very day her daughters executed a trust deed in which they ceded their rights (initially Mrs Armstrong's) to this trust. This trust was directed that an annual payment of £2, 000 must be made to Mrs Armstrong after the trustees have paid income tax on it. The trust further provided that if a balance still remained after this annual payment £100 is to be paid to another beneficiary. If a balance still remained another beneficiary was to be paid £50 and the last beneficiary was also to be paid £50 if a balance still remained after all these payments had been made. At the end of the tax year 30 June 1936 the trust had gross receipts of £4, 580 0s. 7d. of which £ 2, 773. 0s 6d

[20] *Armstrong* 345-347.

was from dividends. The trustees accordingly paid Mrs Armstrong £2, 000 and withheld £ 469 16s. 11d. as income tax payable on it. However, her tax return showed that her income was £ 2, 469 16s. 11d and was made up as follows: £1, 495 7s. 10d. was derived from dividends and £974 9s. 1d. was derived from rents and interest. The Commissioner included the whole £2,469 16s. 11d in her income. Mrs Armstrong objected to this inclusion and appealed against it to the Special Court for Hearing Income Tax Appeals on the ground that as £1,495 7s. 10d. of this sum represented dividends was exempt from normal tax under section 10(1)(k) of the Income Tax Act 40 of 1925 and had to be excluded in the calculation of her taxable income.

The Special Court correctly held that to the extent that the taxpayer's income could be apportioned to each separate source from which it was received, section 10(1)(k) of the 1925 Act as claimed by the taxpayer was indeed applicable to the dividends portion of the income.[21] Hence an amount of £1,495 7s. 10d.of the £2,469 16s. 11d was exempt from normal tax.[22]

The Commissioner felt that the Special Court's decision could not be correct in law and requested that the following questions be stated for the consideration of the Natal Provincial Division:[23]

"...(2) Whether the amount of £2,469 16s. 11d. must be allocated over the three heads of revenue from which the Estate late G. S. Armstrong derived its income for the year in question.

(3) Whether the amount of £1,495 7s. 10d. being the proportion of the said amount of £2,469 16s. 11d. which was allocated to dividends on the basis referred to in the preceding subparagraph, was derived by the taxpayer by way of dividends, and

(4) Whether the exemption under section 10(1)(k) of the Act 40 of 1925 applies to £1,495 7s. 10d."

[21] Ibid, 346.
[22] Ibid.
[23] Ibid, 346-347.

The Natal Provincial Division answered the above questions in favour of the Commissioner. Mrs Armstrong escalated this decision to the Appellate Division. The decision of this court is discussed in the following paragraph.

2.2.2 Analysis of the Appellate Division's Judgment

It was clear form these questions that the Commissioner sought to tax the whole £2,469 16s. 11d as income in Mrs Armstrong's hands. The Appellate Court stated that the most important question in the present case was to determine whether £1,495 7s. 10d. properly fell within section 10(1)(k),[24] and how the trust itself, paying this amount, had been brought into being was not important.[25] The provisions of section 10(1)(k) that were relied on by Mrs Armstrong both at the Special Court and Natal Provincial Division are that dividends received from any company must be exempt.[26] The Natal Provincial Division decided that Mrs Armstrong could not succeed in this argument for the following reasons, namely, (a), section 10(1)(k) required a direct relationship between the company paying the dividend and the person receiving the dividend; and (b), Mrs Armstrong could not sue the company for the payment of the dividend because she received that dividend through the trust created by her daughters and hence the required direct relationship between her and the company was thus absent.[27]

The Appellate Division was of the following view regarding the above reasons of the Natal Provincial Division:[28]

"[T]he crux of the question lies in the simple fact of the intervention of a trustee between the companies and the appellant. It was this intervention which the Provincial Division considered fatal to the claim for exemption under section 10(1)(k)."

[24] Ibid, 347.
[25] Ibid.
[26] Ibid.
[27] Ibid, 348.
[28] Ibid, 347.

The Appellate Division, per Stratford, C.J. refused to accept the reasoning of the Natal Provincial Division. This reasoning was irreconcilable with the purpose behind section 10(1)(k) which clearly required the consideration of the Act as a whole.[29] The reasoning of the Natal Provincial Division was clearly not in line with this purpose. According to the Appellate Division, this purpose of section 10(1)(k) could be understood by making a supposition that Mrs Armstrong was the only beneficiary of the trust and the income of this trust was received by the trustees solely from the companies.[30] If it was then assumed that the reasoning of the Natal Provincial Division reflected the correct construction of this section, the intervention of the trustee between the companies and Mrs Armstrong is what prevents the latter from claiming the exemption and making it possible for the Commissioner to tax the same amount twice.[31] This supposition really exposed the incorrectness in the line of reasoning that was adopted by the Natal Provincial Division.

The fact that Mrs Armstrong could not sue the companies for the payment of dividends could not be used as a yardstick to determine if she fell within the section or not.[32] Accepting this test would defeat the purpose of the section because this would mean if a trustee is put in the company's register as a shareholder on behalf a minor the company could not be sued as the companies do not recognise a shareholder registered in a representative capacity.[33] The Appellate Division had the following to say in this regard:[34]

"…consequences of this kind do not accord with the scheme of the Act which clearly is that income derived from companies should, in the hands of the true recipients of it, be free of the tax which has already been deducted at the source."

Thus what is decisive for claiming the exemption is not the physical receipt of the dividend itself but the source - as the purpose of the section is to free from normal tax

[29] Ibid, 348.
[30] Ibid.
[31] Ibid.
[32] Ibid.
[33] Ibid.
[34] Ibid.

what has already been taxed at the source.[35] It is interesting how the 'representative nature of a trustee' was analysed by the Appellate Division in justifying its construction of section 10(1)(k).[36] Although it is the trustee that receives the amount and eventually distributes it to the beneficiary, that amount is in truth received by the beneficiary from the company.[37] This is so because that dividend amount is largely depended on the performance of the company – if it makes profit or not.[38] The 'trustee' can neither increase the company profit nor decrease it because in truth a trustee is nothing but a 'conduit pipe' and his or her interposition between Mrs Armstrong and the companies could not bar her from falling within section 10(1)(k).[39] Neither could the fact that she received a fixed annual amount, nor the fact that such annuity was paid out of income that was made up of amounts derived from different sources could bar her for claiming the exemption. The Appellate Division held the following view:[40]

"Though the appellant is to receive a fixed amount out of the fund in any one year that amount must be a certain ascertainable fraction of the whole fund distributable and, therefore, apportionment can be calculated on the ratio principle just as simply as if she were given a fraction of the fund."

Mrs Armstrong's appeal was accordingly allowed and the decision of the Natal Provincial Division reversed.

*2.*2 The purpose of the conduit pipe principle

As appears from the facts in *Armstrong* in paragraph 2.1.1 (above) the income of a trust is rarely composed of a single type of amount.[41] This means that it is often made up of different types of amounts. Some of these amounts are exempt from normal tax and some are not. Those which are exempt are not included in the

[35] Ibid.
[36] Ibid, 348-349.
[37] Ibid, 349.
[38] Ibid.
[39] Ibid.
[40] Ibid, 351.
[41] Ibid, 346-347.

calculation of the taxpayer's taxable income while those that are not exempt must be included. With their different identities these amounts all go into the same 'pool', namely the trust. The question that arises is what happens to their identities when they go into this pool and later go out – do they each retain their original identity or do they lose it and adopt a different one? This was clearly the issue in *Armstrong*. The Commissioner believed that when an amount that is exempt from normal tax together with one that is not exempt goes into the trust the exempt amount gets contaminated by the non-exempt amount with the result that both amounts become subject to normal tax.[42] This belief suggested that the amount of £1, 495 7s. 10d. derived from dividends was to be subject to normal tax as it had been mingled in with the other funds of the trust, with £974 9s. 1d. derived from rents and interest which were subject to this type of tax. The argument against the inclusion of £1, 495 7s. 10d. in the taxable income of the Mrs Armstrong was that the moneys paid to the estate of the late Mr Armstrong remained identifiable as such in her hands[43] and it was immaterial how many persons were interposed between the respective companies and herself, provided such persons received the moneys in a representative capacity and received no beneficial interests therein, as they are and were purely conduit pipes and administrative pegs, whose function is and was to pass on dividends less expenses of administration.[44] The court agreed with this argument by the taxpayer and pointed out that the crux of the question lay in the simple fact of *the intervention of a trustee between the companies and the appellant*.[45] It was this intervention which the Provincial Division considered fatal to the claim for exemption under section 10(1)(k).[46] With regard to this *'intervention'* the court held that "in the truest sense the beneficiary derives his income from the company, for that income fluctuates with the fortunes of the company and the trustee can neither increase nor diminish it, because he is a mere 'conduit pipe'."[47] This clearly suggests that the trustee is just a hand that receives the money from the source and hand it over to its rightful owner. And nothing more! This suggestion is

[42] Ibid.
[43] Ibid, 344.
[44] Ibid.
[45] Ibid, 348.
[46] Ibid.
[47] Ibid, 349.

supported by the analysis of the true legal nature of the role of the trustee(s) of a trust. As to the normal tax liability of a trustee the court held as follows:[48]

"He is liable to pay the tax "as if the income were income received by .or in favour of him beneficially." He is entitled, however, to the deductions, etc, that his cestui que trust is allowed and also he is entitled to be indemnified by the latter. On these provisions the Trustee could not be assessed on dividends derived from companies whatever test be applied. Now we cannot suppose that the Legislature had in mind two measures of taxable income, one when the Commissioner elected to tax the representative and another if the beneficiary was taxed. So that in contemplation of the Act when the beneficiary is taxed instead of the representative it is on the basis of his receiving directly what he in fact gets through the medium of his representative."

It follows from this passage that the trustee is entitled to utilise any exemption that the relevant Income Tax Act attaches to any type of amount the trustee receives so long that he or she does so in his or her representative capacity only. This means that the exemption is claimed in the name of the beneficiary and consequently the amount will therefore be exempt in the hands of that beneficiary when later distributed to him or her. This approach by the court reinforced the notion against double taxation that would have resulted if the court had held that the intervention of a trustee prevents the beneficiary from the claiming of the exemption under section 10(1)(k) of the Act owing to the taxpayer not having received the dividends 'herself' or directly from the companies.

Where the income of a trust is derived from dividends received from companies chargeable with normal tax under the Income Tax Act 40 of 1925, the fact that the trustee intervenes between the beneficiary receiving the income of the trust and the companies is no bar to a claim by such beneficiary of the section 10(1)(k) exemption thereon.[49] Even if the income of the Trust is derived partly from such dividends and partly from income liable to normal tax and is divisible among a number of beneficiaries, each beneficiary is entitled to claim exemption for a proportionate

[48] Ibid.

[49] Ibid, 350.

amount of the total income received from the trustee.[50] The fact that the trustee distributes a balance after paying expenses and deducting commission does not affect the position, for such expenses are to be apportioned to the income in respect of which the expenses were incurred or, if incurred in connection with both kinds of income, proportionately to each kind of income and the principle applied even though Mrs Armstrong, instead of receiving a fraction of the total income, receives a fixed amount out of the income each year.[51]

From the above analysis it is clear that that the real purpose of the conduit pipe principle can briefly be summarized as follows: (1). Amounts retain their individual identity when they go into the trust and retain these identities up to the point they reach their beneficial owner; and (2). As long as the beneficiary is to receive an ascertainable portion of the income of the trust that is composed of income from different amounts, exempt and those that are subject to normal tax, the rules relating to apportionment will always apply.

2.3 Confirmation of the conduit pipe principle

As regards the tax liability of the trustee of a trust specifically, the court in *Polonsky* confirmed the 'conduit pipe' nature of a trust holding as follows:[52]

"…in terms of sec. 49(1) every representative taxpayer shall be liable to assessment in his own name in respect of that income, but any such assessment shall be deemed to be made upon him in his representative capacity only. As a general rule the representative taxpayer defined in sec. 48(c) would be liable to assessment in respect of income of persons' who cannot be taxed direct…"

The court in *Armstrong* also had to interpret section 48(c) of the Income Tax Act 40 of 1925. In that case the court held that the trustee is liable to pay the tax only to the extent that it is assumed that the income received by him is his own and as

[50] Ibid.
[51] Ibid.
[52] *Polonsky* 252-255.

compensation he is entitled to the deductions and exemptions that his *cestui que* trust is allowed and also to be indemnified by the latter. As appears from the quote above, *Polonsky* took this interpretation a step further holding that the only time a representative taxpayer is liable is in respect of persons' who cannot be taxed direct and in cases where the beneficiaries of the trust income are uncertain.

2.*4* The conduit pipe nature is not absolute

In our law the operation of the conduit pipe principle is qualified. The qualification is that the nature of an amount received as a dividend by the trustee must exit the trust within the tax year of its receipt.[53] The court in *Rosen*[54] meant this when it said the follows:[55]

"…a trust deed may bestow the trustee with a discretion to pass on dividends to the beneficiary or to retain and accumulate them. If he decides on the latter, I think(but express no firm view) that the dividends, so that, if they are subsequently paid out to the beneficiary, they might possibly no longer be dividends in his hands, for the conduit-pipe had turned itself off at the relevant time. But if he decides on the former, i.e. to pass the dividends on to the beneficiary, the condition suspending the beneficiary's entitlement thereto is fulfilled, and they would constitute dividends in his hands in the same way as if he had been originally entitled to them unconditionally under the trust deed…"

From the above it follows that unless a distribution takes place in the same tax year that dividend is received, the identity or character of that dividend cannot be saved. In the subsequent tax year it will have turned within the trust and assumed a new identity triggering the normal tax consequences in the hands of the beneficiary. This suggests that the conduit pipe principle is limited in its application and does not apply where a receipt of a dividend takes place in the present tax year and its distribution to the beneficiary takes place in the following tax year. It is noteworthy that the conduit pipe principle will still apply even if the beneficiary receives an annuity from

[53] Stiglingh, M…et al *SILKE: South African Income Tax* (2017) 832.
[54] *Secretary for Inland Revenue v Rosen* 1971(1) AD (hereinafter referred as '*Rosen')*.
[55] Ibid, 190.

the trust the income of which is solely made up of dividend income.[56] The beneficiary will still be receiving a dividend. That annuity is regarded as a dividend in the beneficiary's hands for normal tax purposes.[57]

2.5 Conclusion

The aim of this chapter was to investigate the real purpose of the common law conduit pipe in South African law by critically looking at how the court established this principle. *Armstrong* was used mainly because this is the case that introduced the principle into our law. From the analysis of this case it was found that the real purpose of this principle is to prevent the incident of taxing the same amount twice by preserving its identity when passing through a trust until it reaches the beneficial owner and that the existence of a trust through which the amount is paid does not prevent the beneficiary thereof from claiming an allowed deduction or exemption on that amount. It was also found that this principle is not without its limitations – the conduit pipe principle can only preserve the original nature of an amount for a period as long as one unbroken tax year. Thus after the passing of a tax year an exempt amount that has been in the trust is no longer exempt in the hands of its beneficial owner when finally paid to them. Thus this chapter successfully proved that tax avoidance was never within the intendment of this principle – tax avoidance is an incidental consequence of its operation. The purpose was to avoid double taxation as per the reasons advanced by the Appellate Division.

[56] Haupt, P *Notes on South African Income Tax* 37 ed H & H Publications, (2018) 813. (hereinafter referred as 'P Haupt *Notes on South African Income Tax'*)
[57] Ibid.

CHAPTER 3

3.1 Introduction

Trusts in South Africa are currently used by taxpayers to achieve various objectives. These objectives may, for example relate to tax or be purely directed at protecting the taxpayer's assets or property. Our history seems to clearly suggest that although trusts are now part of law, the concept of the trust was not easy to comprehend because it was never ours. Hence our courts and the legislature had to each play a role in unpacking this concept. This chapter will discuss how the concept of the trust was introduced into our law and the benefits of a trust. It will appear from this discussion that the type of each trust as well as the rights a beneficiary of that trust has to either income or capital gains of that trust have different tax consequences for that trust and the beneficiary. However, it must be pointed out that the discussion in this chapter will only focus on the discretionary trusts.

3.2 The trusts historical development and definition

Trusts were foreign to South Africa until the British settlers arrived in the Cape and Natal.[58] Their historical legal development in our law is succinctly summarized by Goebel as follows:[59]

"The legal development of trusts in South Africa spans a period of 150 years, with the earliest reported case in 1833. The trust was a legal institution not known to Roman or Roman-Dutch Law, and was brought to South Africa in the Nineteenth Century by the British Settlers in the Cape and Natal. These settlers were first to use the word 'trust' in their wills, their antenuptial contracts, and their transfers of land. This use of trusts went on for approximately a century before the courts were called upon to decide authoritatively on the concept of trusts, whether or not it formed part of South African law, and if so, on what basis."

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[58] A Goebel *'The Taxation of Trusts: An Analysis of s25B and the Anti-Avoidance Provisions contained in s7 of the Income Tax No. 58 of 1962* (Unpublished LLM Dissertation, University of Natal, 1999) 3.

[59] Ibid. For a more detailed discussion on the origins of trusts see R Swart *Tax benefits of discretionary trusts: abolishment of the conduit pipe principle* (Unpublished LLM Dissertation, North-West University, 2015) at page 3 paragraph 3.2.

The issue was finding one flexible definition that could be utilized in any situation to successfully determine whether there is a valid trust without having to ask how, if it does exist, it was established or its current administration.[60] Our law of trusts recognizes and distinguishes between trusts in both a wide and a narrow sense,[61] like other English speaking countries. In these countries the wide sense to a trust suggests that a trust exists if *(a),* there is a person incumbent with a task to hold the property placed under his or her control not for oneself but for another person – the real owner and *(b),* there must be an obligation or duty on that person to keep the property he administers separate from his personal estate.[62] This means that unless these two requirements are present in a situation no trust can be said to exist in the wide sense. Thus in the wide sense there cannot be a trust until there is a relationship to which the law attaches a responsibility on one person to hold the property for someone else. However, in the strict sense which is also known as a narrow sense a trust is said to exist at the moment when its creator hands either the control or proceeds of that property to the trustee to administer for another.[63] It is clear from these two different approaches used to decide whether a trust does exist that for a wide sense approach the two requirements must simultaneously be present. This is not required in the narrow sense approach as it only places emphasis on either the handing over of control to someone or that profits generated from the property be administered by the trustee instead of the property itself.

3.3 Statutory definition of a trust v the Judicial definition

In 1988 an attempt was made by the Legislature to provide a definition for what constitutes a trust through the introduction of the Trust Property Control Act.[64] A 'trust' is defined in section 1 of the TPC Act as follows:

"The arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed –

[60] Ibid.
[61] Ibid, 2.
[62] Ibid.
[63] Ibid, 3.
[64] Trust Property Control Act 57 of 1988 (hereinafter referred as 'TPC Act').

(a) to another person, the trustee, in whole or in part, to be administered or disposed of according the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or

(b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument, but does not include the case where the property of another is to be administered by any person as executer, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965 (Act 66 of 1965).”

This definition does more than merely providing the definition of what a trust is. It also provides answers as to the question of what type of a relationship gives rise to the existence of a trust and the extent of control one must have over the property for the benefit of another. Clearly this definition embraces how both the wide sense and the narrow sense determine the existence of a trust although these approaches do not define what a trust is. For the purposes of taxation of trusts the Act defines a ‘trustee’ as follows:[65]

“ ***“*trustee*”***, *in addition to every person appointed or constituted as such by act of parties, by will, by order of declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interests or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability;”*

The judiciary has also assisted in defining this concept. In *Est Kemp v MacDonald’s Trustee*,[66] Innes CJ stated that the word ‘trustee’ is an English word and it refers to a person given a duty to deal with the property put under their control for the benefit of

[65] Section 1 of the Act 58 of 1962. This section is a definitions section.
[66] 1915 AD 499.

those on behalf of whom he controls that property.[67] Thus the ownership and beneficial interest should vest in the beneficiary and not in the trustee unless he is both trustee and beneficiary.[68]

Also In *Zinn NO v Westminster Bank NO*,[69] Stratford CJ said that there was no magic in the use of word 'trustee'. Apart from the statutory definition it means one who is entrusted with the affairs of another.[70]

However, in *McCullogh v Fernwood Estate Ltd*,[71] Innes CJ took the concept one step further, distinguishing a trustee from an agent remarking that being a 'trustee', as opposed to an 'agent' requires that the person concerned has the *dominus* of that property place under his or her control.[72]

What emerges from these definitions is that our law recognizes a trust as a legal institution designed to hold property on behalf of another person(s) and the trustee is nothing more than the hand that ensures that the objectives of the trustee are realized.

3.4 Two categories of trusts

South African tax law recognizes and divides trusts into two categories. These trusts are *mortis causa* (testamentary) and inter *vivos* trusts.[73] In either of these trusts an ordinary or special trust can be created.[74] A testamentary trust comes into being as a result of a bequest in a will[75] to ensure, for example, that the deceased's children or surviving spouse or both will be taken care of after his death.[76] A testamentary trust

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[67]Honoré, T & Cameron E '*Honoré's South African Law of Trusts'* 4 ed Cape Town: Juta, (2002) 9. (hereinafter referred as *'Honoré's South African Law of Trusts'*)
[68] Ibid.
[69] 1936 AD 89.
[70] Honoré's *'South African Law of Trusts'* 9.
[71] 1920 AD 204 at 209.
[72] *'Honoré's South African Law of Trusts'* 9.
[73] Stiglingh, M…et al *Silke: South African Income Tax* (2017) 828. See also Brink (supra), 800.
[74] Ibid.
[75] Ibid, 829.
[76] Ibid.

can therefore only come into being at the moment of the deceased's passing on. Hence the duty of the trustee(s) is thus to ensures that there is an ongoing generation of income to meet the living expenses of the deceased's children and/or surviving spouse.[77] An inter *vivos* trust is, on the other hand, created and comes into being during the life time of its creator or founder[78] and is mostly utilized to save estate duty on founder's death.[79] Taxpayers prefer this type of trust because of various other tax benefits they derive while still alive.[80] These tax benefits will be discussed in the following Chapter. However, it must be noted that inter *vivos* trusts can further be distinguished into discretionary trusts and vested trusts.[81]

3.4.1 *Discretionary inter vivos trust*

As opposed to trust under which the beneficiary is certain to get trust property or income, in a discretionary trust no beneficiary has a vested right to the trust property or funds.[82] Thus the trustee is at liberty to decide how much is to be distributed to each beneficiary and who should get the property of the trust.[83] It therefore of importance to be able to differentiate the kinds of rights the beneficiary has under an inter *vivos* trust.[84] The beneficiary will always have either a conditional or vested right but not legal ownership because this will always be for the trustee.[85] The former only retains his or her beneficial ownership.[86] The precise nature of the right the beneficiary enjoys establishes who should bear the normal tax liability on the trust income between the trust and the beneficiary during a particular tax year.[87]

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[77] Ibid.
[78] Ibid.
[79] Ibid.
[80] Ibid.
[81] See the difference between a 'vested right' and 'contingent right' for normal tax purposes discussed in paragraphs 3.3.1 and 3.3.2.
[82] Brink (*supra*) 798. See also Greg Rostron '*What is a discretionary trust and what are the benefits?'* Available at: http://www.findlaw.com.au/articles/4606/what-is-a-discretionary-trust-and-what-are-the-ben.aspx (Accessed on 23/09/2018). See also R Swart *Tax benefits of discretionary trusts: abolishment of the conduit pipe principle* (Unpublished LLM Dissertation, North-West University, 2015) paragraph 19 at 19.
[83] Ibid.
[84] Brink (supra), 800. See also R Swart *Tax benefits of discretionary trusts: abolishment of the conduit pipe principle* (Unpublished LLM Dissertation, North-West University, 2015) 15-16.
[85] Ibid, 16.
[86] Ibid.
[87] Section 25B of the Act 58 of 1962. See also R Swart *Tax benefits of discretionary trusts: abolishment of the conduit pipe principle* (Unpublished LLM Dissertation, North-West University, 2015) 15.

3.4.2 *Vested right v Contingent right*

The line that separates both a vested right and a contingent right has been clearly defined by our courts and thus there is certainty as to what these rights are. In ITC 76[88] the Special Court distinguished the nature of the beneficiary's right as follows:[89]

"Vesting implies the transfer of dominium, and the children had clearly not in the year under review acquired dominium of the trust income or any portion thereof. A vested right was something substantial; something which could be measured in money; something which had a present value and could be attached. A contingent interest was merely a spes – an expectation which might never be realised. From its very nature it could not have a definite present value. In the income tax sense, therefore, a vested right was an accrued right."

In ITC 1328[90] it was held that 'vesting' does not necessarily mean the beneficiary concerned must have a right to payment[91] and that in the present case the income was vested in the beneficiaries as each of them had already obtained a right to such income even though its actual enjoyment had been successfully delayed.[92]

Thus as opposed to a vested right, a contingent right is just an expectation with no guarantee that it will be fulfilled. The beneficiary may also obtain the former right to the trust income through the exercise of trustee's discretion.[93] This means that even though no vested right in the beneficiaries may be inferred from the provisions of the trust deed, vesting may nonetheless still take place if the trustee decides to exercise his or her discretion and make a distribution on that basis. The result of that vesting is that should the beneficiary die before actually receiving that income it will fall into his or her deceased estate.[94] It is suggested that a vested right in relation to a trust income includes (a).income that has become due to the be beneficiary;[95] (b).income

[88] ITC 76 (1927) 3 SATC 68.
[89] Ibid, 70.
[90] ITC 1328 (1980) 43 SATC 56.
[91] Stiglingh, M…et al *Silke: South African Income Tax* (2017) 834.
[92] Ibid.
[93] Ibid, 835.
[94] Ibid, 834. See also Brink & Willemse 801.
[95] Ibid.

that is credited to the beneficiary on account;[96](c).income that has been dealt with for the sole benefit of that beneficiary.[97] In all these instances the beneficiary has a vested right.

3.4.3 *General purpose of establishing a trust*

Before the tax implications attaching to the conditional nature or otherwise of a beneficiary's right to the trust income and the exercise of the discretion by the trustee are considered it is necessary to look at why one may choose to utilize a trust. Generally, a trust is created for various reasons depending on the motive of each individual person.[98] The motive may be as innocent as wanting to ensure that the property of the person will not dissipate after his death or even to ensure a continuous running of a business after his death.[99] However, estate planners find the use of discretionary trusts very efficient in minimizing tax liability[100] rather than the motive for it use being the protection of assets against the uncertain eventualities of life.[101] From an estate duty saving point of view, the founder of the trust sells his valuable assets to the trust so that any further growth in their value accrues to the trust[102] which ensures that such assets will not fall into his or her estate on death.[103]

3.5 Conclusion

This chapter found that although defining what a trust is has always not been an easy task, our courts have played a major role in developing a set of characteristics that, if they are all present in a particular case, a trust can be said to exist. It is also clear from the preceding discussions that even though a trust may be a testamentary trust or an inter *vivos* trust the shared characteristic between the two types of trust is that the property is always held by the trust on behalf of someone – a beneficiary which may be certain or uncertain at that point. It is always important to determine

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[96] Ibid.
[97] Ibid.
[98] Brink & Willemse 798-799.
[99] '*Honoré's South African Law of Trusts'* 10.
[100] Ibid.
[101] *Honoré's South African Law of Trusts'* 11.
[102] Brink & Willemse 798.
[103] Ibid.

the nature of a right that the beneficiary has under the discretionary trust as the tax treatment of its income is contingent on the nature of the beneficiary's right, which in turn affects the impact of the conduit pipe principle on the tax consequences of the trust. The following chapter will discuss the normal tax implications of the right to the income and/or profits that are capital in nature. It will also look at the role the conduit pipe principle plays in the determination of the normal tax liability for both the discretionary trust beneficiary and the trust itself and then will conclude with a discussion on whether, if this principle is abolished so will the tax benefits it currently offers.

CHAPTER 4

4.1 Introduction to the tax benefit of a discretionary trust

There are basically many reasons for which one may use a trust.[104] More often than not the main reason is to avoid or minimize the incidence of taxation.[105] Taxpayers avoid this tax incident by using a 'discretionary trust' and get around the tax rules in section 7 of the Act.[106] These rules are avoided by giving the trustee(s) a discretion to vest the income of the trust to that beneficiary who is often taxed in a lower tax bracket than other beneficiaries or the creator of the trust himself.[107] The tax benefit here is that the income and/or capital gain is not subject to normal tax at a rate applying to either the trust or the creator of that trust. The common law conduit pipe principle brings in an additional tax advantage. As the income of the trust would be made up of amounts from different sources, the beneficiary will be entitled to claim all allowable deductions and exemptions the Act permits thereon. This tax advantage that this principle offers within a discretionary trust is amongst, if not at the forefront of, the reasons this type of trust has enjoyed a lot of attention over the past years. The questions that this chapter will attempt to address are: (a), what does the abolition of this principle in our law means for section 25B, section 7 and para 80 of the Eighth Schedule, and (b), what would happen to the use of discretionary trusts if this principle is abolished? It is necessary to point out before these questions are answered that although this chapter is devoted to answering these questions the main focus is placed on the current normal tax benefits inherent in the application of the conduit pipe principle – that is the role it plays in reducing the normal tax liability of the beneficiary and the trust itself. The structure in this chapter will follow the journal article by Brink & Willemse.[108] However, the question whether a discretionary

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[104] See the list of these reasons in paragraph 3.3.4, Chapter 3.
[105] '*Honorés South African Law of Trusts'* 361.
[106] Brink & Willemse 799.
[107] Ibid.
[108] SM Brink & LC Willemse *'An Investigation into the Future of Discretionary Trusts in South Africa –An Income Tax Perspective'* Journal of Economic and Financial Sciences | JEF | October 2014 7(3), pp. 797-818.

trust is still an effective estate planning tool is beyond both the aim of this dissertation and this chapter and hence no attempts will be made to explore it.

4.2 Current Taxation of discretionary inter *vivos* trusts in South Africa

From the tax period 1 March 2018 to 28 February 2019 all trusts that are not special trusts pay tax at a 45% flat rate while natural persons and special trusts are taxed on a graduated scale from 18% to 45% on their taxable income.[109] Thus a discretionary trust is currently taxed at 45%. Although trusts are not entitled to the primary,[110] secondary[111] or tertiary[112] rebates as a natural person, they are nonetheless regarded as persons for purposes of assessing them to normal tax.[113] Hence the question of their tax on income the trust pays over to the beneficiary is governed by section 25B of the Act[114] subject to section 7of that Act. The capital gain element of the income is regulated by para 80 of the Eighth Schedule to that Act which is also subject to the capital gains rules contained in paras 68, 69, 71 and 72 in that Schedule. These rules operate in the same manner as those in section 7 in that their object is to bring back the capital gain realized by the trust to some other person the rules identify.

It is thus suggested and true that the question as to in whose hands the income and/or capital gains of a discretionary trust is assessable to normal tax is dependent on following three factors:[115]

"(a) the principle relating to accrual,

(b) the conduit pipe principle, and

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[109] Budget 2018 Tax Guide. Available at: http://www.treasury.gov.za/documents/national%20budget/2018/sars/Budget%202018%20Tax%20Guide.pdf (Accessed on 20/10/2018)

[110] Primary rebate for 2018/2019 tax year is R14 067.

[111] Secondary (Persons 65 and older) for 2018/2019 tax year is R7 713.

[112] Tertiary (Persons 75 and older) for 2018/2019 tax year is R2 574**.**

[113] Definition of 'Person' in section 1 of the Act 58 of 1962 includes a trust. See also Brink & Willemse 801. See further Stiglingh, M…et al *SILKE: South African Income Tax* (2017) 829.

[114] Stiglingh, M…et al *Silke: South African Income Tax* (2017) 831. See also M Loubser *'A Case Study Analysis of the Impact of the Davis Tax Committee's First Interim Report on Estate Duty on certain Trust and Estate Planning Structure Used by South African Residents'* (Unpublished LLM Dissertation, University of the Witwatersrand, Johannesburg, 2016) 55**.**

[115] Sections 25B and 7 of Act 58 of 1962. See also A Goebel *'The Taxation of Trusts: An Analysis of s25B and the Anti-Avoidance Provisions contained in s7 of the Income Tax No. 58 of 1962'* (Unpublished LLM Dissertation, University of Natal, 1999) 13.

(c) certain provisions in the Act which govern deemed income."

This means that a discretionary trust creates three potential taxpayers – the creator of the trust, the trust in its own right and lastly the beneficiary. Before the provisions of the Act are discussed, it is necessary to first point out the most important basic principles underlying our law of taxation. These principles are discussed in the following paragraph.

4.2.1 *Basic principles of South African Taxation*

These principles are partly contained in section 5(1).[116] This section provides as follows:

"…subject to the provisions of the Fourth Schedule there shall be paid annually for the benefit of the National Revenue Fund, an income tax in respect of the taxable income received by or accrued to or in favour of –

(c) any person (other than a company) during the year of assessment ending during the period of 12 months ending on the last day of February each year; and…"

The definition of 'gross income' in section 1 of the Act, adds further principles, namely that normal tax is payable in respect of taxable income 'received by or accrued to or in favour' of any person. A company is expressly excluded both because our law does not recognise a company as a 'person'[117] but as a 'legal person' and a company's year of assessment may end in any month of the year depending on its founding documents. Although a company is not a person but a 'legal person', it is not exempt from paying normal tax on its taxable income. A trust is included as it is a person for tax purposes.[118]

From the above provision it follows that unless special circumstances exist, SARS must tax a person on either a 'received by' or 'accrued to' basis – whichever takes

[116] Act 58 of 1962.

[117] A company is not contained in the list of persons in section 1 of the Act 58 of 1962.

[118] See the discussion of the legal nature of a 'trust' in our law in para 3.2 in Chapter 3.

place first.[119] There is no discretion in this regard. The meaning of these terms are discussed in the following paragraph.

4.2.2 *'Received by' or 'Accrued to' in Act 58 of 1962*

The definitions of both these terms are not contained in section 1 of the Act but they have been interpreted by the courts.

As a general rule it was held in *CIR v Delfos*[120] that the Fiscus does not have a discretion regarding the time when to include a particular amount in a person's gross income - it may only include it when it is either received or accrued.[121] Thus the amount is included in the gross income at the earlier of when it is received or when it accrues.[122]

In *Geldenhuys v CIR*,[123] the issue was that the taxpayer had sold a flock of sheep in respect of which she only had a *usufructuary* interest. The Commissioner sought to include the proceeds from the sale in the calculation of her taxable income. The court held that the term 'received by' required that which sought to be taxed to have been received by the taxpayer for their own benefit and the taxpayer in the present case had not received the proceeds of the sale within the meaning of this term. Thus the court held that the proceeds were received for the benefit of the *bare dominium* holders and not the taxpayer herself.[124]

In *Ochberg v CIR*,[125] the issue was whether the additional shares issued by the company to taxpayer, who already held 100% of the issued shares of the company were taxable. The court held that the shares had a value and had been received by the taxpayer within the meaning of 'received by' as they had been received by him

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[119] P Haupt *Notes on South African Income Tax* 20.
[120] *CIR v Delfos* (1933 AD) 242 6 SATC 92.
[121] P Haupt *Notes on South African Income Tax* 20.
[122] Ibid.
[123] *Geldenhuys v CIR* (1947 CPD) 14 SATC 419.
[124] P Haupt *Notes on South African Income Tax* 20.
[125] *Ochberg v CIR* (1931 AD 215) 5 SATC 93.

for his own benefit. The possibility that the shares that he already held may have depreciated in value was irrelevant.[126]

In ITC 1545,[127] the meaning of 'received by' as construed in the above cases was challenged. The argument for the appellant was that an amount could only be said to have been received by the taxpayer if accrual to him/her has also taken place. This means that if the no accrual had yet taken place no receipt could be said to have occurred to the taxpayer resulting in the inclusion in his gross income of that amount. In rejecting this argument the court held, per Scott J, as follows:

"Where, however, an amount is received by a taxpayer on his own behalf and for his own benefit but in pursuance of a void transaction there seems to me to be no reason for holding that such amount is not 'received' within the meaning of the section, if that word is to be given its ordinary literal meaning. Not to do so would lead to anomalies. It would mean, for example, that if a trader were to sell his goods on a Sunday in breach of a local by-law, the price paid to him would not be 'received' by him and would not for part of his gross income. I can find nothing in the Act to justify such construction; nor was any basis suggested by counsel for limiting the meaning of the word 'received' in this way. The mere fact that the receipt was the consequence of a void transaction is no reason for ignoring it. Indeed, it does not follow that because a contract is prohibited by statute and therefore void inter-partes, it is to be totally disregarded and all the consequences flowing from it ignored."

The definition of the term 'accrued to' although also not contained in the Act, is well established through case law in the South African law of taxation. In *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd*,[128] the meaning of 'accrual' per Watermeyer J in *W H Lategan v CIR*[129] was upheld and followed.[130] In the latter case the issue was whether the purchase price payable partly in the year of the credit sale and partly in the subsequent tax year had accrued to the taxpayer in the first year of the sale

[126] P Haupt *Notes on South African Income Tax* 20.
[127] ITC 1545 (1992) 54 SATC 464.
[128] *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* (1990 (2) SA 353 (A)) 52 SATC 9.
[129] *W H Lategan v CIR* (1926 CPD 203) 2 SATC 16.
[130] P Haupt *Notes on South African Income Tax* 23.

despite the fact that the balance was due and payable in that subsequent year as per the terms of the credit sale contract. The taxpayer, Lategan, argued that the amount that was payable in the following tax year could only accrue to him then. The court held that ‘accrued to’ means ‘become entitled to’ and that followed immediately after delivery of the subject of the sale to the buyer had taken place. Thus the full purchase price had accrued to Lategan. In following this reasoning by Watermeyer J in *Lategan*, the court in *Peoples Stores* (*supra*) held that ‘accrued’ was not defined in our law and meant to ‘become entitled to payment’. The fact that it may be only be due and payable outside the current tax year does not affect the position. Hence the space in time between sale and payment does not affect the accrual of the amount.[131]

In *Mooi v SIR*,[132] the court extended the scope of the ‘entitled to’ principle as was laid down in the above cases.[133] The court in that case held that ‘accrued to’ requires that the taxpayer must have an ‘unconditional entitlement to the amount’. Thus if the entitlement is dependent on the occurrence of a future event then no ‘accrual’ can be said to have taken place until that future event has occurred.[134]

It follows from the discussion of the above cases that an amount becomes taxable when it is ‘received by’ or ‘accrues to’ the taxpayer, and that both a receipt and an accrual are not necessary for taxation to take place. But most amounts are usually received by and accrue to a taxpayer. It must be pointed out that although an amount that is capital in nature will not be included in the gross income, it may still be subject to normal tax through the Eighth Schedule to the Act.[135] Hence it follows that certain types of amounts may be excluded from a person’s gross income as will appear from the following discussion.

[131] Ibid.
[132] *Mooi v SIR* (1972 AD) 34 SATC 1.
[133] P Haupt *Notes on South African Income Tax* 23.
[134] Ibid.
[135] Section 102 of the Act 58 of 1962 state that the onus of poof rests on the taxpayer to prove that the amount is not subject to normal tax. The taxpayer can adduce any evidence in support of his or her claim in this regard. There is nothing that suggest that a court would only require a certain type of evidence. Thus it is up to each taxpayer how this onus of proof is discharged.

4.2.3 *Provisions of the Act 58 of 1962 dealing with the taxation of income and capital gains of a resident trust*

4.2.3.1 *Section 25B*

This section is the first section to consider in order to determine in whose hands the trust income is taxable.[136] Hence it is called the 'principal taxing section' relating to trusts.[137] This section provides that unless the deeming rules in section 7 apply the trust income is always assessable to normal tax in the hands of either the beneficiary or the trust.[138] The question as to who is to be taxed in a particular case is contingent on whom that income vests.[139] Thus if it vests in the beneficiary it will be taxed in his hands otherwise the normal tax liability will lie with the trust.[140]

Subsections (1) – (3) of section 25B will not be cited again here in full. These subsections were fully covered in Chapter 1.[141] Section 25B(1) provides as follows:[142]

"…to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to the trust."

Although in truth the amount has not been received by the beneficiary it is, unless the attribution rules in section 7 apply, assessable in his or her hands in terms of this subsection owing to the vested right of the beneficiary. It is immaterial whether or not the income is actually paid to the beneficiary in that year - the income has accrued to him. The tax benefit inherent in the income being vested in the beneficiary is that the beneficiary is taxed at a graduated scale from 18% to 45%. Otherwise the income is taxed at a 45% tax rate in the hands of the trust. It appears from the use of the words

[136] P Haupt *Notes on South African Income Tax* 805.
[137] Ibid.
[138] Ibid.
[139] Ibid.
[140] Ibid.
[141] See Note 19 in Chapter 1 (Above). Section 25B is cited verbatim in that note.
[142] Act 58 of 1962.

"…ascertained beneficiary..." that before the question of vesting may be considered the beneficiary must be capable of being identified or must be known.

Section 25B(2) provides that:[143]

"Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion… that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary."

The income of a trust is still assessable at a 45% flat rate in the trust up to the point that the trustee exercises their discretion and distributes the income to the beneficiary.

Section 25B(3) regulates the deductions and allowances that the beneficiary or the trust may claim on the amounts deemed to have been received by or accrued to either of them. It provides that:[144]

"…to the extent to which that amount is under that subsection deemed to be an amount which has accrued to –

(a) a beneficiary, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary;

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

This section ensures that deductions and allowances claimed are directly linked with each amount for which such a deduction or allowance is sought. This means the beneficiary may claim such a deduction or allowance on that amount, or a portion thereof, is deemed to be his. This applies equally to the trust. Thus the deduction or allowance may be allocated between both the trust and beneficiary proportionately.[145]

[143] Act 58 of 1962.
[144] Act 58 of 1962.
[145] P Haupt *Notes on South African Income Tax* 806.

The entitlement on deductions and allowances under section 25B(3) discussed above is not absolute. Section 25B(4) prohibits the deductions and allowance that may be claimed by the beneficiary or the trust during the year of assessment from exceeding the total income accruing to the beneficiary from the trust in terms of section 25B(1).[146]

Section 25B(5) provides that:[147]

"The excess of expenditure over income in s25B(4) shall be deducted by the trust in that year but limited to the taxable income of the trust before the deduction of such expenditure. Where the trust is not subject to tax in South Africa, the excess expenditure is carried forward and treated as a deduction or allowance which the beneficiary may claim in the year from the amount (income) he or she gets from the trust."

In essence this subsection ensures a match between the expenditure that the trust incurred and the income from which the deduction is claimed. The excess of expenditure incurred in the current tax year cannot be claimed in the following tax year – it must be claimed in the tax year during which it arose only.

Section 25B(6) provides that:[148]

" If the trust cannot absorb the full deduction or allowance disallowed to the beneficiary the excess may be granted as a deduction or allowance to the beneficiary in the next year of assessment subject to the same limitation as in s25B(4)"

This subsection ensures that the excess expenditure is not lost in the year it arose owing to the trust not having had enough income to claim the deduction on. The beneficiary may use the excess expenditure carried forward from the previous tax year to reduce his or her taxable income in the current tax year notwithstanding the fact that the excess expenditure was not incurred in respect of that taxable income.

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[146] Act 58 of 1962.

[147] Act 58 of 1962; P Haupt *Notes on South African Income Tax* 805-806.

[148] Act 58 of 1962; P Haupt *Notes on South African Income Tax* 806.

Section 25B(7) provides that:[149]

"The provisions of s25B(4) – (6) do not apply in respect of any amount deemed to have accrued to any beneficiary in terms of s25B(1) where the beneficiary is not subject to tax in South Africa on that amount."

This subsection provides that even though the beneficiary may have deductions or allowances that he or she may claim on the amount vested in him or her that deduction is only limited to amounts that are taxable in his hands in South Africa. Hence it does not matter whether the beneficiary is a South African resident or not – only the 'South African' amount must be subject to tax in South Africa.

A trust can only distribute taxable income to the beneficiary and not losses.[150] It is barred from doing so by the provisions of section 25B(4) – (6).[151]

4.2.3.2 Section 7

If section 7 applies it enjoys preference over section 25B because the latter section is made subject to the provisions of section 7.[152] Section 7 is essentially an anti-avoidance section deeming back to the donor of the trust income that arose by reason of the donor's donation or similar disposition.[153] Hence the provisions of section 7 are only concerned with the person who injected the asset(s) into the trust and not the person who brought the trust into being.[154]

The most important subsections of section 7 which could affect income distributed by or retained in trusts are 7(2)(a), 7(3), 7(5), 7(6), 7(8), 7(9), 7(10) and 7(7) to a lesser extent.[155] The circumstances that may trigger the application of each subsection are considered hereunder.

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[149] Act 58 of 1962; Ibid.
[150] P Haupt *Notes on South African Income Tax* 806.
[151] Ibid.
[152] Ibid.
[153] Ibid.
[154] Ibid.
[155] Ibid.

Section 7(2)

This subsection finds application where a spouse donates to a trust or grants an interest-free loan to the trust and income arising from any of these actions by the other spouse is distributed to the other spouse. Consequently the first spouse is taxed on that income as if it is his.[156]

Section 7(3)

This subsection applies if 'by reason of' a donation, settlement or similar disposition made by a parent income is then received by a child of that parent.[157] Although that income is received by the child it is deemed to be that of a parent.

Section 7(5)

This subsection only applies in respect of income that is retained by the trust and such income arose 'in consequence of' a donation, settlement or disposition.[158]

Section 7(6)

This subsection only applies to income distributed by the trust if the following requirements are present or met:[159]

- There is a stipulation in the deed of donation that the right to receive income may be revoked and possibly be conferred on another;
- The power to confer this right to receive income is retained by that person who conferred that right to the recipient of that income.

The income so received is deemed to be that of the person retaining those powers to revoke that right to receive that income.

[156] P Haupt *Notes on South African Income Tax* 807.
[157] Ibid.
[158] Ibid.
[159] P Haupt *Notes on South African Income Tax* 808.

Section 7(8)

Section 7(8)(a) only applies if owing to a donation that was made by a South African resident to a trust an amount is received by or accrues to a non-resident.[160]

The provisions of section 7 and its subsections do not apply unless there is a 'donation, settlement or other disposition'. These terms are not defined in this section.[161] However our courts have defined them in the following cases:

'Donation'

In *Welch's Estate v CSARS*,[162] the court considered the meaning of this term in section 55(1) of the Act and held that "a 'donation' requires a motive of sheer liberality or disinterested benevolence."[163]Thus a donation is a "wholly gratuitous disposal made out of the donor's liberality or generosity."[164] The disposal still qualifies as a donation even if is for a consideration that is illusory, simulated or minimal.[165]

'Settlement'

A settlement is also a gratuitous disposal of property that is made on "certain terms and conditions often to the trustees of a trust."[166] In *Bulmer v IRC*,[167] it was held that a 'settlement' had an element of bounty.[168]

'Other disposition'

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[160] Ibid.
[161] Ibid.
[162] *Welch's Estate v CSARS*, (2004) All SA 586 (SCA), 66 SATC 303.
[163] Ibid.
[164] P Haupt *Notes on South African Income Tax* 808.
[165] Ibid.
[166] Ibid.
[167] English case of *Bulmer v IRC* (1967 CH 145 1966 ALL ER 801.
[168] P Haupt *Notes on South African Income Tax* 808.

This term has caused problems because it is clearly an ambiguous term.[169] The uncertainty as to its meaning which had existed for years was because of its origin in the Rhodesian case of *Barnett v COT*,[170] which held that the meaning of this term was not only limited to a gratuitous disposal but it extended to include a transfer, transaction, plan, scheme or arrangement not in the gift form.[171]

This interpretation was, with respect, wrong as it brought all possible forms of transferring ownership over in assets within the application of section 7.[172] The uncertainty as to the meaning of this terms was finally resolved in 1980 in the following two cases.[173] In *Ovenstone v SIR*,[174] it was held that "the words 'other disposition' should be interpreted *ejusdem generis* with 'donation' and 'settlement', i.e. having the same meaning as donation and settlement, and that the section should be read as 'donation, settlement or other disposition'."[175]

In *Joss v SIR*,[176] it was held, per Coetzee J, that " 'other disposition' excluded transaction that were made for full value in money or money's worth and there had to be an element of liberality."[177]

The meaning of 'disposition' is now certain and according to the interpretation from these two cases it means "any disposal of property made, either wholly or to an appreciable extent, gratuitously out of the liberality or generosity of the disposer."[178]

'**By reason of' in section 7(3)**

[169] P Haupt *Notes on South African Income Tax* 808.
[170] *Barnett v COT* (1959 FC) 22 SATC 326.
[171] P Haupt *Notes on South African Income Tax* 808-809.
[172] P Haupt *Notes on South African Income Tax* 809.
[173] Ibid.
[174] *Ovenstone v SIR* (1980 AD);Ibid.
[175] Ibid.
[176] *Joss v SIR* (1980 TPD), SATC 206;Ibid.
[177] *Joss v SIR* (1980 TPD); P Haupt Notes on South African Income Tax 809.
[178] P Haupt *Notes on South African Income* Tax 809.

Two cases have interpreted this term and are authority with regard to its meaning. In *Ovenstone v SIR*,[179] Mr Ovenstone granted to his two children loans at an 8,5% interest rate per annum to purchase shares. The arrangement was that they would repay the loans out of the dividends from these shares. Each child received R6000 as a dividend in the 1969 year of assessment. The issue before the court was whether the Revenue Service (currently 'SARS') was correct in taxing these dividends received by Mr Ovenstone's children in his hands in terms of section 7(3). It was held that the tax assessment was correct as the children concerned received those dividends 'by reason of' the initial loans provided to them by Mr Ovenstone. Thus section 7(3) was correctly applied. The court further held that the words 'other disposition' meant a disposition with an element of gratuity. Thus the charging of a favourable rate of interest on the loan was in fact a gratuitous disposal and hence it was only the part of the dividends that related to the gratuitous part of the disposition that had to be deemed his in terms of section 7(3). The tax assessment on the full amount of dividends, however, was allowed by the court because Mr Ovenstone was unable to provide to the court a reasonable method of apportionment.

In *Joss v SIR*,[180] Mr Joss sold shares to a certain company in which only he and his minor children were shareholders on loan account. The issue in this case (as in *Ovenstone* discussed above) was whether the dividends income received by Mr Joss' minor children could be taxed in his hands in terms of section 7(3). The court held that the sale of shares to the company could not be a gratuitous disposition as it was made at fair price and neither was the loan that arose pursuant to this sale. However, the non-charging of interest on the loan was in fact a gratuitous disposition and the interest-free loan brought about a continuous donation of interest to the company which partially benefited his children. Thus the donation of interest fell within section 7(3) but was not a donation attracting donations tax. Accordingly, the dividend income had to be allocated between the amount of the loan arising from the sale of shares and the interest not charged on

[179] *Ovenstone v SIR* (1980 (2) SA 721(A)), 42 SATC 55; P Haupt *Notes on South African Income Tax* 809.
[180] *Joss v SIR* (1980 TPD), 41 SATC 206; Ibid.

that loan. Consequently, only that part of the dividend that related to the non-charging of interest could be taxed in his hands in terms of section 7(3).

'In consequence of' in section 7(5)

In *CSARS v Woulidge*,[181] Mr Woulidge set up two identical trusts for his two children and then sold shares in a company to these trusts on loan account. Although he sold these shares at their market value, he charged no interest on the loan. The issue before the court was whether the sale was a disposition falling within the ambit of section 7(3). The court held as follows:

(a).For purposes of section 7(3) an apportionment must be done where a disposition contains both appreciable elements of gratuitousness and of proper consideration in order to accurately determine how much is to be deemed a parent's in terms of that section;

(b).The sale of the shares in question at their full value could not qualify as a 'gratuitous disposition';

(c).The non-charging of interest is a continuing donation up until the capital is paid. Although an interest-free loan itself could not be a donation, in the present case it was a donation due to the fact that there was a contractual right on Mr Woulidge's side to charge interest – which he did not charge. Hence the non-charging of interest under these circumstance was in fact a disposition within the terms of section 7(3);

(d).The interest that Mr Woulidge had to charge but did not is the portion of the income to be deemed his in terms of section 7(3); and

(e).Mr Woulidge's non-charging of interest constituted an appreciable element and the gratuitous disposition had to be calculated by compounding interest on the loan as long as the loan remained unpaid. The court further held that the *in duplum* rule did not apply with the result that such interest could continue to be compounded.

[181] *CSARS v Woulidge* (62 SATC 1, [1999] 4 All SA 519 (C); P Haupt *Notes on South African Income Tax* 809-810.

It follows from the above cases that 'in consequence of' and 'by reason of' occurring in section 7 bear the same meaning.[182] Thus income arising 'by reason of' is also arising 'in consequence of.[183] What is crucial is apportioning or allocating such income between the gratuitous and non-gratuitous parts of the disposition.[184] Although the court in *CSARS v Woulidge* (above) held that interest on an interest-free loan could be compounded, SARS calculates it on a simple basis in practice.[185]

4.2.3.3 Para 80 of the Eighth Schedule to the Act 58 of 1962

Sections 25B and 7 discussed above only apply to the income element of taxpayer's taxable income.[186] The Eighth Schedule contains the deeming rules that regulate the capital element of taxable income in paragraph 80.[187]

Para 80 of the Eighth Schedule to the Act provides as follows:[188]

"(1) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary (other than any person contemplated in paragraph 62(a) to (e)) who is a resident, that gain –

(a) must be disregarded for the purposes of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of.

(2) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than any person contemplated in paragraph 62(a) to (e)) who is a resident has a vested interest or acquires a vested interest (including an interest caused

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[182] P Haupt *Notes on South African Income Tax* 809.
[183] Ibid.
[184] Ibid.
[185] Ibid, 810.
[186] P Haupt *Notes on South African Income Tax* 809-815.
[187] Ibid.
[188] Ibid, 847.

by the exercise of a discretion) in that capital gain but not in the asset, the disposal of which gave rise to the capital gain, the whole or portion of the capital gain so vested-

(a) must be disregarded for the purposes of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the gain vests."

The trust is liable for CGT on disposals of trust assets unless the special rules in paras 80(1) and 80(2) above apply.[189] These rules divert the CGT liability to another person.[190] Para 80(1) is triggered by the acquisition of an interest in an asset of the trust by the resident beneficiary.[191] Para 80(2) applies when a beneficiary under a trust has only a vested interest in the capital gain realized.[192] Both these sub-paras determine that the gain must be disregarded by the trust but be included in determining the aggregate capital gain and loss of the beneficiary of that trust.[193] These rules reinforce the conduit pipe nature of the trust in relation to the capital gains.

4.2.4 Nature of income and tax benefits of the conduit pipe principle

The Act requires certain amounts to be completely excluded from the calculation of a person's taxable income while other amounts are only partially exempted therefrom. Those amounts are exempt notwithstanding the fact that they were either 'received by or accrued to' the taxpayer. These exemptions are dealt with in section 10.[194] Section 10(1)(*i*)(i) grants a resident taxpayer that is a natural person a partial exemption on the amount received by or accrued to him or her from a South African investment. This section provides as follows:

"There shall be exempt from the tax-

[189] Ibid.
[190] Ibid.
[191] Ibid.
[192] Ibid.
[193] Ibid.
[194] Act 58 of 1962.

(*i*) *in the case of any taxpayer who is a natural person, so much of the aggregate of any interest received by or accrued to him or her, other than interest in respect of a tax free investment as defined in section 12T(1), from a source in the Republic as does not during the year of assessment exceed-*

(i) *in the case of any person who was or, had he or she lived, would have been at least 65 years of age on the last day of the year of assessment, the amount of R34 500; or*

(ii) *in any other case, the amount of R23 800."*

Amounts received in the form of dividends are also exempt from the calculation of taxpayer's taxable income in terms of section 10(1)(k).[195] This section provides as follows:

"There shall be exempt from the tax-

(k)(i) *dividends (other than foreign dividends) received by or accrued to or in favour of any person: Provided that this exemption shall not apply-*

(aa) to dividends (other than those distributed out of profits of a capital nature

and those received by or accrued to or in favour of any person who is neither a resident, nor carrying on business in the Republic) distributed by a company the shares of which are 'property shares' as defined in section 47 of the Collective Investment Schemes Control Act, 2002, on shares included in a portfolio comprised in any collective investment scheme in property managed or carried on by any company registered as a manager under section 42 of that Act for purposes of Part V of that Act; or…"

It is worth noting that the provisions of section 10(1)(k) enjoy authority over those of paragraph (k) in the 'gross income' definition.[196] That paragraph specifically includes in the gross income of a taxpayer any dividend he or she receives during the tax year and the origin of that dividend, i.e. local or foreign is not relevant – it must be included. However, section $10(1)(i)$ exempts only interest that arose within South Africa.[197] By means of a comparison it is clear from the provisions of both these exemptions that one gives a total exemption whereas the other only grants a partial

[195] Act 58 of 1962.

[196] Paragraph (k) of the definition of 'gross income' in section 1 of Act 58 of 1962 includes in the gross income of a person any amount received or accrued by way of a dividend or a foreign dividend.

[197] P Haupt *Notes on South African Income Tax* 85.

one. Consequently, the interest exemption is limited to the following amounts: R34 500 for person who is 65 years or above[198] and R23 800 for a person under 65 years.[199] Even though a person in receipt of a dividend may be a South African resident he is not entitled to the dividends exemption if that dividend arises from the circumstances mentioned in item (aa).[200]

Dividends tax is currently levied at a flat rate of 20% on any amount paid as a dividend by a company that is not a headquarter company.[201] The company withholds this amount (20%) and distributes the net amount to the shareholder of that dividend who will then not pay normal tax on it.[202] The shareholder is exempted from paying normal tax on the dividend by section 10(1)(k) of the Act.

The benefit that the conduit pipe principle has always offered for South African taxpayers (natural persons only) is that although dividends and interests from a South African source is received by the trust, the beneficiaries will still be able to claim both the above exemptions on the amounts distributed to them by the trust. The discussion that follows will attempt to expose what will happen to the identity of a South African dividend and interest income from South African investments if the 'common law conduit pipe principle' is finally abolished in our law. This exposition is considered both from a case where the trustee exercises it discretion in paying over the 'discretionary trust' income to the beneficiary and where that discretion is not so exercised. Thus any referral hereinafter to the 'trust income' or just a 'trust' should be taken as referring to the 'discretionary trust'.

4.2.5 Current determination of normal tax where the trustees pay over income in their own decision[203]

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[198] Ibid.
[199] Ibid.
[200] Ibid, 87.
[201] P Haupt *Notes on South African Income Tax* 466.
[202] Ibid.
[203] Adapted from the case study done by Brink & Willemse. See Note 15 (above) 804-807.

For the purposes of the following calculations the following assumptions or suppositions are made:

(1). The Zwezwe Family Trust is a South African discretionary trust with a single beneficiary. The beneficiary is also a South African resident and a natural person below 65 years of age. Hypothetically the income of this family trust is composed of the following amounts that it received during the 2018 year of assessment:

a) R4 million from selling a capital asset;
b) R80 000 as interest derived from a local investment; and
c) R100 000 representing local dividends.

(2).This scenario is on the footing that the conduit pipe principle still applies and that no deductible allowance under the Act was previously claimed and granted in respect of the asset sold in (a) above. This asset was purchased for R3 million. Table 'A' demonstrates the current determination of the normal tax liability flowing from the discretion of the trustee. In Table 'A' this discretion is exercised in paying over the income of the trust to the beneficiary during the tax year 2018.

Table A

Normal tax liability of The Zwezwe Family Trust	Amounts (R)
Taxable income	0
Explanation: There is no taxable income, as all the mentioned accruals vest in the beneficiary in the same year of assessment in which the amounts were received by or accrued to the trust.[204] The amounts vest in the beneficiary owing to the trustee's discretion.[205] For the purposes of this scenario it is assumed the beneficiary is in receipt of no other income.	

[204] See section 25B(2) of the Act 58 of 1962 in Note 19 (Above).
[205] Brink & Willemse 804.

Normal tax liability of the beneficiary	Amounts (R)
Gross income:	**180 000**
Dividends from a South African Company	100 000
Interest amount from South African investment	80 000
Less: Exemptions:	**123 000**
Interest exemption (section10(1)(*i*))[206]	23 800
Dividend exemption (section 10(1)(k))[207]	100 000
Income:	**57 000**
Plus: Taxable capital gain (section 26A)[208]	384 000[209]
Taxable income	**441 000**[210]
Ordinary income tax	108 219[211]
Less: Primary rebate	13 635
Normal tax due to SARS	**94 584**

Explanation:

As seen from the above calculation of the normal tax liability for both the Zwezwe Family Trust and its beneficiary all the receipts of the trust are vested in the beneficiary in terms of the provisions of section 25B(2) and hence are taxable not in the trust but in the beneficiary's hands. The benefit of the 'conduit pipe principle' is that the beneficiary is entitled to claim the section 10(1)(k) exemption on the portion of the income attributable to the dividend income, the basic interest exemption, the annual exclusion of R40 000 on capital gain realised and the primary rebate of R13 635.

The following scenario will consider the tax implication flowing from the non-exercise of the trustee(s) discretion to distribute the trust income during the 2018 year of assessment.

[206] Act 58 of 1962.
[207] Act 58 of 1962.
[208] Act 58 of 1962.
[209] Capital Gain calculation: ([R4 000 000 – R3 000 000] – R40 000) R960 000 × 40% = R 384 000.
[210] During the 2018 tax year the beneficiary was in receipt of no other income.
[211] Calculation of ordinary income: R97 225 +36% = R108 219.

4.2.6 Current determination of normal tax where the trustees do not pay over income in their own decision[212]

If the very same information used in the above scenario is applied except that the trustee's discretion is now not exercised, the current determination of the tax liability will be as illustrated hereunder.

Table B

Normal tax treatment of The Zwezwe Family Trust	Amount (R)
Gross income :	**180 000**
Dividends from a South African Company	100 000
Interest amount from South African investment	80 000
Less: Exemptions:	80 000
Dividend exemption (section 10(1)(k))	100 000
Income	**80 000**
Plus: Taxable capital gain (section 26A)	800 000[213]
Taxable income	**880 000**
Ordinary income tax	382 500[214]
Normal tax due to SARS	396 000

<u>Explanation:</u>

Table B illustrates how the normal tax liability of The Zwezwe Family Trust is determined with no vesting of income vests in terms of section 25B(2). Hence the tax assessment is made in the hands of the trust at a 45% flat rate. As the trust is not a natural person it is accordingly only entitled to the dividends exemption. It does not also qualify for the R40 000 annual exclusion on its capital gains and neither qualify to claim the primary rebate of R13 635 available to natural persons.

[212] Adapted from the case study done by Brink & Willemse. See Note 15 (above), 804-807.
[213] Capital Gain calculation: (R4 000 000 – R3 000 000) × 80% = R800 000.
[214] Calculation of ordinary income: R880 000 × 45% = R382 500.

The above two tables considered the normal tax liability of both the beneficiary of 'discretionary trust' and of the trust itself. The determination of the normal tax liability is done in the above tables to reflect the current tax benefit of the 'common law conduit pipe principle' to the beneficiary. In the latter's determination of normal tax liability the exempt amounts are as such even when they are in his/her hands. The trust in respect of these amounts operates as a 'slide' between one point and another - connecting the source of these amount and the beneficiary thereof. It is clear from these calculations that a discretionary trust has quite significant tax advantages for a taxpayers owing to the tax implications associated with the exercise of a trustee's discretion. As seen from the preceding calculations the high tax rate (45% for the current 2018/19 year of assessment) applicable to trusts can always be escaped by vesting the trust income in the beneficiary.

While the above tables considered the determination for normal tax liability with the common law conduit pipe principle still being part of our law of taxation, the following hypothetic scenarios will attempt to show how the determination will be different from the above with this principle no longer part of our law. The first scenario will determine the liability where the trust receipts and accruals vested in the beneficiary owing to the exercise of the trustee's discretion. The last scenario will consider the tax liability on the footing that the trust receipts and accruals do not vest in the beneficiary

4.2.7 The trustee's discretionary vesting of income in the beneficiary where the conduit pipe principle is abolished[215]

The information used for Table A and B above is still used for the purposes of the illustrations in Table C and D. However, Table C and D considers the hypothetical tax implication for both the trust and the beneficiary where the trustees of the trust decide to distribute all of the income to the beneficiary during the 2018 year of assessment with the conduit pipe no longer part of our law.

[215] Adapted from the case study done by Brink & Willemse. See Note 15 (above), 806.

Table C (The conduit pipe principle is no longer part of our law)

Calculation of normal tax liability for The Zwezwe Family *Trust*	Amount (R)
Gross income :	**180 000**
Dividends from a South African Company	100 000
Interest amount from South African investment	80 000
Less: Exemptions:	**100 000**
Dividend exemption (section 10(1)(k))	100 000
Income:	80 000
Plus: Taxable capital gain (section 26A)	800 000[216]
Taxable income	**880 000[217]**
Deduct: Distribution to beneficiary of taxable income	850 000[218]

<u>Explanation:</u>

The Zwezwe Family Trust is only entitled to claim the dividends exemption but not the R13 635 primary rebate available to a natural person and the R40 000 annual exclusion on capital gains realised. The trust distributes only taxable income to the beneficiary because it does no longer possess the ability to pass exempt amount. The hypothetical case here is that the common law conduit pipe principle is no longer part of our law. Thus the beneficiary will not be able to claim both the dividends exemption and the basic interest exemptions because the different amounts making up the income distributed no longer have their original character.

[216] Capital Gain calculation: (R4 000 000 – R3 000 000) × 80% = R800 000.

[217] This amount of R880 000 represents an amount that The Zwezwe Family Trust can claim as a deduction in its determination of normal tax liability. However, this amount as it distributed to the beneficiary within the same tax year (2018) it arose will be taxable only in the beneficiary's hands not the trust.

[218] The proposed taxation of discretionary trusts means that where the receipts and accruals of the trust are vested in the beneficiary the trust will be able to claim the amount it distributed to the beneficiary in its taxable income. The result is that such distributed income will be taxable only in the beneficiary's hands.

Table D illustrates a hypothetical normal tax calculation for the beneficiary where the conduit pipe principle is abolished.

Table D (The conduit pipe principle is no longer part of our law)

Calculation of normal tax liability of the *beneficiary*	Amount (R)
Taxable income received from The Zwezwe Family Trust	850 000[219]
Taxable income	**850 000**[220]
Ordinary income tax	267 124[221]
Less: Primary rebate	13 635
Normal tax due to SARS	**253 489**

Explanation:

It is clear from the above calculation that the distribution of the taxable income by The Zwezwe Family Trust will result in no normal tax liability on its part as it will be entitled be deduct the income it distributed to the beneficiary as a deemed deduction. However, the income distributed to the beneficiary is taxable in its own hands. As the conduit pipe principle is no longer available the character of each amount making up the total distribution is lost with the result that the beneficiary cannot claim the basic interest exemption, the annual exclusion of R40 000 on capital gains realised but only the primary rebate of R13 635.

4.2.8 The trustees do not vest the income in the beneficiary where the conduit pipe is abolished[222]

[219] This amount is distributed to the beneficiary during the same tax year it arose. See Note 150 (above).
[220] The beneficiary had no other receipts and/or accruals during the current tax year, 2018.
[221] Calculation of normal income tax: R209 032 + 41%= R267 124.
[222] Adapted from the case study done by Brink & Willemse. See Note 15 (above), 807.

Where the receipts and/ or accruals of The Zwezwe Family Trust are not vested in the beneficiary and retained in the trust the normal tax determination will be as illustrated in Table B above. The same result would follow even in the event the trust is taxed in its own right notwithstanding whether the beneficiary has a vested right to the receipts and accruals of the trust.

4.3 Conclusion

From the above comparison of the tax liability for both the discretionary trust and the beneficiary using the current calculations of liability with the conduit pipe principle still part of our law and a hypothetical scenario where this principle is no longer part of our law, it is clear that if the principle is finally abolished the normal tax implication would be severe for the beneficiary as only the primary rebate of R13 635 would be available. Discretionary trusts would only distribute taxable income. The amount passing through these trusts would no longer retain its nature as is the case presently. It is true that if this principle is abolished discretionary trusts may not be as attractive as they are now in future. However, from the protection of assets perspective these trusts will still be as effective as they presently are.[223]

[223] See paragraphs 4-5 of Chapter 5 for detailed reasons against the abolition of the conduit pipe principle in our law.

CHAPTER 5

5.1 Conclusion

The common law conduit pipe principle is one of many other principles in South African tax law that taxpayers have come to exploit in the trusts. This exploitation has to a large extent resulted in the real purpose of this principle being confused for tax avoidance. The operation of this principle has the effect that a discretionary trust is a conduit pipe in respect of a dividend received by a resident taxpayer from a South African company and interest income from a South African investment. These types of amounts, including capital gains made by a trust, retain the identity until the reach the hands of the beneficiary. The main aim of this study was to clarify the confusion in relation to the purpose and value of this principle in our law and answer the core research question – whether we should retain this principle in our South African law. To determine the real purpose of this principle this research traced this principle back to *Armstrong* which introduced it into our law, in Chapter 2 of this dissertation. By an in-depth analysis of the judgment of this case it was found and submitted that the real purpose of this principle was not prevent an incident of taxing the amount both at the source and again in the recipient's hands. Hence although it possesses the ability of being used to avoid normal tax, this was never within its intendment as per the judgment in *Armstrong.*

Chapter 3 of this dissertation explained that our courts have played a major role in developing a set of characteristics which, if they are all present in a particular case, then a trust can be said to exist. Hence whether a trust may be a testamentary trust or an inter *vivos* trust, the shared characteristic is that the property is always held by the trust on behalf of someone – a beneficiary which may be certain or uncertain at that point. It was also found that ii is always important to determine the nature of a right that the beneficiary has under the discretionary trust as the tax treatment of that income is contingent on the nature of the beneficiary's right.

Chapter 4 discussed the normal tax implication of the beneficiary's right to the income and/or capital gains of a discretionary trust. It focused on the benefit of the conduit pipe principle in the taxation of a discretionary trust and revealed how these trusts would be taxed if this principle is abolished and that amounts received by discretionary inter *vivos* trusts, would no longer retain their original character. This means that the tax advantages of claiming the section 10 exemptions from the calculation of taxable income will fall away with the result that the distribution of that amount is income in the hands of the beneficiary. Unless the income of the trust is vested in the beneficiary, it will be subject to a harsh 45% tax rate in the trust.

Chapter 5 found that if this conduit pipe principle is done away with in our law discretionary inter *vivos* trust will undoubtedly no longer be as attractive as they have been over the years. However, it was also found that even if this principle is abolished and section 25B and Para 80 are repealed discretionary trusts will remain an effective device for a taxpayer who wants to use this type of trust for other purposes other than for taking advantage of the conduit pipe principle. Although the DTC has persistently recommended the abolition of this principle, it is submitted that it still remains part of our South African law. This follows from the fact that the intention to abolish this principle was not repeated in the 2018 National Budget Speech as had been anticipated. Neither has there to date been an Amendment Bill proposing the repeal of the conduit pipe principle in in section 25B and para 80 of the Income Tax Act 58 of 1962. Other than the increase of the tax rate for ordinary trusts from 41% to 45% there is no change to the taxation of discretionary trusts in our law. It is submitted that the 4% increase is a measure that is hopefully adopted to discourage the use of trusts.

It is concluded that this principle should be retained in our law owing to the purpose that it is really meant to serve, and which still remains relevant today. The National Treasury and SARS ought to find other less drastic measures to discourage the exploitation of the conduit pipe principle to avoid normal tax, as outlined in this dissertation.

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