

**'The influence and effect of s 7 (the 'deemed income' provisions), s 25B and the donations tax provisions of the Income Tax Act, and the relevant provisions of the Transfer Duty Act, the Value Added Tax Act and the Estate Duty Act, on the establishment, utilisation and dissolution of testamentary and inter vivos trusts.'**

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Being a technical report submitted by

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to

  
the University of Natal

in part satisfaction of the requirements of the award of the degree of

Master of Law

**ABSTRACT**

The aim of this technical report is to serve as a handy exposé of the relevant provisions of various statutes for attorneys, accountants and other advisors who have to deal with the relevant tax laws affecting the establishment, utilisation and dissolution of trusts.

The South African Acts which are the subject of this technical report were promulgated on or before 31 December 1998. They are as follows :

- The Income Tax Act, No. 58 of 1962.
- The Transfer Duty Act, No. 40 of 1949.
- The Value Added Tax Act, No. 89 of 1991.
- The Estate Duty Act, No. 45 of 1955.

The principal South African taxes dealt with in this report are as follows :

- Normal Tax.
- Donations Tax.
- Transfer Duty.
- Value Added Tax.
- Estate Duty.

**DECLARATION**

I hereby declare that this report is entirely my own work.

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## Chapter 1

### Introduction

The emerging trend of using trusts for a variety of purposes sometimes creates the impression that a trust is a modern concept which has recently been invented. Nothing could be further from the truth. The South African law of trusts is substantially a fusion of some concepts which originated from English law, and which were introduced in South Africa from the early nineteenth century, with the Roman Dutch legal principles which had previously been brought to this country by the early Dutch settlers. The popularity of trusts, especially inter vivos trusts, has blossomed in recent years primarily, it has been suggested,<sup>1</sup> as a result of the perceived advantageous tax implications of trusts.

Trusts create an opportunity for the inventive minded to create a suitable entity for any desired purpose. The converse of that opportunity is the minefield of fiscal provisions which exists for the unwary or the uninformed.

The purpose of this work is to distil from various fiscal laws, those provisions which should be foremost in the mind of any attorney, accountant or financial advisor who advises others about the formation and use of trusts.

### Historical Perspective

It is beyond the scope of this work to set out a chronological record of all the changes which have occurred in the relevant fiscal legislation and case law over time. [It must be noted, though, that numerous significant changes have been made to the Income Tax Act during the last decade.] A brief perspective of some of the recent changes is set out below for background information.

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<sup>1</sup> Pace and Van Der Westhuizen at B1.

For many years, the general practice of the Commissioner of Inland Revenue was to treat a trust as a taxable person, and to levy tax on the undistributed income of a trust at the rate applicable to unmarried persons.<sup>2</sup> Until the 1991 year of assessment, the legislation allowed trusts the primary rebate, but that concession was abolished with effect from the 1992 year of assessment. Also, the basic R2 000 interest exemption did not apply to trusts.

The Commissioner's practice of taxing trusts on their undistributed income was called into question in the case of *Friedman and others NNO v CIR : In re Phillip Frame Will Trust v CIR*<sup>3</sup> which, as the name of the case suggests, dealt with the levying of tax on a testamentary trust. In the court *a quo*, it was held that a trust was not a taxable entity. That decision was upheld by the Appellate Division<sup>4</sup>. The result of those decisions was that the legislature immediately made two significant amendments to the Income Tax Act in 1991. The Act was amended (retrospectively, with effect from 1 March 1986), in the following respects:

- The definition of 'person' was amended to include in its wording a description of trust fund consisting of cash or other assets which were administered and controlled by a person acting in a fiduciary capacity where such a person was appointed under a deed of trust or by agreement or under the will of a deceased person;
- Section 25B was enacted. The nature and effect of s 25B are dealt with later.

Until the 1991 amendments were effected, the definition of 'person' had included the estate of the deceased person, but did not make mention of trusts. In 1992, the definition of 'person' was amended further to simply refer to 'any trust', and

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<sup>2</sup> At that time, different tax rates applied to married and unmarried persons.

<sup>3</sup> 1991 (2) SA 340 W, 53 SATC 166

<sup>4</sup> *CIR v Friedman and others N N O* 1993 (1) SA 353, (55 SATC 39).

a new definition of 'trust' was inserted in the Act.

The definition of a 'trust' now uses the wording which had been introduced into the definition of 'person' in 1991. The definition of a 'trust' now reads as follows:

'... means any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person.'

### **Formation of trusts**

In view of the fact that the application of fiscal legislation to trusts depends in part on the nature or structure of the trust itself, which in turn is determined in part by how the trust itself was formed, it is necessary to give some consideration as to how trusts are formed.

From the perspective of the mode of creation of a trust, there are two broad categories, namely,

- testamentary trusts, and
- inter vivos trusts.

A testamentary trust is one which is created in terms of the will of a deceased person. The exact nature and operation of a testamentary trust is dictated by the provisions of the will. A testamentary trust comes into existence when the executor of the estate of the deceased person has completed the formalities in the winding up of the deceased estate and thereafter hands over to the trustee those assets which devolve on the trust. The trustee of a testamentary trust can be, but need not necessarily be, the person who attended to the winding up of the estate (that is, the executor). If there is an overlapping identity between the executor and the trustee, then at some point in time the executor, in his capacity as executor, must nevertheless transfer or convey ownership of assets concerned to the trust. In the case of immovable property devolving upon a trust, the title deed must be

endorsed<sup>5</sup>.

An inter vivos trust is one which is created by a person during his lifetime. Before embarking on the main substance of this report, it is appropriate to give a brief overview of the procedure involved in the creation of an inter vivos trust.

Normally, having identified the need for which the trust is to be created, the person who desires the trust to be created (or a related person or acquaintance) will cause a trust deed to be prepared,

- setting out the object of the trust,
- identifying the intended beneficiaries of the trust,
- and setting out details of the mechanics or procedures according to which the trust is to operate.

That person is commonly referred to in a trust deed as 'the promoter', 'the donor' or 'the founder' of the trust. For convenience, that person will henceforth be referred to in this report as 'the founder' of the trust.

A trust can only operate through the agency of natural persons, so trustees must be selected and appointed in order to manage the affairs of the trust. A trustee can be an incorporated entity (for example, a trust company) which in turn nominates an individual or individuals to act on its behalf. It is therefore customary for the founder to select whom he would like to have appointed as the first trustees and to have the identity of those persons set out in the trust deed. The trust deed is usually signed by the founder and the first trustees, who undertake (by their signature of the trust deed) to accept appointment of trustees and to act in accordance with the trust deed.

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<sup>5</sup> In terms of s 40(1)(b) of the Administration of Estates Act.

The above exposition was set out in the judgment in the case of *Ogus v SIR* where the deed of trust which was under consideration in that matter was described as follows:<sup>6</sup>

'The deed of trust is basically a contract between the donor and the trustees for the benefit of the beneficiaries. The donor determined unilaterally what was to be subject to the trust, who the beneficiaries were to be, what each was to receive and the circumstances under which he was to receive it. What the donor asked the trustees to agree to was not the content of the terms decided upon by him, but the assumption of formal ownership and the duty to carry out those terms. The donor determined the regime governing the *corpus* of the trust and the trustees merely undertook to hold the *corpus* and apply that regime to it. In this respect, the deed of trust agrees with the ordinary kind of case.'

It is conceivable for a trust to have only one trustee, but the norm is to have at least two or three trustees. Consequently, reference will henceforth be made in this report to 'the trustees' in the plural.

It is also possible for an oral trust to be formed by the intended founder and the intended first trustees, and in certain circumstances it is appropriate to constitute a verbal trust. Evidential difficulties are obviously likely to arise in the management of an oral trust, so it is always advisable for a written trust deed to be prepared to encapsulate the matters verbally agreed upon by the founder and the first trustees.

An inter vivos trust comes into existence when the founder and the first trustees reach agreement. In the case of a written trust deed, that will obviously only be when the trust deed is signed by the founder and the first trustees. But, no person can act as a trustee under a written trust deed until he or she has been authorised by 'letters of authority' issued by the Master of the High Court under the provisions of s 6 of the Trust Property Control Act.

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<sup>6</sup> 1978 (3) SA 67 (T), 40 SATC 100 at 105.

It is beyond the scope of this report to set out what the usual requirements of the Master of the High Court are before he will issue the letters of appointment of trustees. For purposes of this report, it can be presumed that, provided the Master's requirements are complied with, the persons selected by the founder as the first trustees will be appointed to act on behalf of the trust.

The Trust Property Control Act introduced clarity on certain issues concerning the regulation of trust assets. That Act is not a codification of trust law in South Africa. Broadly speaking, the Trust Property Control Act defines a trust as meaning an arrangement whereby ownership in property is, by virtue of a trust instrument, made over either

- to a trustee to be administered for the beneficiaries of the trust; or
- to the designated beneficiaries, but subject to the property being administered by trustees in terms of a trust deed.<sup>7</sup>

### **General Propositions**

It is beyond the scope of this report to indulge in a jurisprudential exposition of the nature and characteristics of a trust, but it is appropriate to simply record some general propositions and their origin:

- It is established law that a trust is not a legal person as such, and that the assets and liabilities of a trust vest in the trustees. A trust has been held in numerous cases to be a legal institution *sui generis*. The trustees are the owners of the trust property for the purposes of the administration of the trust only. In their capacities as trustees, they have no beneficial interest in

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<sup>7</sup> In some literature, the first category of trust is referred to as an 'ownership trust' or 'a trust in the strict sense', and the second category is referred to as a 'bewind trust'. It has also been pointed out that the difference between the two types of trusts is marginal and of little consequence.

the trust property. The beneficial interest in the assets held by the trustees is enjoyed by the beneficiaries. It is, however, instructive to note that in regard to certain fiscal provisions, trusts have acquired a quasi-juristic personality.<sup>8</sup>

- Trusts can be used for the purposes of protecting assets. The rider must be added that the use of a trust as a screen for fraudulent purposes will be open to attack by third parties and would probably be treated by any court to be a sham and of no legal effect.
- A testamentary disposition to an inter vivos trust is valid.<sup>9</sup>
- Generally, a testator cannot delegate his testamentary power by leaving it to the executor of the estate to decide who the heirs in his estate should be or what each heir should inherit. A testamentary trust is unique, and it is therefore legitimate for a testator to give directions to the trustees to select income and capital beneficiaries from a named class. The granting by a testator, in the creation of a testamentary trust, of the discretion to the trustees to decide which particular beneficiaries out of a class or category of beneficiaries should receive benefits from the testamentary trust, is not a delegation of the testator's testamentary power<sup>10</sup>.
- In terms of the doctrine of *stipulatio alteri* (that is, the stipulation of benefits for third parties) there must be an acceptance by the third party before a binding obligation or relationship comes into existence between the parties to the *stipulatio*. In *Crookes NO and another v Watson and others*<sup>11</sup> it was

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<sup>8</sup> The Value Added Tax Act impliedly recognises a trust as having a distinct corporate identity.

<sup>9</sup> *Burnett v Kohlberg* 1984 (2) SA 137 E and 1986 (3) SA 12 A.

<sup>10</sup> *Braun v Blann and other N N O* 1992 (4) SA 166 (W).

<sup>11</sup> 1956 (1) SA 277 AD.

held that the beneficiaries in a trust do not acquire any rights in the trust until they accept benefits from the trust.

## **Structure**

For convenience, this report first identifies and describes briefly in Chapter 2 the taxes which have a bearing on the circumstances of trusts and the parties involved in them. Then, the overall common law and statutory framework which regulates the taxation of the receipts and accruals of trusts are dealt with in Chapter 3. Thereafter, in Chapters 4 to 7, each of the relevant fiscal provisions (except estate duty) is dealt with separately at each stage in the life cycle of a trust, namely

- when it is formed,
- when it acquires assets,
- while assets are held by the trust, and
- when the trust is wound up.

Estate duty implications are dealt with separately in Chapter 8. The transfer duty aspects of the 'sale' of an interest in a trust and the lock-stock-and-barrel sale of a trust will be dealt with in Chapter 9. Finally, Chapter 10 deals briefly with s 103.

## Chapter 2

### Types of Taxes

The following taxes will be dealt with in this report:

- Normal tax as levied in terms of the Income Tax Act (which is colloquially referred to as 'income tax', and will therefore be referred to in this work as 'income tax').
- Donations tax.
- Transfer duty.
- Value added tax.
- Estate duty.

A trust may be liable for the payment of Joint Services Board levies or Regional Service Council Levies, but the ramifications of the statutes under which those levies are payable are beyond the scope of this report.

#### Income Tax

Income tax is levied in terms of the Income Tax Act.

Until the 1998 year of assessment, a trust was taxed at the rate applicable to natural persons.<sup>12</sup> With effect from the 1999 year of assessment, trusts are taxed at the following rates:

- 35% of the first R100 000 of taxable income, and
- 45% of the taxable income in excess of R100 000.

As indicated above, the definition of 'person' in the Income Tax Act now includes

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<sup>12</sup> The distinction between married and unmarried taxpayers having been abolished.

any 'trust'. Consequently, a trust is subject to all the civic obligations imposed on any person to register as a taxpayer. In terms of s 66 of the Income Tax Act, if a trust falls within the provisions of that section it must be registered as a taxpayer and thereafter render returns in accordance with the provisions of the Act.

In terms of Practice Note 21 which was issued on 1 June 1994, the trustees of an inter vivos trust must ensure that the trust is registered at the office of the receiver of revenue in whose area the office of the trustees is situated 'in order to ensure that effective control is exercised by receivers of revenue over the tax liability of the donor and the beneficiaries in the case of an inter vivos trust'.

The trustee is the representative taxpayer of the trust and the trustee is therefore bound by the duties and obligations of a trust as to the submission of returns and the actual payment of tax where appropriate.<sup>13</sup>

*Meyerowitz on Income Tax*<sup>14</sup> suggests that the trustees should, in the first instance, determine what portion of the trust's receipts is taxable in the hands of the trust, and they should advise the beneficiaries as to what portion of the trust's receipts, deductions and allowances are attributable to them for tax purposes. It can readily be appreciated that the relevant information is unlikely to be clear to the beneficiaries from the annual accounts prepared by the trustees.

The notion of residence always has a bearing on the taxation of receipts or accruals of any person, whether a natural person or a juristic person. In the case of a trust, and in respect of the taxation of any receipts in the hands of a trust, *Meyerowitz on Income Tax*<sup>15</sup> suggests that the residence of a trust is to be found in the

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<sup>13</sup> The trustee is not the representative taxpayer of any beneficiary of the trust in respect of the trust's receipts which are taxable in the hands of that beneficiary in terms of the deemed income provisions of s 7. See *Meyerowitz on Income Tax* in § 36.8.

<sup>14</sup> *Meyerowitz on Income Tax* in § 16.142.

<sup>15</sup> *Meyerowitz on Income Tax* in § 16.137.

country where the central management and control of the trust abides, and not necessarily in the country where the trustees or the majority of them reside.<sup>16</sup>

## Donations Tax

Donations tax is levied in terms of Part V of Chapter II of the Income Tax Act on the value of any property disposed of (whether directly or indirectly, and whether in trust or not) under any donation by any person who, in the case of a person other than a company, is ordinarily resident in the Republic, or, in the case of a company, is a domestic company.<sup>17</sup> The tax is payable by the donor.<sup>18</sup>

A 'donation' means 'any gratuitous disposal of property including any gratuitous waiver or renunciation of a right'.<sup>19</sup>

'Property' is defined as 'any right in or to property movable or immovable, corporeal or incorporeal, wherever situate'.<sup>20</sup>

Donations tax is levied at 25% of the value of the property donated. The Income Tax Act contains detailed provisions as to how the value has to be determined, and in particular the valuation of limited interests in property.<sup>21</sup>

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<sup>16</sup> The issue is not expressly dealt with in either the Income Tax Act nor the Trust Property Control Act, and it would appear not to have been dealt with in any case law to date. The only persuasive authority in this regard is the case of *Nathan's Estate v CIR* 1948 (3) SA 866 (N), 15 SATC 328 where the court held a trust to be resident in Natal because the trustees were resident in Natal and it was from Natal that the fund was administered.

<sup>17</sup> Section 54.

<sup>18</sup> Section 59.

<sup>19</sup> Section 55(1).

<sup>20</sup> Section 55(1).

<sup>21</sup> Section 62.

The Income Tax Act also sets out various exemptions, and one of these is property disposed of under a donation if that property is 'disposed of under and in pursuance of a trust'.<sup>22</sup>

Another significant exemption which is referred to later is the exemption in respect of so much of the value of all property disposed of by a donor who is a natural person as does not during the year of assessment exceed R25 000.<sup>23</sup>

If the asset donated to a trust is immovable property,<sup>24</sup> transfer duty will also be payable on the transfer of the immovable property into the name of the trustees.

### **Transfer Duty**

Transfer duty is levied in terms of the Transfer Duty Act. For transfer duty purposes, a trust is now<sup>25</sup> regarded as a juristic person, so transfer duty is levied at the rate of 10% of the value of the property being transferred.

Perhaps as an illustration of the unique nature of a trust,<sup>24</sup> it is worth recording that, prior to 1996, the rate at which a trust paid transfer duty was determined by the identity of the beneficiaries. Until then, s 2(7) of the Transfer Duty Act had provided that if all the beneficiaries of a trust were natural persons, the amount of transfer duty payable in respect of the acquisition of immovable property by that trust would be determined on the sliding scale which applies to natural persons.

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<sup>22</sup> Section 56(1)(l)

<sup>23</sup> Section 56(2)(b).

<sup>24</sup> In which event the property will be registered in the name of 'The Trustees for the time being of The ... Trust, No. ...'.

<sup>25</sup> Since 1996, as a result of the insertion of the definition of 'person' in the Transfer Duty Act by Act 37 of 1996. The definition is similar to the definition of 'person' in the Income Tax Act, and specifically includes reference to any 'trust'.

The corollary was that if any one beneficiary was not a natural person, transfer duty was levied at the rate payable by a juristic person.

When s 2(7) was repealed in 1995, the Commissioner mistakenly called for payment of transfer duty by trusts as if trusts were juristic persons. When the misunderstanding of the essential nature of a trust was realised, s 2(8) was inserted in the Transfer Duty Act in 1996 to provide that a trustee of a trust is 'deemed to be a person other than a natural person'! Thus, the nature of the beneficiaries in a trust is no longer relevant for transfer duty purposes.

### **Value Added Tax**

Value added tax (VAT) is levied in terms of the Value Added Tax Act on the supply of goods and services by a registered vendor. Thus, in addition to the burden which afflicts all consumers of paying VAT on all its purchases from registered vendors, VAT considerations arise where a trust carries on an enterprise.

The definition of 'person' in the Value Added Tax Act includes a trust fund. Thus, if a trust carries on or intends to carry on an enterprise, all the provisions of the Value Added Tax Act apply to the trust. The trustee is the representative vendor and is responsible for all the trust's obligations in respect of VAT.<sup>26</sup>

There are significant VAT consequences where a trust which is a registered vendor is wound up.

### **Estate Duty**

Estate duty is levied in terms of the Estate Duty Act. It is levied at the rate of 25% of the dutiable amount of the estate, which is determined in accordance with the provisions of the Estate Duty Act. The relevant provisions of the Estate Duty Act

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<sup>26</sup> *Meyerowitz on VAT* at A2.2 and A20.

are dealt with later.

## The Conduit Principle and Section 25B

### The Treatment of Receipts

The inclusion of a reference to a trust in the definition of 'person' in the Income Tax Act in 1991 has not negated the well-established 'conduit principle' in regard to the taxation of trusts.

It has been a long standing principle of trust law that a trust merely serves as a conduit for the receipts or benefits flowing through it to the beneficiaries of that trust. That principle was accepted by the Appellate Division in the case of *Armstrong v SIR*<sup>27</sup> and was confirmed in the case of *SIR v Rosen*.<sup>28</sup>

Consequently, to the extent that the receipts and accruals of a trust pass through the trust into the hands of the beneficiaries of the trust, those receipts have always been taxed in the hands of the beneficiaries. The receipts and accruals which did not pass into the hands of the beneficiaries and were retained in the trust, were taxed in the hands of trustees at the rate applicable to unmarried persons. That was the situation until *Friedman's case*.

As was stated in the historical perspective above, *Friedman's case* gave rise to two significant changes to the Income Tax Act, namely

- the inclusion of the description of a trust in the definition of 'person'; and
- the introduction of s 25B.

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<sup>27</sup> 1983 AD 343, 10 SATC 1.

<sup>28</sup> 1971 (1) SA 172, 23 SATC 343.

It has been in the application of the conduit principle that trusts have been useful tools from a tax-planning point of view. The extent to which the conduit principle can be used for tax planning purposes in respect of a particular trust, depends in part on whether the trust is

- a 'discretionary trust' or
- a 'vesting trust'.

A discretionary trust is one in which the trustees decide from time to time (usually annually) what benefits should devolve from the trust upon the beneficiaries out of the income earned by the trust from its assets or activities.

In a vesting trust, the beneficiaries are entitled, as of right, to receive in due course the income which is earned by the trust from its assets or activities. Thus, in the case of a vesting trust, the income vests in the beneficiaries directly, without any intervention by the trustees.

Until the introduction of s 25B into the Income Tax Act, the conduit principle set out above regulated the taxation of trusts. In effect, s 25B codified the basis of taxation which had evolved from the case law.

Section 25B(1) and (2) read as follows:<sup>29</sup>

- (1) Any income received by or accrued to or in favour of any person in his capacity as the trustee of a trust referred to in the definition of 'person' in Section 1, shall, subject to the provisions of Section 7, to the extent to which such income has been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, be deemed to be income which has accrued to such beneficiary, and to the extent to which such income is not so derived, be deemed

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<sup>29</sup> Section 25B(3), (4), (5) and (6) will be dealt with later.

to be income which has accrued to such trust.'

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

Thus, s 25B provides that any income received by or accrued to or in favour of the trustees (whether of a testamentary trust or an inter vivos trust) is, subject to the provisions of s 7 (which are dealt with later) deemed to be income which has accrued to a particular beneficiary of that trust where that income has been derived for the immediate or future benefit of that particular beneficiary, who enjoys a vested right to that income.

The phrase 'an ascertained beneficiary with a vested right to such income' as used in s 25B(1) means a beneficiary who is entitled as of right to receive the income.

Section 25B(2) deals with the situation where a beneficiary of a discretionary trust has acquired the right to any receipts and accruals of that trust in consequence of the exercise by the trustees of the discretion granted to the trustees in terms of the trust deed or will. In terms of s 25B(2), those receipts and accruals are deemed to have been derived for the benefit of the beneficiary concerned, and are therefore taxed in the hands of the beneficiary in terms of s 25B(1).

Consequently, s 25B(1) and (2) leave in tact the conduit principle which was recognised in *Armstrong's case* and confirmed in *Rosen's case*, and confirm two general principles:

- In the case of a vesting trust, any receipts and accruals earned by a trust<sup>30</sup>

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<sup>30</sup> Net of any deductions and allowances which are deductible in terms of the Income Tax Act.

are taxable in the hands of the beneficiaries, in proportion to their respective entitlement to those receipts and accruals, and the receipts and accruals retained in the trust are taxed in the hands of the trustees; and

- In the case of a discretionary trust, a beneficiary is only taxed on the receipts and accruals which pass through the trust to the beneficiary concerned as a result of the exercise by the trustees of their discretion, and the receipts and accruals retained in the trust are taxed in the hands of the trustees.

The levying of normal tax is an annual event. In the case of a discretionary trust, the beneficiary only acquires an enforceable right to income when the trustees exercise their discretion.

When must the discretion be exercised? *Meyerowitz on Income Tax*<sup>31</sup> suggests that the trustees should exercise their discretion before the end of February each year. In ITC 1033<sup>32</sup> the court indicated that, in relation to s 7(5) it would be sufficient to effect the incidence of the tax if the discretion was exercised within a reasonable period after the close of the year of assessment. The court suggested *obiter* that a reasonable period would be by the end of the period allowed by the Commissioner's notice for the lodging of income tax returns.

### **The Anti-Avoidance 'Deemed Income' Provisions**

Any consideration of the taxability of the receipts actually received and accruals arising from the holding of assets by a trust is dominated by the complex provisions of s 7 of the Income Tax Act. Section 7 contains a number of anti-avoidance provisions which are aimed at preventing the diversion of income from one taxpayer to another who is less heavily taxed.

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<sup>31</sup> *Meyerowitz on Income Tax* in § 16.135.

<sup>32</sup> (1964) 26 SATC 73.

Trusts have frequently been used to achieve diversions of that nature, so the deemed accrual provisions of s 7 are of relevance to the taxation of income received by and accruals to or through a trust. The following is a brief overview of scope and effect of the various subsections:

Section 7(1): An amount is deemed to have accrued to a person even if the amount has not actually been received by that person, but has been invested, accumulated or otherwise capitalised in that person's name or on his behalf.

Section 7(2): This section deals, amongst other things, with donations between spouses. Income derived by a recipient spouse in consequence of a donation, settlement or other disposition made by the donor spouse on or after 20 March 1991, or in consequence of a transaction, operation or scheme entered into or carried out by the donor spouse on or after that date, is deemed to be the income of the donor spouse if the sole or main purpose of that donation, settlement or other disposition or of that transaction, operation or scheme was the reduction, postponement or avoidance of the donor's liability for tax, levy or duty which, but for the donation, settlement or other disposition, transaction, operation or scheme would have become payable by the donor under the Income Tax Act or any other act administered by the Commissioner. Thus, if the donation is effected through a trust, the income of the recipient spouse arising from the donation will be deemed to be income in the hands of the donor spouse.

Section 7(3) and 7(4): Income of a minor child is deemed to be the income of his parent in certain circumstances. The parent of a minor child is taxed on any amount which is received by, or for the benefit of

his child in consequence of any donation, settlement or other disposition made by the parent or any other person, whether directly or indirectly. Thus, receipts and accruals derived by a trust established by a parent for the benefit of a minor child will, in these circumstances, be taxed in the parent's hands.

**Section 7(5):** Income of a trust is deemed to be the donor's income to the extent that it has been withheld because of a stipulation relating to that donation. Thus, the donor of any assets to a trust will be taxed on any income which is received by or accrues to the trust, and which is not distributed to the beneficiaries in the same year in which it is received by or accrues to the trust, if the trust deed prohibits the distribution of that income until the happening of some event (for example the attainment by the beneficiary of a certain age). A more detailed analysis is set out later.

**Section 7(6):** This section applies where a person's right to receive income arising in consequence of a donation may be revoked or conferred on someone else as a result of certain powers retained by the donor. In that event, the donor is subject to tax on the income. Where a donation has been made to a trust, s 7(6) might apply, in which event, the income received by or accrued to the trust as a result of that donation will be taxed in the hands of the donor.

**Section 7(7):** If a donor retains the right to recover assets or rights which he has donated, then any receipts or accruals earned from that donation are deemed to be the income of the donor. The provisions of this section would apply, for example, if the donor transfers an income-producing asset to the trust on the basis that he may regain ownership of the asset at a stated

time in the future or on the happening of a stated event.

The term 'donation, settlement or other disposition' is used repeatedly in s 7. For a disposal of assets to fall within the ambit of that phrase, the property must have been disposed of gratuitously, that is with an element of liberality.<sup>33</sup>

In the case of *Joss v SIR*<sup>34</sup> it was held that the granting to a trust of an interest-free loan which enabled the trust to purchase income-producing assets (shares) is a continuing donation which is therefore a disposition within the meaning of s 7(3). The wording of s 7(3) is similar to that of s 7(5) in the use of the words 'any donation, settlement or other disposition'. An interest-free loan is therefore regarded as a disposition for the purposes of s 7(5). This was confirmed by the Appellate Division in *Ovenstone's case*.

Before embarking on a detailed analysis of s 7(5) it must be emphasised that this provision does not apply to trusts and similar arrangements, but the reality is that receipts and accruals which pass through trusts are often affected by the provisions of s 7(5). A detailed analysis of the ramifications of s 7(1) to 7(4) is not necessary, but a detailed analysis of s 7(5) and s 7(6) follows :

Section 7(5) reads as follows :

'If any person has made any donation, settlement or other disposition which is subject to a stipulation of condition, whether made or imposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of any income as would, but for stipulation or condition, in consequence of the donation, settlement or other disposition be received by or accrue to or in favour of the beneficiaries, shall, until the happening of that event or the death of that person, whichever first take place, be deemed to be the income of that income.'

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<sup>33</sup> *Ovenstone v SIR* 1980 (2) SA 721 A, 42 SATC 55.

<sup>34</sup> 1980 (1) 674, 41 SATC 206.

Section 7(5) embodies two conditions, both of which must be satisfied:

- There must be a stipulation or condition which has the effect that the person entitled to certain income does not receive that income until the happening of an event.
- But for the stipulation or condition, the income would be received by or accrue to the person concerned.

If both conditions are present in the trust deed of an inter vivos trust, then each person who has made a donation, settlement or other disposition to the trust is taxable on the income derived from the donation, settlement or other disposition no matter who made the stipulation nor who founded the trust.<sup>35</sup>

The general aim of s 7(5) is to prevent the avoidance of tax liability where and so long as a beneficiary does not enjoy the income derived from the donation, settlement or other disposition. Until the decision of the Appellate Division in *Estate Dempers v SIR*<sup>36</sup>, there had been uncertainty as to the proper meaning of s 7(5) and the decisions of the various special courts had not been uniform. In *Estate Dempers v SIR*, the court held that, by virtue of the terms of the particular trust deed being dealt with in that matter, but for the stipulation in the trust deed which gave rise to the withholding of income in the hands of the trustees, the income which had accumulated in the trust would have accrued to and been received by the beneficiary, and the court accordingly held that s 7(5) applied to the accumulated income. The court summed up as follows:

'In trust the application of the devolutionary portion of that subsection (the second condition referred to above) involved a hypothetical, notional enquiry which cannot be directed solely to questions such as whether the beneficiaries' right to income is vested or

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<sup>35</sup> *Meyerowitz on Income Tax* in § 16.144.

<sup>36</sup> 1977 (3) SA 410 A, 39 SATC 95.

contingent. The question which the court must ask itself is whether, in the absence of the stipulation withholding trust income, which income would have been received by or have accrued to the beneficiary. In answering this question regard must be had to the terms of the instrument generally, the donor's general benevolent intention, as evinced by the terms of the instrument, and all the relevant circumstances. In this enquiry the fact that in terms of the instrument as a whole, the beneficiary has a vested right to the income would, as I have indicated, be an important factor but it would not be the sole touchstone.'

The court held that, in the circumstances of that particular case, but for the stipulation withholding the income, the accumulated income would have accrued to or been received by the donee, and accordingly s 7(5) applied to that accumulated income.<sup>37</sup>

Does the exercise of the trustee's discretion constitute an 'event' for the purposes of s 7(5)?

The issue was touched on in *Estate Dempers' case*, but the court reached its conclusion without having to decide that point. Accordingly, as *Meyerowitz* reports,<sup>38</sup> the question whether the exercise of a trustee's discretion constitutes an event is still an open one.

*Meyerowitz*<sup>39</sup> summarises the current position under s 7(5) as follows:

- '(1) Where a trust deed provides that the income or any portion thereof which is not paid out in the year of receipt or accrual (either because the deed prevents this or leaves it to the trustee's discretion) shall be accumulated until the happening of some fixed or contingent event, there is a stipulation which falls within the scope of s 7(5), namely that the accumulated income shall not be received by the beneficiaries until the happening of a stipulated fixed or contingent event.

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<sup>37</sup> *Meyerowitz on Income Tax* in § 16.144.

<sup>38</sup> *Meyerowitz on Income Tax* in § 16.145.

<sup>39</sup> *Meyerowitz on Income Tax* in § 16.147.

- '(2) Where a stipulation exists, s 7(5) deems the accumulated income to be the donor's if, in the absence of the stipulation, having regard to the terms of the deed generally, the donor's general benevolent intention, as evinced by the terms of the deed, and all relevant circumstances, it can be predicated that the accumulated income would have accrued to or have been received by the beneficiaries (or some of them). If ITC 1328<sup>40</sup> be rightly decided, s 7(5) will not apply where the beneficiary has a vested right to the income in the sense that his right to the income is certain albeit that the enjoyment thereof is postponed; in such case the income is deemed to be the beneficiary's in terms of s 7(1).
- '(3) Current income which is paid out during the year of assessment by the trustee in the exercise of his discretion is not deemed to be the donor's income under s 7(5).
- '(4) Income which is deemed to be the donor's, does not constitute income in the hands of the beneficiaries when subsequently paid out to them, whether as capital or accumulated income.'

It must be borne in mind that where the beneficiaries of the trust are the minor children of the donor, the donor will be taxed on the receipts of the trust under s 7(3) or 7(4) even if s 7(5) is not applicable.

The application of s 7(5) changes significantly when the donor dies because the deeming provision falls away in respect of the receipts and accruals of the trust after the donor's death, even where the conditions for the application of s 7(5) are present. In that case, the income is taxable in terms of s 25B in the hands of either the beneficiaries or the trustees, depending on the circumstances.<sup>41</sup>

Section 7(5) only applied to the receipts derived 'in consequence of' the donation, settlement or other disposition. It does not apply to any other receipts which may have been received by or accrued to the trust and which were not received or accrued in consequence of the donation, settlement or other disposition.

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<sup>40</sup> (1981), 43 SATC 56.

<sup>41</sup> *Meyerowitz on Income Tax* in § 16.149.

A consolation for the donor is that if the donor is taxable on the trust's receipts in terms of s 7(5) he is entitled to recover from the trustees so much of the tax as is due to the inclusion in his income of the deemed income.<sup>42</sup>

Section 7(6) reads as follows:

'If any deed or donation, settlement or other disposition contains any stipulation that the right to receive any income thereby conferred may, under powers retained by the person by whom that right is conferred, be revoked or conferred upon another, so much of any income as in consequence of the donation, settlement or other disposition is received by or accrues to or in favour of the person on whom that right is conferred, shall be deemed to be the income of the person by whom it is conferred, so long as he retains those powers.'

It has been held<sup>43</sup> that what the section contemplated is an express provision in the trust deed which reserves the right to the donor to revoke the right to income given and to confer it upon another. *Meyerowitz*<sup>44</sup> suggests that this judgment goes too far in holding that the donor's right to revoke must be expressly reserved, and that the reservation of the power to revoke can be implied (for example, if the trustees are given the discretion in the trust deed to revoke the right of any beneficiary to income and to confer that income on another beneficiary, where the donor is one of the trustees and is, in terms of the trust deed empowered to bind the trustees in the event of any dispute. In those circumstances, the donor will clearly have retained the power to revoke the right to receipts and accruals and to confer them on another). Where the donor has retained the power to revoke any right to income or to confer that right upon another, the receipts and accruals which would otherwise have accrued to the person originally entitled to receive those receipts and accruals are deemed to be the donor's receipts and accruals and are taxable in the donor's hands.

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<sup>42</sup> Proviso to s 90 of the Income Tax Act.

<sup>43</sup> ITC 673 (19), 16 SATC 230.

<sup>44</sup> *Meyerowitz on Income Tax* in § 16.151.

If s 7(6) is applicable because the donor has retained the power to revoke, that section will cease to apply from the time the donor ceases to retain that power. That cessation could occur either by the donor renouncing that power or upon the death of the donor.

Again, any tax payable by the donor as a result of the inclusion of the receipts of the trust in his income may be recovered by him from the trust.<sup>45</sup>

One consolation which Broomberg and Kruger<sup>46</sup> point out is that the anti avoidance provisions can actually work perversely to create a tax advantage where, for example, it is desirable for income to be earned in the hands of the donor rather than in the hands of the beneficiary who actually receives and retains the income. This situation could arise where efforts are being made to reduce the value of the donor's estate for estate duty purposes.

### **The Treatment of Deductions and Allowances**

Normal tax is only levied on 'taxable income', which is what remains after various deductions and allowances have been subtracted from 'income', which is in turn what remains after all exempt income has been excluded from 'gross income'.

The terms 'taxable income', 'income' and 'gross income' are all defined in the Income Tax Act. A detailed analysis of what those terms encompass is beyond the scope of this report, but for present purposes it must be borne in mind that expenses incurred by a taxpayer in the production of 'income' can be deducted from that 'income' in deriving the taxpayer's 'taxable income', provided that the expenditure was not of a capital nature and, in the case of income from trade, only to the extent to which such monies were laid out or expended for the purposes of trade.

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<sup>45</sup> Proviso to s 90 of the Income Tax Act.

<sup>46</sup> *Tax Strategy* at 15.

One of the uncertainties which had bedeviled the taxation of trusts was the tax status of expenditure incurred by the trustees in generating receipts and accruals for the benefit of the beneficiaries. Could the beneficiaries deduct from their own receipts and accruals (from the trust and from other sources) any expenditure or loss incurred in generating the receipts or accruals from the trust?

This uncertainty was remedied in part by the introduction of s 25B(3) in the Income Tax Act in 1991. Section 25B(3) reads as follows:

'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 income referred to in subsection (1) shall, *to the extent to which* such income is under the provisions of that subsection deemed to be income which has accrued to a beneficiary or to the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by such beneficiary or trust, as the case may be.' (emphasis added)

Thus, the accumulative effect of s 25B(1) and (3) was that receipts and accruals derived by a trustee for the immediate or future benefit of any ascertained beneficiary with a vested right to the income are deemed to be the receipts and accruals of the beneficiary, but any deduction or allowance relating to those receipts and accruals was effectively deemed to have been incurred by the beneficiary.

Initially, there was some doubt as to whether it was the intention of the legislature to grant losses to trusts and trust beneficiaries in terms of s 25B(3). In certain instances the view was apparently held that the wording of s 25B(3) has a "ring-fencing" effect, that is that this section limits the allowable deductions and allowances to income (as defined) in the hands of trusts and trust beneficiaries.

In order to remove that doubt, the Commissioner issued his Practice Note 23 dated 17 June 1994. The last paragraph of Practice Note 23 reads as follows:

'The wording in s 25B(3) "to the extent to which" can, therefore, not be construed as

meaning that deductions and allowances be limited to the income of a trust or a trust beneficiary. What it in fact means is that such deductions and allowances are to be allocated between a trust or trust beneficiary in the same proportion as the income has been allocated. Therefore, any deduction or allowance which would be available to a trust beneficiary in terms of s 25B in the determination of taxable income derived from trust income, will be deductible in full in the hands of the beneficiary.'

What Practice Note 23 dealt with, therefore, was the manner of allocation of deductions and allowances, not the quantum of the deduction.

The statement in the paragraph cited above, that any deduction or allowance is deductible in full in the hands of the beneficiary, implied that the amount of the deduction was not limited to the amount of the beneficiary's receipts and accruals from the trust.

*Meyerowitz*<sup>47</sup> suggests that the apportionment to a beneficiary of deductions and allowances under s 25B(3) should be based on the ratio that the net income of the trust vesting in the beneficiary bears to the total net income of the trust.

The following example illustrates the application of the principle:

### **Example**

Assume that a trust has gross income of R100 of which R6 consists of dividends. The balance of the gross income is derived from the letting of industrial premises, in respect of which the trust is entitled to an allowance of R10. Assume further that, in the production of that income, expenses of R20 are incurred. Assume, finally, that in the exercise of their discretion, the trustees decide to distribute R50 to the sole beneficiary of the trust, and to retain the balance of the net income in the trust.

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<sup>47</sup> *Meyerowitz on Income Tax* in § 16.140.

Gross Income of trust	R100
Less exempt income	6
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Income	94
Less:	
Expenses	-20
Allowance	-10
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Taxable income	R64
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The net cash receipts and accruals of the trust are R80 (R100 - R20 expenses)

Thus, the taxable income of R64 is apportioned as follows:

● to the beneficiary: 50/80 of R64	40
● to the trust: 30/80 of R64	24
	<hr/>
	R64
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Practice Note 23 did not deal with the problem of how s 25B(3) should be applied where the trust deed provided for the vesting of the net income of the trust (that is gross income less expenses) rather than 'income' for income tax purposes.

In consequence, there would be a portion of the trust's 'income' which would not vest in the beneficiary (that portion usually being the trust's expenses).

A further problem which arise in those cases was that, unless the trust deed provided that a beneficiary was responsible for making good all expenditure incurred by the trust (for example, in the case of a trading trust or, arguably, where a beneficiary has a vested right to both income and capital), there can be no apportionment of a loss resulting from an excess of expenditure over receipts or accruals because, in these circumstances there would be no net income to vest.

A loss arising from an allowance, rather than a deduction, could be claimed by an income beneficiary since an allowance does not affect the cash flow of the trust.

As s 25B(3) refers to 'income' and a beneficiary with a vested right 'to such

income' it would appear that the section means 'income' as defined (that is 'gross income' less exempt income).

This is confirmed by the reference in Practice Note 23 in paragraph quote above, to 'income' (as defined).

Thus, although Practice Note 23 brought some clarity to the interpretation of s 25B(3) it still left it unclear how s 25B(3) had to be applied in the circumstances where the deductions and expenses exceeded the receipts and accruals, and the trust deed provided for the vesting of trust income.

If the actual expenditure by the trust exceeds the income earned by the trust, then the loss suffered by the trust could not be apportioned to the beneficiaries because there would have been no net income which could have vested in the beneficiaries.

An exception would arise in the case of a so-called business trust if the beneficiaries are only entitled to income from the trust if they are obliged to make good the expenses of the trust

If a trust suffers a loss for tax purposes as a result of any allowance being claimed, then it is used to be possible for the beneficiary to claim the tax loss as a deduction from his other receipts or accruals in determining his taxable income.

*Meyerowitz*<sup>48</sup> suggests that where a beneficiary has a vested right to both income and capital, it can be said that, where the trust suffers a loss, it is really at the expense of the beneficiary and that, because of this, the beneficiary is entitled to deduct that loss, even though there is no net income for distribution.

*Meyerowitz* suggests further that the same logic applies to a trading trust under which the participants bear any losses which the trust may make in the carrying

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<sup>48</sup> *Meyerowitz on Income Tax* in § 16.140.

on of the trust's trade.

The lack of clarity on the application of s 25B(3) almost inevitably gave rise to a considerable amount of abuse, so s 25B was amended in 1998 by the introduction of subsections (4), (5) and (6). Those provisions read as follows:

- '(4) Notwithstanding the provisions of subsection (3), any deduction or allowance contemplated in that subsection which is deemed to be made in the determination of taxable income of a beneficiary of a trust during any year of assessment shall be limited to the income which is deemed to be income which has accrued to such beneficiary in terms of subsection (1) during such year of assessment.
- '(5) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the income contemplated in that subsection, shall be deemed to be a deduction or allowance which may be made in the determination of the taxable income of the trust during such year of assessment: Provided that the sum of such deductions and allowances shall be limited to the taxable income of such trust during such year of assessment as calculated before allowing any deduction or allowance under this subsection.
- '(6) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the sum of the income contemplated in subsection (4) of such beneficiary and the taxable income of such trust contemplated in subsection (5), shall for the purposes of subsection (3) be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by such beneficiary by way of income referred to in subsection (1) during the immediately succeeding year of assessment.'

These provisions apply to new trusts created on or after 11 March 1998 and in respect of existing trusts with effects from the years of assessment commencing on or after 1 January 1999.

The effect of those provisions is to limit the amount of the expenses and deductions which can be claimed by a beneficiary in respect of receipts and accruals from a trust during any particular tax period, to the amount of the receipts and accruals which the beneficiary received from or accrued from the trust during that tax period.

Any excess of the expenses and deductions over the amount received by or accrued to the beneficiary can be taken into account in the determination of the taxable income of the trust during that tax period (up to the amount of the taxable income of the trust before taking the excess of expenses and deductions into account).

If there still remains an excess of expenses and deductions over and above the taxable income of the trust, the excess is carried forward to the next year of assessment and may be deducted from the beneficiary's receipts and accruals from the trust in the determination of the beneficiary's taxable income in the following year.

*Meyerowitz*<sup>49</sup> describes the effect of s 25B(4), (5) and (6) as follows:

- '1. No loss whether arising from actual expenditure by the trust or because of allowances is apportionable to any beneficiary, to the extent that it exceeds the income apportioned to him.
- '2. To the extent that the sum of expenditure and allowances in any year exceeds the income deemed to be that of the beneficiaries, it is deductible in the determination of the trust's income, if any, for that year, but also limited to the taxable income, if any, of the trust before the deduction of the excess.
- '3. Should the loss not be fully absorbed by the income of the trust in the relevant year, the excess is carried forward into the succeeding year and may be deducted by the beneficiaries to the income to which the excess relates, provided, again, that if the losses exceed the beneficiaries income, the excess remains in the trust to be used as set out in (2) of this paragraph in the succeeding year of assessment.'

The following example will illustrate the application of the new provisions:

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<sup>49</sup> *Meyerowitz on Income Tax* in § 16.140.

**Example**

Assume that the gross income of a trust in year 1 is R100 and the deductions and allowances relating to that income amount to R150, and that in year 2 the trust's gross income is R200 and the deductions and allowances relation to that income amount to R120. Assume further that the sole beneficiary has a vested right to 80% of the income of the trust.

**Year 1**

The deductions and allowances which would, but for s 25B(4) have been attributable to the beneficiary (80% of R150 = R120) exceed the income which the beneficiary is entitled to (80% of R100 = R80). Thus, R80 of the deductions and allowances attributable to the beneficiary are deductible from the R80 received by or accrued to the beneficiary from the trust. The balance of the deductions and allowances (R150 - R80) would, for s 25B(4), have been deductible from the income retained by the trust (20% of R100 = R20). By virtue of s 25B(5), only R20 of the deductions and allowances can be deducted from the income of the trust. The balance of the deductions and allowances (that is R150 - R80 - R20 = R50) must be carried forward to the following year of assessment, when it can be deducted from the income due to the beneficiary from the trust.

**Year 2**

The income to which the beneficiary is entitled (80% of R200) = R160

The amounts which can be deducted from that income are

• Share of the balance of the deductions and allowances carried forward from Year 1 (80% of R50)	40
• 80% of the deductions and allowances in Year 2 (80% of R120)	96
	<hr/> R136 <hr/>

Taxable income of the beneficiary in year 2 (R160 - R136)	<u>R24</u>
In respect of the trust, the income will be (20% of R200)	<u>R40</u>
The amounts which may be deducted from that income are	
<ul style="list-style-type: none"> <li>● share of the balance of the deductions and allowances carried forward from the previous year (20% of R50)</li> </ul>	10
<ul style="list-style-type: none"> <li>● share of the deductions and allowances in year 2 (20% of R120)</li> </ul>	24
	R34
	<u>R6</u>
Taxable income of the trust (R40 - R34)	<u>R6</u>

### The Retention of Identity

Where receipts and accruals of a trust are taxable in the hands of beneficiary, those receipts and accruals do not lose their identity simply because they have passed through the trust. The consequence of that fact is that receipts and accruals which are subject to any particular tax treatment because of, for example,

- the source from which they emanated, or
- because of the nature of the receipts (whether it is dividends or interest), or
- because of the circumstances of the recipient (for example, a non-resident of South Africa),

the receipt or accrual will be taxed in the hands of the beneficiary on that basis.

Thus, whether any amount taxable in the hands of the beneficiary constitutes revenue from a source within or deemed to be within the Republic of South Africa must be determined without reference to the tax that it passed through the trust.

Similarly, whether the income is or is not exempt from tax because of its nature must be determined in relation to the beneficiary and not in relation to the trust. Where the income is apportionable amongst several beneficiaries, each kind of income must likewise be apportioned among them, unless the trust instrument directs, or confers a discretion upon the trustees to decide what receipts are to go to whom.<sup>50</sup>

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<sup>50</sup> *Meyerowitz on Income Tax* in § 16.137.

## Chapter 4

### **Fiscal Provisions Applicable when a Trust is Formed**

No income tax liability arises merely from the formation of a trust.

It is customary for the founder of a trust to undertake in the trust deed to donate a small amount to the trust. The amount donated can be as little as R100. A small donation of that magnitude is unlikely to be subject to donations tax if the founder of the trust is a natural person, because of the R25 000,00 annual exemption applicable to all natural persons in respect of donations made during any financial year.

## Chapter 5

### **Fiscal Provisions Applicable when Assets are Acquired by a Trust**

Practically speaking, there are only three ways in which a trust can acquire assets. The three ways are

- by donation,
- by inheritance, or
- by purchase.

For convenience, each of those modes of acquisition is dealt with separately.

#### **Donation**

Donations tax will be payable on the value of any property donated to a trust. Donations tax is payable by the donor.

If the asset donated to a trust is immovable property, then transfer duty will also be payable on the transfer of the property into the name of the trustees. The amount of transfer duty will be calculated on the fair market value of the property as declared by the donee, or as determined by the Commissioner. Transfer duty will be payable by the trust, as the person acquiring the property.

#### **Inheritance**

As indicated above under the general propositions, it is legitimate to bequeath assets to an inter vivos trust.<sup>51</sup>

In the case of immovable property bequeathed to an inter vivos trust, no transfer

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<sup>51</sup> *Burnett v Kohlberg* 1984 (2) SA 137 E and 1986 (3) SA 12 A.

duty is payable in respect of the transfer of the property from the estate to the trust in terms of s 9(e) of the Transfer Duty Act. This exemption is of general application to all inheritances from deceased estates and does not only apply specifically to inheritances devolving on inter vivos trusts.

## **Purchase**

For any arrangement between parties to constitute a valid agreement of purchase and sale, there must be a certain or ascertainable purchase price. The purchase price does not have to be equal to or remotely close to the intrinsic value of the asset sold. Thus, the purchase price can be artificially low or artificially high. Depending on the nature of the asset and the relationship between buyer and seller, an artificially high or low purchase price can have donations tax consequences. This is so because the Commissioner may disregard the purchase price agreed to by the parties and levy donations tax on the difference between the agreed purchase price and the 'fair market value' as determined in terms of the provisions of the Income Tax Act.<sup>52</sup>

## **Transfer Duty and Value Added Tax**

In the case of immovable property purchased by a trust, transfer duty will be payable by the trust as purchaser.<sup>53</sup> Where the immovable property is acquired by a trust from a seller who is a registered vendor in terms of the Value Added Tax Act, VAT will be payable on the purchase price and the transfer is exempt from transfer duty.<sup>54</sup> If the trust is also a registered vendor, the VAT paid in respect of the purchase of the immovable property will obviously be recoverable by the trust as a VAT input credit.

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<sup>52</sup> Section 62(4) and (5).

<sup>53</sup> Section 3 of the Transfer Duty Act.

<sup>54</sup> Section 9(15) of the Transfer Duty Act.

Where a trust which is a registered vendor acquires immovable property from a seller who is not a registered vendor (in which case transfer duty is payable, not VAT), then the trust may recover the amount of the transfer duty paid as a notional input VAT credit.<sup>55</sup>

In respect of the registration of any transfer of immovable property or any interest in immovable property, a transfer duty receipt must be lodged in the Deeds Office with the transfer documents, unless the transfer is exempt from transfer duty.

In order to obtain that transfer duty receipt, the purchaser and seller must lodge with the appropriate office of the receiver of revenue declarations in which they declare, amongst other things, what they believe is the fair market value of the property. Usually, this is the same as the purchase price, but the parties might, for whatever reason, declare a value different from the purchase price.

In the case of immovable property purchased by a trust for a purchase price which, in the opinion of the Commissioner is less than the fair market value of the property, the Commissioner may determine the fair market value of that property.<sup>56</sup> Thereafter, the transfer duty payable in respect of the acquisition of that property must be calculated in accordance with the value as so determined or the consideration payable or the declared value, whichever is the greatest.<sup>57</sup>

It seems trite to state that, where assets are sold, the purchase price is usually paid at the time of delivery or transfer of the assets but this need not necessarily be so.

In the case of a newly created trust, the trust can either borrow funds in order to pay the purchase price, or the seller can effectively lend the purchase price to the trust by allowing the purchase price to be payable on demand.

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<sup>55</sup> Section 11 of the Value Added Tax Act.

<sup>56</sup> Section 5(6) of the Transfer Duty Act.

<sup>57</sup> Section 5(6) of the Transfer Duty Act.

If the purchase price is to be borrowed from a third party in order to effect payment to the seller, the borrowing can be from a financial institution in terms of an interest-bearing loan, or it can be an interest-free loan from someone linked to the trust, for example, the founder or a beneficiary.

Also, if the purchase price is payable on demand, the granting of credit by the seller to the trust can either be interest bearing or be interest free.

If a loan is interest free, then the provisions of s 7(5) of the Income Tax Act are relevant. These provisions have been set out above.

It must be mentioned that the use of interest-free loans has caused some consternation to the fiscal authorities over a considerable period of time because interest-free loans are seen as a toll to deprive the fiscus of tax revenue on the interest which would have been earned if the loans had of borne interest. The issue was considered by the Margo Commission and has also been targeted for consideration by the Katz Commission. It can therefore be expected that there might in future be some changes to fiscal legislation in respect of interest-free loans.

The loan account can be reduced over time by the creditor, that is the seller, donation an amount to the trust each year. The amount of the donation can be a maximum amount of the annual exemption from donations tax.

### **Pre-formation Contracts**

One of the regular frustrations of any property lawyer recurs when the prospective purchaser of immovable property announces at the time of signing an agreement (or, even more frustratingly, after the agreement has been signed!) that he wishes to transfer the property into a trust which he would like to form.

It frequently happens that the promoter of a company or close corporation wishes

to secure the purchase price of a property before going to the trouble and expense of forming the company or close corporation to acquire and hold that property. Or, the founder may wish to buy certain immovable property before the formalities required for the establishment of the company or close corporation have been completed.

Time is often of the essence.

The Companies Act and Close Corporations Act both contain statutory provisions which regulate the execution of pre-incorporation contracts.<sup>58</sup>

But it is not possible for interested party to purchase a property 'as trustee of a trust to be formed'. It has always been, and still is, possible to achieve a similar result by the use of the common law doctrine of *stipulatio alteri*, which is loosely described as the stipulation of a benefit for a third person.

The full ramifications of that doctrine are beyond the scope of this report, but it is sufficient for present purposes to record that, for the proper application of the doctrine of *stipulatio alteri*, the contracting party must contract in his capacity as a principal for the benefit of the third party and not as the agent for the benefit of the third party.

The conclusion of contracts on behalf of a trust before the trust has been formed, and more specifically, before the trustees have been authorised to act on behalf of the trust is complicated by the following issues:

- An agent cannot act for the principal which does not yet exist, so the difficulty cannot be circumvented by pretending that the purchase is the agent of the trust to be formed.

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<sup>58</sup> Section 35 of the Companies Act, 61 of 1973 and s 53 of the Close Corporations Act, 88 of 1984.

- The Trust Property Control Act does not contain any pre-incorporation provisions similar to those contained in the Companies Act and Close Corporations Act.
- Furthermore, s 6 of the Trust Property Control Act provides that any person whose appointment as trustee in terms of a trust instrument comes into force after the commencement of that Act, may only act in that capacity if he has been authorised in writing by the Master of the High Court. The authorization is achieved by the issued by the Master of 'Letters of Authority'.

The issue is not merely an academic one, because if the intended acquisition of the property on behalf of the trust is not correctly structured, it may transpire that the acquisition constitutes two transactions for transfer duty purposes

- one transaction between the seller and the person purporting to act on behalf of the trust, and
- a second transaction between the person and the trust.

To counter this difficulty, various legal practitioners have offered different suggestions in letters and articles written in the attorneys' monthly journal, *De Rebus* and elsewhere<sup>59</sup> over the last six years or so, and a low key debate has ensued.

One of the earlier contentions was that a person can, in certain circumstances, act as a trustee for a trust to be formed, provided that the trust instrument confers on the trustees the necessary powers to ratify and adopt the transaction, and provided

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<sup>59</sup> Especially in journals dealing with conveyancing and property law matters.

further that the trustees in fact do ratify and adopt the transaction.<sup>60</sup>

Another suggestion, which was originally made tentatively in reply to the abovementioned contention, is for the intended founder of the trust and the trustees to create an oral trust.<sup>61</sup> The provisions of the Trust Property Control Act only apply to written trust deeds. As indicated above oral trusts are valid and binding. Obviously, though, they entail potential evidential difficulties and it would be a brave property lawyer who would, in normal circumstances, advise his client to sell his property to an oral trust. Compelling surrounding circumstances would have to prevail. Even if the prospective purchaser were to offer to placate the seller by binding himself as surety for the obligations of the oral trust, it is submitted that, if the oral trust turns out to be a nullity, then the agreement between the seller and that nullity must, *ipso facto*, also be a nullity.

It has been suggested that, in any even, the oral trust does not achieve the desired result because the trustees of the oral trust have no legal capacity to authorise the agent to act on their behalf, because such authority must be in writing.<sup>62</sup> Thus, trustees of the oral trust have no legal capacity to authorise an agent to act on their behalf until they themselves are authorised by the Master to act as trustees.<sup>63</sup>

Other practitioners have replied that the trustees of an oral trust can act without

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<sup>60</sup> ANJ Pinnock: *Conveyancing Bulletin*, March 1993 at 80. The author acknowledged that the issue was arguable.

<sup>61</sup> A Schoeman: *Conveyancing Bulletin* June 1993 at 6.

<sup>62</sup> Section 2 of the Alienation of Land Act, 61 of 1981, which provides that no alienation of land shall be of any force or effect unless it is contained in a deed of alienation signed by the parties thereto or by the agents acting on their written authority.

<sup>63</sup> AS West (Chief: Deeds Training Justice College, Pretoria) *Conveyancing Bulletin* December 1993 at 5 and 1999 *De Rebus* at 37.

first having to be authorised by the Master.<sup>64</sup>

It has been contended that the only safe option is for the parties to make use of the *stipulatio alteri* doctrine.<sup>65</sup>

In the case of a *stipulatio alteri*, the signatory and the seller in effect create an option in favour of the trust that is still to be formed, entitling the trust to buy the property after the trust has been formed. Thus, the trust is only obliged to buy the property if it exercises the option. If that were the end of the matter, the seller would be left up in the air until the trust is formed and it exercises the option. Thus, the seller will usually require the signatory to be bound personally as buyer if, for whatever reason, the trust is not formed or if the trust decides not to exercise the option to buy the property.

A prudent draftsman would ensure that those two requirements,

- The formation of the trust, and
- The exercise of the option

be carried out within a stated period or by a stipulated deadline.

The important feature of an arrangement of that nature is that it does not constitute a single contract, but a combination of two contracts

- the first contract for the benefit of a third party (that is the trust to be formed) giving the trust an option to buy the property, and

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<sup>64</sup> Kritzinger D 1994 *De Rebus* at 142.

<sup>65</sup> Norton G & Douglas K: 'Buying a property on behalf of a trust to be formed' *Journal of Business Law* Volume 2 No. 1 at 41.

- secondly, a conditional sale of the property to the signatory (that is a sale subject to the condition that if the trust is not formed or does not exercise the option to buy, the signatory himself will be personally bound).

Those contracts should obviously be incorporated in a single document, which would have to be carefully drafted.

If any uncertainty was created by careless drafting, the Commissioner might be able to contend that the signatory has bought the property himself and then disposed of his right to receive transfer of the property to the trust. If that contention were to be upheld, double transfer duty would be payable.

This unfortunate eventuality befell the buyer in *Collins v CIR*.<sup>66</sup> This case did not specifically involve an acquisition for or on behalf of a trust, but the reasoning is applicable. The main reason why double transfer duty was imposed was because the exercise of the option took place after the expiry of the agreed period for the exercise of the option.

Thus, the agreement should clearly state that the signatory will be bound only if the trust is not formed or does not exercise the option to purchase. If the agreement records the contractual obligations in that matter, transfer duty would be payable only once.

Alternatively, to achieve the same result, the signatory could buy the property himself on condition that, if the trust is formed and exercises the option to buy, the sale to the signatory will fall away.

### **A Proposal- the Delayed Transfer of Immovable Property Sold to a Trust**

One of the main problem areas in the use of trusts for estate planning purposes is

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<sup>66</sup> 1992 (3) SA 698 A.

how to 'get' assets into the trust. In respect of property which can be acquired by minimal transaction costs, the problem is less acute. But where the property which the estate planner wishes to transfer to trust is immovable property, then the high transaction costs of transfer duty and conveyancing fees can be prohibitive. A possible solution to the problem is for the transaction to be structured on the following basis. Assume the following:

- The estate planner and the trustees entered into a written agreement<sup>67</sup> on 1 January 1990 for the purchase and sale to the trust of a dwelling owned by the estate planner for a purchase price of R100 000.
- The estate planner and the trustees decided in 1990 not to transfer the dwelling into the name of the trust at that time, and also decided not to pay the transfer duty and to bear the penalties in due course.
- Ten years later on 1 January 2000 the estate planner and his family decide that they no longer wish to reside in the property concerned, and would like to sell it. A purchaser is found and a selling price of R300 000 is agreed upon, and the parties intend to have the transfer registered within one month of the date of sale.

For illustrative purposes, the recent change in the rate of transfer duty applicable to purchases by trusts will be ignored, and therefore it will be further assumed that transfer duty was payable in 1990 at 10% of the purchase price. On the basis of that assumption, the transfer duty payable on the sale from the estate planner to the trust would have been R10 000.

Transfer duty is payable within six months of the date of acquisition,<sup>68</sup> which in

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<sup>67</sup> Any agreement in respect of the acquisition of immovable property must be in writing.

<sup>68</sup> Section 3(1) of the Transfer Duty Act.

the present example would have been 1 January 1990. Penalties are levied on transfer duty not paid within that six month period at the rate of 10% a year.<sup>69</sup>

The amount of penalty duty is 'calculated in respect of each completed month' over the period from the end of the six month period during which transfer duty should have been paid, until the date of payment. In effect, therefore, penalty duty accrues from the end of the seventh month after the date of acquisition and is calculated according to the number of completed months. Thus, up to and including 31 January 2000, the amount of penalties levied on the amount of the transfer duty payable in terms of the original sale will be as follows:

$$10\% \text{ of R10 000} \times (121 - 7) \text{ months} \times 1/12 = \text{R9 500.}$$

The estate planner now has the following two courses of action:

- The estate planner can procure that the trust then sells the dwelling to the purchaser for R300 000, and the two transfers (that if the first transfer from the estate planner to the trust, and the second transfer from the trust to the purchaser) are registered simultaneously (call this 'scenario A').
- The estate planner, the trust and the purchaser can enter into a tripartite agreement in terms of which the three parties agree that the first agreement between the estate planner and the trust will be cancelled and a new sale agreement is concluded between the estate planner (as seller) and the purchaser for the sale of the dwelling to be purchaser for R300 000 (call this 'scenario B').

Provided that the tripartite agreement has been worded correctly, the effect of the tripartite agreement is that the first sale agreement falls away completely, including

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<sup>69</sup> Section 4(1) of the Transfer Duty Act.

the obligation to pay transfer duty,<sup>70</sup> and a new sale agreement is concluded. The disadvantage of scenario B is that the proceeds of the sale of the dwelling (which will include any capital growth in the value of the dwelling over the ten year period) will be payable to the estate planner and end up in his hands, which will defeat the estate planning objective of the first agreement.

If scenario A were to be followed, the transfer duty in respect of the first sale agreement would still have to be paid, including the penalties which would have accrued thereon. The amount payable would be R19 500 calculated as follows:

Transfer duty on R100 000	R10 000
Penalties thereon (as above)	9 500
	<hr/>
	R19 500
	<hr/>

On the credit side, however, in attending to the distribution of the purchase price due by the ultimate purchaser to the trust in terms of the scenario B, and the original purchase price of R100 000 due by the trust to the estate planner in terms of the first agreement, most of the eventual selling price would end up in the hands of the trust. Thus, at a cost of R19 500 in transfer duty and penalties, R18 500 of capital growth could have been accumulated in the trust, rather than in the estate of the estate planner.

Of course, looking at these illustrative figures, it is possible to argue that the estate planner could have achieved an even more favourable result by simply donating R25 000 to the trust each year. But that suggestion presupposes that the estate planner has R25 000 in readily disposable cash to donate to the trust each year.

Also, if the sale agreement between the estate planner and the trust is correctly worded, the agreement could fall within the ambit of the Alienation of Land Act,

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<sup>70</sup> No transfer duty is payable in respect of any transaction which has been cancelled.

and enjoy the protection afforded by the provisions of that Act in the event of the estate planner being sequestrated.<sup>71</sup>

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<sup>71</sup> Section 22 of the Alienation of the Land Act, No. 68 of 1981.

## Chapter 6

### **Fiscal Provisions Applicable While Assets are held by a Trust and Income Earned from Them.**

For convenience, consideration of the tax implications of assets being held by a trust is dealt with separately in respect of

- Income-Earning investments (interest or dividends),
- Immovable property held for rent-producing purposes, and
- Residential dwelling occupied by the beneficiaries of a trust (for example in the case of an ordinary 'family trust'.

Also, the tax implications in relation to each type of property will be considered separately in relation to

- the beneficiary of the trust,
- the trust itself,
- the founder of the trust, and
- the donor of any assets to the trust.

### **Income-Earning Investments**

#### ***The Beneficiary***

A beneficiary with a vested right to some or all of the receipts and accruals of a trust (either in terms of the provisions of the trust deed itself or by virtue of the exercise by the trustees of their discretion to award certain income to a beneficiary) will be taxed on those receipts and accruals after the deduction from those receipts and accruals of those of the trust's deductions and allowances which are attributable to the earning of that income. By virtue of the new s 25B(4) he deduction is limited to the total amount of those receipts.

The cumulative effect of the conduit principle and the retention of the identity of the trust's receipts and accruals, gives rise to opportunities for trustees to maximise the benefits enjoyed by the beneficiaries of a discretionary trust (and a vesting trust where the trustees have a discretion as to what type of receipts and accruals vest in which beneficiaries) by the judicious appropriation of the receipts and accruals of a trust.

Where the receipts and accruals of a trust consist of dividends or interest or rentals, the specific provisions of the Income Tax Act applicable to those types of receipts and accruals will apply to the taxation of that income in the hands of the beneficiary who receives those receipts and accruals.

Thus, if a beneficiary who is a non-resident of South Africa becomes entitled to amounts received by or accrued to a trust and that trust receipts and accruals consist of interest, the amount will be exempt from tax in terms of s 10(1)(hA), provided that the beneficiary has not at any time been ordinarily resident in the Republic, and has not carried on a business in the Republic during the year of assessment in which the income vests in him and has not resided in the Republic for more than 183 days during that year of assessment.

In the case of a beneficiary which is a company (which, by definition, includes a close corporation or any other incorporated association), the exemption applies if the company is managed and controlled outside the Republic.

Thus, where the creator of a trust (be it the testator or the founder) has in the creative deed of the trust, granted the trustees the discretion to determine the type of receipts or accruals to vest in the various beneficiaries (having regard to the personal circumstances of each beneficiary), the trustees can arrange the distribution of the receipts and accruals so as to achieve the most tax efficient result for the beneficiaries. For example, if there are more than one beneficiaries, one of whom is a non-resident, and some of the receipts or accruals consist of interest, the trustees should aware this interest to the non-resident beneficiary.

Complications arise in respect of an annuity payable by a trust, because trust income does not necessarily retain its identity in the hands of the annuitant. In terms of s 10(2) of the Income Tax Act, the exemptions provided in s 10(1)(h) and 10(1)(k) do not apply in respect of any part of an annuity.

If the trust's receipts were derived from the dividends, then the dividends will be exempt from taxation in the hands of the beneficiary.<sup>72</sup>

If the amount passing through the trust to the beneficiary was originally interest, then the first R2 000 of that interest will be exempt from tax in the hands of the beneficiary if the beneficiary is a natural person.<sup>73</sup>

It is a statement of the obvious that the greater is the number of beneficiaries to whom receipts and accruals can be distributed, the greater is the opportunity for the spread of receipts and accruals among the beneficiaries. Because of the progressive nature of the scale of tax rates, the trustees may if they have a discretion reduce the total amount of tax payable on the receipts and accruals earned from the trust's assets by allocating those receipts and accruals among the beneficiaries in the most tax efficient way.

For example, rather than vest trust receipts in the financial head of a particular household (which would cause that person to bear all the tax at that person's marginal rate), the trustees should apportion the total trust income destined for a particular household among those members of that household who are beneficiaries of the trust. The result may be that considerably less tax may have to be paid in total on the receipts and accruals of that household from the trust.

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<sup>72</sup> In terms of s 10(1)(k).

<sup>73</sup> In terms of s 10(1)(l)(xv).

### ***The Trust***

The trust, through the trustees, will be taxed on the receipts and accruals which are retained in the trust. Subject to s 25N(5), the balance of the appropriate deduction and allowances are deductible from those receipts and accruals before they are taxed to the maximum amount of those receipts and accruals.

One negative aspect of the levying of income tax on the receipts and accruals retained in the trust is that the rebates provided for in s 6 are only available to natural persons.<sup>74</sup>

Income which has been taxed in the hands of the trust (because there has been no automatic vesting or discretionary vesting in a beneficiary) is not taxed again when it is distributed to a beneficiary. One income has been treated as income of the trust and taxed in the hands of the trust, it is so deemed for all time for tax purposes, and does not accrue to the beneficiary as 'gross income' for tax purposes.<sup>75</sup>

Thus, where a trustee has a discretion to aware to a beneficiary funds which have already been taxed in the hands of the trust, the trustees should avoid confusion between those taxed funds and the current receipts and accruals of the trust.

### ***The Founder***

The founder is in no way liable for any tax on the income on the trust merely because he was instrumental in bringing the trust into existence, whether he did so in terms of his will consequent upon his death, or by virtue of an inter vivos trust.

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<sup>74</sup> In the 2000 year of assessment, a primary rebate of R3 710 and an additional rebate for persons over 65 years of age of R2 765.

<sup>75</sup> *Estate Dempers v CIR* 1977 (3) SA 410 (A), 39 SATC 95.

In the case of a testamentary trust, the founder would in any event have ceased to be a taxpayer on his death. His estate is a new taxpayer separate and distinct from the taxpayer himself.<sup>76</sup>

If the founder of an inter vivos trust has also donated assets to the trust then he may incur a tax liability by virtue of the deemed income provisions of s 7, but that liability will be incurred as the donor, not as founder of the trust.

### ***Any Donor***

Any person who has donated assets to a trust may be taxable on some of the receipts and accruals of the trust if those receipts and accruals have been earned by the trust as a result of the 'donation, settlement or other disposition' of the kind contemplated. Obviously, there must be a link between the benefits of the donation, settlement and other disposition and the receipts or accruals. It will be recalled that, by virtue of the decision in *Joss' case*,<sup>77</sup> an interest-free loan has been held to be a continuing donation of the interest saved, so the sale of assets to a trust on loan account will give rise to taxable income in the hands of a seller.

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<sup>76</sup> In terms of the definition of 'person' in the Income Tax Act.

<sup>77</sup> *Supra*

## **Immovable Property held for Investment Purposes**

### ***The Beneficiary***

If the beneficiary has a vested right to the receipts of the trust (again either in terms of the trust deed itself or by virtue of the exercise by the trustees of their discretion), he will be taxed on those receipts after the deduction of appropriate deductions and allowances. Once again, the amount of the deductions and allowances will be limited to the total amount of the receipts and accruals.

### ***The Trust***

Once again, the trust, through the trustees, will be taxed on the receipts and accruals which are retained in the trust, and in the levying of that tax, the balance of the appropriate deductions and allowances are deductible from those receipts and accruals before they are taxed.

### ***The Founder***

Again, the founder will not incur any tax liability merely because he founded the trust.

### ***Any Donor***

If the immovable property from which the rentals were received was donated to the trust, then the rentals received and accrued, net of expenses, will clearly have been derived from a donation, settlement or other disposition, so the net rentals will be taxable in the hands of the donor.

If the property was sold to the trust in terms of a an interest-free loan, then the interest free element will constitute a continuing donation, and the seller will be

taxable on so much of the trust's receipts as have been derived as a result of the donation, settlement or other disposition.

### **Residential Dwelling**

Where a trust owns a residential dwelling for the sake of providing accommodation to the beneficiaries of the trust, the trust is not obliged to charge the beneficiaries a rental for occupying the property, as the provision of accommodation can be one of the ways in which a trust can provide benefits to the beneficiaries. Obviously, expenses will be incurred by the trust. These will include

- municipal rates and similar charges,
- repairs and maintenance,
- insurance, and
- interest incurred on any loan used to pay the purchase price of the property.

These can be recovered by the trust by charging a rental to the beneficiaries occupying the property. Alternatively, those expenses can be paid by a third party on the basis of loans advanced to the trust.

### ***The Beneficiary***

No income tax implications befall a beneficiary who enjoys the occupation of a residential dwelling which is owned by the trust of which he is a beneficiary.

### ***The Trust***

If the trust charges the beneficiary a rental for occupying the property, then to the extent that that rental exceeds the trust's expenses, tax will be payable on that net

rental. Obviously, it would be sensible for the rental to be exactly equal to the expenses of the trust.

### ***The Founder***

The founder of the trust need not fear any adverse tax implications from the fact that the beneficiaries might enjoy the occupation of the trust-owned dwelling, either for no rental or for a rental sufficient only to defray the expenses of the trust.

### ***Any Donor***

If the trust does not derived from the dwelling any receipts or accruals in excess of its expenses, there can be no tax liability for the donor.

## Chapter 7

### Tax Implications of the Winding up of a Trust

Most trust deeds include provision for the trust to be wound up in certain circumstances, either

- upon the happening of any event, or
- if the trustees (either together with or without the beneficiaries) so resolved.

Likewise, most trust deeds provide for the devolution of the wealth accumulated in the trust to the beneficiaries on the winding up of the trust.

In the case of a discretionary trust, the trustees can, during the lifetime of the trust (subject of course to their fiduciary duty) distribute all the current and accumulated income and capital in the trust to the beneficiaries in accordance with their discretion. Then, they can attend to the accounting exercise of balancing the books of the trust and notifying the Master of the High Court, and the Commissioner, that the trust has been liquidated.

#### Donations Tax

No donations tax will be payable on any devolution to the capital beneficiaries on the winding up of the trust because any property 'disposed of under and in pursuance of any trust' is exempt from donations tax.<sup>78</sup>

#### Transfer Duty

In the case of immovable property registered in the name of a trust, transfer duty

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<sup>78</sup> Section 56(1)(l) of the Income Tax Act.

may or may not be payable on the transfer of that property to the ultimate beneficiaries on the winding up of the trust, depending on the facts or circumstances of the trust concerned. The relevant exemptions are set out in s 9(4)(a) and (b) of the Transfer Duty Act, which read as follows:

'No duty shall be payable-

- (a) in respect of a change in the registration of property acquired as a result of the termination of the appointment of an administrator of a trust under a will or other written instrument or of a trustee of an insolvent estate; or
- (b) where the trust property is transferred by the administrator of a trust in pursuance of the will or other written instrument in pursuance of which the administrator was appointed -
  - (i) to the persons entitled thereto under such will; or
  - (ii) to a relative as contemplated in the definition of 'relative' in section 1 of the Estate Duty Act, 1955 (Act No. 45 of 1955), where the trust was founded in terms of such other written instrument by a natural person for the benefit of such relative: Provided that no consideration is paid directly or indirectly by such relative in respect of the acquisition of such trust property.'

The effect of these provisions can be re-stated as follows:

- In the case of a testamentary trust, the devolution of the assets from the trust to the beneficiaries (being the ultimate heirs) is exempt from transfer duty in terms of either s 9(4)(a) or s 9(4)(b)(i) (see above).
- In the case of an inter vivos trust, no transfer duty is payable when the trust property is transferred to the capital beneficiaries provided the following are present:
  - The beneficiary is a 'relative' of the founder of the trust, as defined in the Estate Duty Act. (A relative in relation to the founder would be the spouse of the founder, anybody related to the founder or his spouse within the third degree of consanguinity, or any spouse of

anyone so related.)<sup>79</sup>

- The trust was created for the benefit of that relative.
- No consideration is payable by the beneficiary for the acquisition of the property. (If any consideration is payable, then transfer duty will be payable on the amount of that consideration.)

### **Value Added Tax**

If, prior to the intended winding up of a trust, it has been carrying on an enterprise, either one of two courses of action can be taken:

- The trust may cease to be a registered vendor.
- The trust may sell its enterprise as a going concern (in which case the supply will be zero rated if the purchaser is also a registered vendor).

If the second course of action is taken, the trust will then be in possession of the proceeds of the sale of the enterprise, and the proceeds can be distributed to the beneficiaries.

If the first course of action is followed and the trust ceases to be registered as a vendor, a liability for output tax arises because the trust is deemed to have supplied all the assets forming part of the enterprise immediately prior to the cessation. The consideration for the supply will be the lesser of the following two amounts:

- The cost to the trust of the acquisition, manufacture, assembly, construction

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<sup>79</sup> For the purpose of determining the relationship between any child referred to in the definition of 'child' in the Estate Duty Act (which includes an adopted child) and any other person, an adopted child is deemed to be related to its adoptive parent in the first degree of consanguinity.

or production of the goods or services; plus

- any tax charged in respect of the supply to the trust of the goods or services or of any components, materials or services used by the trust in such manufacture, assembly, construction or production; plus
  - where such goods (including any rights) constituted trading stock for the purposes of income tax, any further costs (including VAT) incurred by the trust in getting the trading stock into its existing condition or location; plus
  - any costs (including tax) incurred in transporting or delivering the goods or the providing of the services.
- The open market value of such property.<sup>80</sup>

Once the VAT liability arising from the deemed supply has been dealt with, the subsequent disposal of the trust's assets will not be subject to VAT.

If the beneficiaries wish to take advantage of the zero rating of the supply of the enterprise as a going concern, they should purchase the enterprise from the trust, rather than to take over the enterprise as a distribution *in specie* from the trust. If the enterprise is taken over *in specie*, VAT will be payable.<sup>81</sup>

The provisions set out above apply to both inter vivos and testamentary trusts, with the exception that in the case of a testamentary trust, the assets might have been acquired free of VAT.

Whether or not the trust would have had to pay VAT on the acquisition of assets from the deceased estate depends on the circumstances in which the executor dealt with the assets in the winding up of the estate, but that topic is beyond the

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<sup>80</sup> *Meyerowitz on VAT* at A11.5 and B87.

<sup>81</sup> *Meyerowitz on VAT* at B87.

scope of this report.<sup>82</sup>

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<sup>82</sup> See *Meyerowitz on VAT* at B87.

## Chapter 8

### Estate Duty

Estate duty implications do not arise as a result of any event in the life cycle of the trust itself, but rather at the end of the life cycle of the natural persons who have been involved in the affairs of the trust! It is therefore more convenient to deal with the provisions of the Estate Duty Act in regard to the demise of

- the founder,
- the beneficiaries,
- the trustees, and
- any donor.

The concept of levying a tax on deceased estates, together with the levying of donations tax (which is really an advance payment of estate duty) has been under scrutiny for a long time.

About fifteen years ago, the Margo Commission proposed that estate duty and donations tax should be replaced by a new tax referred to as a 'capital transfer tax'.

The question is again being considered by the current Katz Commission.

Over the recent past, the influence of estate duty has waxed and waned, as a result of adjustments made to both the rate of estate duty and donations tax and by the amount of the primary rebate which is deductible from the gross value of any estate before determining the dutiable amount of the estate on which estate duty is payable.

A brief synopsis of parts of the Estate Duty Act is necessary.<sup>83</sup> In terms of the Act, estate duty is payable in respect of the estate of every person who was ordinarily resident in the Republic at the date of his death.

Estate duty is charged on the 'dutable amount' of the estate of a deceased person. For purposes of the Act, the estate of any person consists of

- all the property of that deceased person as at the date of his death;<sup>84</sup> and
- all property which is deemed to be the deceased's property as at that date.<sup>85</sup>

In terms of s 3(2), property is defined as

'any right in or to property, movable or immovable, corporeal or incorporeal, and includes:

- (a) fiduciary, usufructuary or other like interest in property (including a right to an annuity charged upon property) held by the deceased immediately prior to his death;
- (b) any right to an annuity (other than a right to an annuity charged on property) enjoyed by the deceased immediately prior to his death which accrued to some person on the death of the deceased, but does not include -
- (c) ....'

The 'interest' referred to in s 3(2) amounts to a beneficial interest held by the deceased immediately prior to his death but not the bare dominium held by a trustee.<sup>86</sup> The interest need not amount to a real right in the property, but a personal right, similar to that of a trust beneficiary suffices.

Where under a discretionary trust, the trustees have the discretion to withhold the

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<sup>83</sup> In this part of this report, reference to sections will be to sections of the Estate Duty Act unless the context otherwise indicates.

<sup>84</sup> Section 3(2).

<sup>85</sup> Section 3(3).

<sup>86</sup> *CIR v Sive's Estate* 1955 (1) SA 249 A at 265, 20 SATC 66 at 80, *CIR v MacNeillie's Estate* 1961 (3) SA 833 A at 840, 24 SATC 282.

income or capital from the beneficiary altogether, the beneficiary's interest in the trust property does not constitute an interest in property in terms of s 3(2).<sup>87</sup>

The 'deemed property' referred to above includes 'all property which the deceased was competent to dispose of for his own benefit or for the benefit of his estate'.<sup>88</sup>

Thus, if a trust deed contains a provision that the founder may vary the terms of a trust deed in a way that he or his estate can benefit from the trust property, then the trust property will be deemed, for estate duty purposes to constitute an asset in the founder's estate in the calculation of the estate duty payable by his estate. It must be understood that the deemed property provision does not mean that the trust is a nullity and that the assets are actually owned by the deceased and that they consequently devolve in terms of the deceased's will. Far from it. It is only in the application of the Act that the wealth accumulated in the trust is treated as part of the wealth of the deceased in calculating the estate duty payable in his estate.

If the trust had been created for estate planning purposes, the intention of which is usually to remove wealth from the estate planner's estate before his death, then a provision of that nature in a trust deed would be catastrophic.

It must also be noted that, for s 3(3)(d) to be applicable, the deceased must have retained more than just the right to dispose of the property in the trust. The deceased must have been competent to dispose of the property for his own benefit or for the benefit of his estate. So, for example, even where the deceased had a power of appointment or retained under a deed of trust the power to revoke or vary the provisions thereof relating to the trust's property, if neither he, nor his estate, could obtain any benefit by the exercise of the power of appointment or the revocation or variation of the rights under the trust deed, s 3(3)(d) is not applicable.

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<sup>87</sup> *Meyerowitz on Income Tax* in § 27.1 - 27.27, Pace and Van Der Westhuizen: *Wills and Trusts* at B65.

<sup>88</sup> Section 3(3)(d).

Therefore, where the right is reserved in the trust deed for the testator to determine the formula for the distribution of capital among the beneficiaries by means of his will, if he is in terms of the trust deed prohibited from benefiting himself or his estate from the trust, then a testamentary reservation will not cause s 3(3)(d) to be applicable.<sup>89</sup>

### ***The Founder***

The mere act of founding a trust will not *ipso facto* cause the assets of the trust to constitute either property or deemed property in the founder's estate for estate duty purposes.

### ***The Beneficiary***

If any rights enjoyed by a beneficiary pass to one or more third parties as a result of the death of the beneficiary, the value of those rights might constitute a deemed property in the estate of the beneficiary for estate duty purposes, depending on the wording of the trust deed and the circumstances of the trust.

### ***The Trustees***

A trustee or an administrator under a trust who has no beneficial interest in the trust property, although holding the legal ownership of it, is a mere administrative 'peg'.<sup>90</sup> The trustee is not a person to whom any advantage accrues by the death of the deceased. Thus, the trustees cannot be liable for the estate duty payable on a limited interest ceasing, even if there are no ascertained beneficiaries.<sup>91</sup>

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<sup>89</sup> See *Meyerowitz on Income Tax* in § 27.50.

<sup>90</sup> Stein: *Estate Duty Principles and Planning*. Note 10.2 at 118.

<sup>91</sup> See the remarks of Schreiner JA in *CIR and others v Sive's Estate* 1955 (1) SA 249 A at 265, 20 SATC 66 at 80.

It is also clear that a trust created inter vivos or under a will may not be regarded as a 'person' for purposes of the determination of the liability for estate duty.<sup>92</sup>

### ***Any Donor***

No estate duty issues arise on the death of the donor of assets to a trust. Once the donor has transferred property to the trust by way of a donation, that property, no matter what its value at the donor's death cannot form a part of his dutiable estate for estate duty purposes.<sup>93</sup> This is obviously equitable because the donations tax will (or at least should!) have been paid. As stated above, donations tax is really an advance payment of estate duty.

Where the estate of the founder or a beneficiary of the trust or a donor of assets to a trust is liable for estate duty because benefits which have accrued to the trust are deemed property in that person's estate (for example, the proceeds of an insurance policy) the executor of that estate is not entitled to recover the estate duty payable from the trust.<sup>94</sup> This is because it has been held that a trust cannot be regarded as a 'person' who can be made liable for the estate duty. Consequently, it has been suggested<sup>95</sup> that it is advisable for the trust to indemnify the estate of any interested party for any liability for estate duty which is attributable to any benefit which accrues to the trust.

Stein in the book entitled *Estate Duty Principles and Planning*, sets out a number of specific suggestions in the sections of the book at the end of each chapter, headed 'Practical Planning Points'. The following specific suggestions have been made:

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<sup>92</sup> *CIR v MacNeillie's Estate* 1961 (2) SA 833 A, 24 SATC 282.  
*CIR v Jacobson's Estate* 1961 (3) SA 841 A, 24 SATC 292.

<sup>93</sup> Stein in § 11.1 at 127.

<sup>94</sup> Stein in § 10.10 note 5 at 124.

<sup>95</sup> *Ibid.*

- 'The cession of a policy to an inter vivos trust may provide a suitable means of reducing the duty of a substantial policy taken out of a person's life. Upon the insured's death, the premiums paid and any consideration paid for the cession of the policy (plus 6% compound interest) are deductible from the proceeds.<sup>96</sup>
- 'A further advantage when the policy is taken out or acquired by an inter vivos trust is that the proceeds of the policy would vest in the trust rather than the members of the deceased's family. The proceeds would therefore not swell the estates of the members of the family and thus possible create a second liability for estate duty when they die.<sup>97</sup>
- 'An inter vivos trust may also be usefully employed when the policy is taken out purely as an investment rather than for the purpose of providing life cover. The investor may make an interest-free loan to the trust to enable it to effect a standard, single premium, whole-life policy on his ... life that is tax free for income tax purposes. While the proceeds of the policy would be dutiable on the investor's death, they would have to be reduced by the amount of the single premium compounded at 6% from the date of payment to the date of death.<sup>98</sup>
- 'When a policy is taken out not to obtain life cover but as a pure investment plan an inter vivos trust may be used to effect the policy on the joint lives of two or more of its younger beneficiaries, the proceeds being payable only on the death of the last survivor. The proceeds would not form part of the estate of the creator of the trust or his ... spouse, and may therefore be a very meaningful saving in estate duty.<sup>99</sup>
- 'A common objective of an inter vivos trust is to peg the value of the creator's estate for estate duty purposes or to prevent further growth of another family member's estate, for example, a wife or a child who already has a substantial estate. The "gross assets" concerned are transferred directly to the trust or to an investment-holding company, the shares in which are held by the trust.<sup>100</sup>

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<sup>96</sup> Stein in § 5.9 Note 1 at 56.

<sup>97</sup> Stein in § 5.9 Note 5 at 57.

<sup>98</sup> Stein in § 5.9 Note 3 at 57.

<sup>99</sup> Stein in § 5.9 Note 5 at 57.

<sup>100</sup> Stein in § 11.7 Note 1 at 35.

- 'The decision whether to transfer the assets to a holding company or directly to the trust requires a consideration of such matters as control of income tax.<sup>101</sup>
- 'The transfer of assets must be effected by the transferor at a fair market value in order to prevent a possible liability for donations tax.<sup>102</sup>
- 'From the estate duty point of view, there is no bar to the creation of an interest-free loan in favour of the transferor, whether in the company or in the trust, in consideration for the disposal of the "growth assets". The benefit of an interest-free loan accruing to the company or the trust is not regarded as a donation made by the transferor, either for estate duty or donations tax purposes.<sup>103</sup>
- 'A vested right to receive income from a trust forms property in the estate of the beneficiary and is subject to estate duty.<sup>104</sup>
- 'Liability for estate duty may be avoided if the beneficiaries are not given vested rights to income and the trustees are instead given a discretionary power whether to pay income to them.<sup>105</sup>
- 'The consequences for estate duty must be borne in mind if a donor donates assets to a trust and retains the right under the trust deed to revoke or vary any rights conferred by the donation. Such a donation takes effect for estate duty purposes only on the date on which the right is terminated. If the right is not terminated prior to the donor's death, the donation must be valued at the date of death, with the result that the efforts to arrest the growth of the estate would fail. If this restriction is to apply, the form of the donation may be an important consideration. For example, if a trust is to be formed to hold the shares in, say, a property company, the donor should donate cash to the trustee (who will then take up the shares) rather than donate the shares to the trust.<sup>106</sup>

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<sup>101</sup>Stein in § 11.7 Note 2 at 135.

<sup>102</sup>Stein in § 11.7 Note 3 at 135.

<sup>103</sup>Stein in § 11.7 Note 4 at 135.

<sup>104</sup>Stein in § 11.7 Note 5 at 135.

<sup>105</sup>Stein in § 11.7 Note 6 at 135.

<sup>106</sup>Stein in § 11.7 Note 7 at 135.

- 'As a precautionary measure, it is advisable not to permit the donor to retain the power to revoke or vary any of the terms of the trust deed. The donation must be irrevocable. The mere fact that it may be possible for the donor, together with the trustees, in the absence of the acceptance of the benefit by the beneficiaries to revoke the donation and to return the property to himself ..., cannot however, make the donation irrevocable. The Commissioner accepts that the retention of the power by the donor to revoke the appointment of a trustee or to appoint new or additional trustees does not amount to the retention of a right to revoke or vary a right conferred by the donation.<sup>107</sup>
- 'For a donation to a trust to be effective immediately for estate duty purposes, the trustee must be entitled to the property donated at the date of the donation.<sup>108</sup>
- 'If under the terms of the trust deed any person (not necessarily the donor) is competent to dispose of any trust property or the profits of any trust property for his .. own benefit or for the benefit of his ... estate, the value of the property or the value of the right to profits must upon that person's death be included in his ... dutiable estate. The problem may be remedied if the person gives up the power to dispose of the property for his ... own benefit or for the benefit of his ... estate.<sup>109</sup>
- 'A variation or an amendment of a trust deed by the donor and the trustees (with or without the consent of the beneficiaries) will not usually have donations tax or estate duty implications. But if, in effecting the variation or amendment, the donor and the trustees must be joined by the beneficiaries who have already accepted the existing benefits under the trust deed, any variation or amendment involving a waiver or renunciation of existing vested rights by the beneficiaries may constitute a donation by them both for donations tax and estate duty purposes. An unconditional waiver or renunciation by the beneficiaries of contingent right that have not yet vested will not usually result in a liability for donations tax or estate duty.<sup>110</sup>
- 'A donations tax disadvantage is created if a donor makes a donation to a trust subject to a terms that the trust is liable for the donations tax. The value of the donation for

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<sup>107</sup>Stein in § 11.7 Note 8 at 135.

<sup>108</sup>Stein in § 11.7 Note 9 at 136.

<sup>109</sup>Stein in § 11.7 Note 10 at 136.

<sup>110</sup>Stein in § 11.7 Note 12 at 136.

donations tax purposes is the full amount of the donation (the liability of the trust to pay donations tax is ignored). Should the donor make a smaller donation to the trust (to allow for his ... liability for donations tax) and pay the donations tax himself ..., the donations tax would be calculated on the reduced value of the donation.<sup>111</sup>

- 'If a testator's children have substantial estates in their own rights, the creation of a testamentary trust in the will for the benefit of the grandchildren and their descendants ought to be considered.<sup>112</sup>
- 'If a right to income vests in a beneficiary, liability for estate duty may arise on his ... death when this right ceases.<sup>113</sup>
- 'If the right to income is not vested but depends upon the exercise of a discretion by the administrator to pay income to the beneficiaries in such proportions as he ... thinks fit, no liability for estate duty would arise on the death of the beneficiary, even if he were receiving payments of income regularly in the years prior to his ... death. Consideration ought therefore to be given to the creation of a discretionary testamentary trust, no matter who the beneficiaries might be. This is an effective method for avoiding estate duty in the hands of successive beneficiaries.<sup>114</sup>
- 'If an estate is very substantial, it may be advisable to create a number of discretionary trusts, for example, one for each child or grandchild or even one for the descendants of each grandchild. This procedure may have the effect of postponing liability for estate duty for many years and in addition confer income tax benefits resulting from the creation of a number of taxable entities.<sup>115</sup>
- 'The administrators of a trust are sometimes directed to use the trust income for the maintenance of the beneficiaries in amounts that they (the administrators), in their unfettered discretion, think fit. The Commissioner considers that for estate duty purposes

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<sup>111</sup>Stein in § 11.7 Note 13 at 136.

<sup>112</sup>Stein in § 11.8 Note 2 at 136.

<sup>113</sup>Stein in § 11.8 Note 3 at 137.

<sup>114</sup>Stein in § 11.8 Note 4 at 137.

<sup>115</sup>Stein in § 11.8 Note 5 at 137.

such a right of the beneficiaries to claim maintenance constitutes a vested right that ceases upon the death of a beneficiary ... and must be valued and included in his ... dutiable estate.<sup>116</sup>

- 'If a testator creates a vested right to income in a testamentary trust for his ... spouse the right must be valued on his ... death and the value will be deductible in the determination of his ... dutiable estate. The value of the right ceasing on the survivor's subsequent death will then be dutiable in his ... estate.<sup>117</sup>
- 'To achieve the maximum estate duty advantage, a surviving spouse should receive a vested right to income in a testamentary trust. If the trustee has a discretion to allocate the property accruing to the trust in terms of the deceased's will or any income from that property to any person other than the surviving spouse, no deduction will be available to the estate of the first dying spouse under s 4(q).<sup>118</sup>
- 'A married person may eliminate his ... entire liability for estate duty by bequeathing his ... entire estate to his ... surviving spouse - assuming that he ... ultimately predeceases him.... But this would create a potential liability for estate duty on the death of the surviving spouse. The surviving spouse's potential liability for duty may, however, be eliminated if R1 million is bequeathed to person other than his ... spouse, perhaps through a testamentary trust, and the balance of the estate is bequeathed to the surviving spouse. In this way all but R1 million would be deductible under s 4(q) and the remaining net estate of R1 million would be eliminated for estate duty purposes by the primary abatement of R1 million.<sup>119</sup>

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<sup>116</sup>Stein in § 11.8 Note 6 at 137.

<sup>117</sup>Stein in § 11.8 Note 7 at 137.

<sup>118</sup>Stein in § 11.8 Note 8 at 137.

<sup>119</sup>Stein in § 11.8 Note 10 at 137.

**Chapter 9****Tax Consequences of a Sale of 'Beneficiary Rights'**

It is trite to record that it is legally possible for a trust to be structured on the basis that a beneficiary's interest in that trust is an identifiable stake which can be sold by the beneficiary of the trust. The unit trust industry is testimony to that reality. Legal recognition has also been given to that reality by the enactment of the Unit Trust Control Act which regulates the operation of those trusts.

On a more localised scale, it is also common for trusts to be used for acquisition and development of immovable property. In respect of a trust of that nature, the trust deed can provide for the sale by any beneficiary of his participation in the trust either to other beneficiaries or to a third party. The powers and duties of the beneficiary in respect of a trust of that nature are usually regulated in the trust deed. Where the trust owns immovable property, the question arises as to whether or not the sale by a beneficiary of his stake in the trust creates a liability for payment of transfer duty. It has been argued that in respect of transactions of that nature, no transfer duty should be payable.<sup>120</sup> The reasoning appears to be sound for the reason that the assets of a trust vest in the trustees, and therefore any beneficiary's interest in a trust is usually only what is termed in legal jargon *a ius in personam ad rem acquirendam* (loosely translated, meaning a personal right to acquire property).

Thus, if the beneficiary disposes of his interest to a third party, by whatever means, what the third party acquires is precisely the *ius in personam ad rem acquirendam* against the trustee. This is a personal right.

Generally speaking, transfer duty is payable on the transfer of real rights in land. The rationale for the above argument is that, since the rights of beneficiaries of

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R S Green: 1997 *De Rebus* at 763.

conventional type business trusts are personal in nature, the cession by a beneficiary of his interest in the trust will not give rise to the imposition of transfer duty. The caution is expressed, though, that the terms of the particular trust deed will in each instance determine whether a cession of an interest in that trust is a cession of a personal right or a real right.

It was conceded by the proponent of that argument that the reasoning does not apply to the sale of an estate planning trust. It is the consequence of the sale lock-stock-and-barrel of an entire estate planning trust which will now be explored.

Before dealing with any fiscal provisions, some caveats should be noted. It is argued by some that, conceptually, it is not possible to 'sell' an entire trust because of the very nature of a trust. As is indicated above, a trust is an arrangement whereby the benefits of the assets owned by the trust have been separated from the control of those assets. It is true that there is frequently a significant overlap between those exercising control (that is, the trustees) and those enjoying the benefits of the assets (that is, the beneficiaries) but that overlap should not blur the distinction between the enjoyment of the benefits and the exercise of control.

Consider the case of a family trust formed for estate planning purposes, which owns a dwelling which serves as the family home.

- Can that trust be sold?
- If so, to whom is the purchase price paid, the trustees or the beneficiaries?
- If the purchase price is paid to the beneficiaries, on what basis must the purchase price be shared amongst the beneficiaries - equally, or pro rata according to seniority or some other criterion?
- If the trust is a discretionary trust, will the trustees decide which

beneficiaries are entitled to the proceeds?

- Do the trustees owe different fiduciary duties to the various beneficiaries, depending on their ages or other needs or characteristics?
- Also, how can the provisions of the sale agreement be enforced if the purchaser proves to be dilatory?
- Will the trustees be able to enforce the provisions of the sale agreement, or are the beneficiaries empowered to do so (especially in the case of a discretionary trust)?

The jurisprudential niceties of the sale of an estate planning trust are beyond the scope of this report. It will be presumed, therefore, for purposes of this report that it is legally competent for a trust to be sold.

The sale of a trust is usually effected by way of the following structure:

- A sale agreement recording the intended sale of the beneficiary rights in the trust from the outgoing beneficiaries (the sellers) to the incoming beneficiaries (the purchasers).
- A cession in respect of the beneficiary rights to give effect to the sale, the *causa* for the cession being the sale.
- The resignation of the existing trustees, and their replacement by new trustees chosen by the purchasers.

If the trust being sold owns shares, the only tax which would be levied on the sale of the investments by the trust to a third party would be marketable securities tax as levied in terms of the Stamp Duties Act at the rate of 2,5 cents for every R10, or part thereof, of

- the amount or value of the consideration given for the transfer of the marketable security, or
- where no consideration is given or the consideration given is less than the value of the marketable security transferred, of the value of the marketable security transferred.<sup>121</sup>

The sale of that trust by those who claim to be entitled to sell the trust (rather than the sale by the trust itself of the investments to the intended purchaser and the subsequent distribution of the funds received from that sale to the beneficiaries of the trust as a capital distribution) would have the effect of avoiding marketable securities tax, because marketable securities tax is levied on the transfer of marketable securities, and the sale of the entire trust would not require any change in ownership of the shares to be registered.

But, if the trust is one of the estate planning type which owns immovable property, then the notion of the sale of that trust raises different issues in regard to transfer duty because of the specific provisions of the Transfer Duty Act.<sup>122</sup>

Section 2, in essence, reads as follows:

'... there shall be levied ... on the value of any *property*... acquired by any person or after the date of commencement of this Act by way of a *transaction* or *in any other manner*, or on the amount by which the value of the *property* is enhanced by the renunciation on or after the said date, of an interest in or restriction upon the use and disposal of that *property*, at the rate of - ....'

(emphasis added)

'Property' is defined, amongst other things, as 'land and any fixtures thereon, and

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<sup>121</sup> Item 15(3)(h) of the tariff of stamp duties set out in Schedule 1 to the Stamp Duties Act.

<sup>122</sup> For convenience, the Transfer Duty Act will be referred to in this part of this report as simply 'the Act', and references to sections will be to sections of the Transfer Duty Act.

includes .... any real right in land...’.

A ‘transaction’ is defined as

‘an agreement whereby one party thereto agrees to sell, grant, donate, cede, exchange, lease or otherwise disposes of property to another, or *any act whereby any person renounces any interest in or restriction in his favour upon the use and disposal of property.*’

It is submitted that the use and enjoyment of land constitutes an interest in property, whether the right to use that land is enjoyed by a beneficiary as of right or as a result of the exercise by a trustee of their discretion to grant the right of use to a particular beneficiary.

It is further submitted, therefore, that the sale of a property-owning estate planning trust in accordance with the structure set out above, which incorporates the passing from the seller (the outgoing beneficiary) to the purchaser (the incoming beneficiary) of what is termed the ‘beneficiary rights’, which expressly if not implicitly include the right to the use and enjoyment of the property owned by the trust, constitutes a ‘transaction’ as defined in the Act. That being so, transfer duty must surely be payable in terms of the Act.

It seem inevitable that the issue will come before a court one day. It is understood that the notion of the sale of a trust arose in a matter which came before the Cape Income Tax Special Court recently, and that the court ruled in favour of the Commissioner. Efforts to obtain a copy of the judgment in that matter have proved fruitless. The only official word which has been gleaned is a short, two paragraph letter, dated 3 December 1996, from the South African Revenue Services to a firm of attorneys in Pietermaritzburg, of which the second paragraph reads as follows:

‘Transfer Duty is payable on the acquisition of property. The acquisition of the beneficial rights is a transaction as defined and subjected to transfer

duty.'

No reasoning is furnished.

Even if, in the future, a court holds that the acquisition of a property-owning trust lock-stock-and-barrel, does not constitute a 'transaction' within the scope of the definition set out in the Act, then it is submitted that the entire arrangement might fall foul of the provisions of s 103 of the Income Tax Act anyway.

After all, the usual rationale for the purchase of an entire property owning trust lock-stock-and-barrel (rather than the purchase of the immovable property concerned from the trust) is precisely to avoid the payment of transfer duty!

## Chapter 10

## Section 103(1)

Reference was made earlier to s 103(1). It is also beyond the scope of this report to embark on a detailed analysis of all the ramifications of s 103(1), especially the recently-introduced business purpose test. It would be remiss, though, not to give some indication of its content and effect. It should suffice simply to re-state the essential elements of s 103(1)<sup>123</sup> are as follows:

Whenever the Commissioner is satisfied that any

- transaction, operation or scheme has been entered into, or carried out,<sup>124</sup> and
- which has the effect of avoiding, reducing or postponing the liability for the payment of any tax imposed by the Income Tax Act,<sup>125</sup> and
- having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out
  - in the case of a transaction, operation or scheme in the context of business, in the manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and
  - in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not in the context of business, by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or
- has created rights or obligations which would not normally be created

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<sup>123</sup> As summarised by Pace and Van Der Westhuizen at B 60.

<sup>124</sup> *Meyerowitz v CIR* 1963 (3) SA 863 at A.

<sup>125</sup> *Smith v CIR* 1964 (1) SA 324.

between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and;<sup>126</sup> and

- was entered into solely or mainly for the purpose of avoiding, reducing or postponing any tax or levy imposed by any act administered by the Commissioner,<sup>127</sup>

then the Commissioner shall determine the liability for tax in terms of the Income Tax Act as if the transaction, operation or scheme had not been entered into or carried out.

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<sup>126</sup> *SIR v Lowe* 1983 (3) SA 551 A.

<sup>127</sup> *SIR v Gallagher* 1978 (2) SA 461 A.

## Chapter 11

### Conclusion

It has been suggested<sup>128</sup> advise that it is unwise to select a trust or any other entity as the vehicle for a particular purpose merely because of its perceived income tax and estate duty benefits because, with tax legislation as fluid as it is at present, those benefits might not survive the passing of the next set of amendments.

Despite all the potential difficulties which complicate transactions involving trusts, Broomberg and Kruger point out that a trust still remains a viable alternative to a company as a possible contracting party<sup>129</sup>.

- First, no secondary tax on companies is payable on distributions from a trust.
- Secondly, income derived by a trust and which is taxable in the hands of a beneficiary does not lose its identity<sup>130</sup>.

Furthermore, there are other non-tax considerations for using a trust as a contracting party. For example, much like a company, a trust confers limited liability on the trustees in that the Trust Property Control Act specifically provides that the assets of the trust are distinct from the personal assets of the trustees and the founder. Also, a trust can endure in perpetuity or at least until terminated in accordance with the terms of the trust deed. Thus, while a trust might not have a separate legal personality, and can only exercise its rights and obligations via the trustees acting in a representative capacity, a trust in effect has perpetual

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<sup>128</sup> Pace and Van Der Westhuizen at B1.

<sup>129</sup> *Tax Strategy* at 15.

<sup>130</sup> *Armstrong's case (Supra)* and *Rosen's case (Supra)*.

succession.

Having located and, hopefully, diffused the landmines embedded in the minefield of fiscal legislation referred to in the introduction to this report, it is hoped that the reader will not be too intrepid to tread a path through the fiscal minefield to the potentially fertile and remunerative environment beyond.

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