

THE COMMON LAW AND TAXATION OF TRUSTS IN SOUTH AFRICA

IN THE TWENTY-FIRST CENTURY: With Emphasis on Business Trusts

By

MTHOKOZISI RODNEY MTHETHWA

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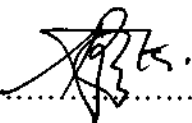
SUPERVISOR : PROF. W D GEACH

SUBMITTED : OCTOBER 2004

DECLARATION



I declare that this dissertation: **THE COMMON LAW AND TAXATION OF TRUSTS IN SOUTH AFRICA IN THE TWENTY-FIRST CENTURY – With Emphasis on Business Trusts** represents my own work and that all the sources that I have used or quoted have been indicated and acknowledged by means complete references.


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M R MTHETHWA

DURBAN

OCTOBER 2004

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I wish to record my sincerest gratitude to my supervisor, Professor W D Geach for his invaluable assistance and guidance in making this work a success. Without his assistance and tenacity, this work would not have been completed.

I would also like to thank and dedicate this work to my dearest wife, Bongi, and my loving children: Sihle, Buhle, Ayanda, Anele and Gcina who had to persevere long hours of absence and neglect whilst I was engrossed with this project. May it be a source of inspiration throughout their lifetime.

I also dedicate this work to my late grandmother, Ntombenhle, and my aunts, Ntomb'lezi and Mirriam.

MTHOKOZISI RODNEY MTHETHWA

DURBAN

The purpose of this technical report is not to establish a definitive answer as to the validity and suitability of a business trust as a new form of a business entity, but is aimed at addressing the uncertainties that have emanated from the use of a traditional trust structure as a business vehicle. A critical analysis of the recommendations made by the Margo Commission that the taxation treatment of business trusts and companies should be aligned in order to avoid the tax abuse of business trusts will also be undertaken.

Globally trusts, especially discretionary inter vivos trusts, are formed purely for carrying on a business including owning and letting of property. However, there are divergent views whether a trust can be used for commercial purposes. Honoré (1985 : Preface) is of the opinion that "The use of trusts for business purposes – no new phenomenon, since testators long since saw the advantage of setting up a trust to carry on their enterprises after their death – raises complex issues of control. It should not be assumed without thorough investigation of the past record and future possibilities of business trusts that there is no room for a tertium quid between the commercial partnership and the incorporated company". Wunsh (1986 : 561 – 82) says that a business trust provides a method of setting up or continuing a business alternative to an incorporated company or close corporation (Honoré, 1992 : 74). In general a business trust is a pure trust the main object of which is to carry on a business enterprise with a view to making a profit and distributing it amongst the beneficiaries.

Notwithstanding the fact that the Trust Property Control Act which controls all forms of trusts was enacted in 1988, Honoré (1992 : Preface) is of the view that business trusts call for some further regulation, but not for the full panoply detailed in the Companies Act or even the Close Corporations Act.

The analysis of the recommendation of the Margo Commission to align the taxation treatment of business trusts and companies shows that business trusts are not close substitutes for companies as they are 'pure trusts' formed purely for protecting the founder's business for the benefit of the beneficiaries. Although there may be similarities, there are also dissimilarities between business trusts and companies. Further, there are no compelling reasons for changing the current tax regime since taxing business trusts like companies will not necessarily improve equity or efficiency and particularly prevent perceived tax abuse. Tax abuse should be addressed at its source through better enforcement action to limit tax abuse opportunities.

In conclusion it will be shown that although a business trust can at present provide certain tax advantages while still preserving the limited liability of the trustees, legislation is gradually being introduced which will

result in trading trusts being taxed on the same basis as companies. However, the researcher submits that the legislature will not be solving the problem by aligning the tax treatment of business trusts and companies.

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CHAPTER 1

ORIENTATION TO THE STUDY

1.1 INTRODUCTION

The purpose of this work is twofold. The first is to investigate the suitability of a business trust as a vehicle for carrying on a business when compared to other well-known forms of vehicles such as companies, close corporations, partnerships and sole proprietorships. The second is to analyse the recommendations of the Margo Commission that the tax treatment of business trusts should be aligned with that of companies.

1.2 ANALYSIS OF THE PROBLEM

It was revealed that in certain instances an inter vivos trust is created with the sole purpose of being used as a vehicle for conducting a business. There has been an increasing use of the traditional trust structure for commercial purposes. That this is so, the business trust structure has been subject to scrutiny by the Margo Commission. The Margo Commission (1987 : 213) commented thus on business trusts:

“...serious concern has been expressed at the extensive use which is being made of the so-called trading or business trusts. It has become clear that special treatment must be accorded to those trusts”.

The Margo Commission (1987 : 214) further commented that these so-called business trusts are usually structured in such a way that the participants enjoy the advantages of limited liability. The South African Law Commission, referred to by the Margo Commission, was mandated to investigate the South African Law of Trusts and recommended in its working paper on trust law which was released in 1983 that there was no need to comment on establishing trust law principles and that the South African Trust Law should not be codified. In 1988 a bill, which was proposed by the Law Commission expressed no reservations about the trusts right to existence in South Africa. On the contrary, it highlighted the popularity, flexibility and usefulness of the trust (Olivier, 1990 : 21). The primary concern with regard to business trusts is that a trust structure is not a new form of a trading entity and cannot be used for any commercial purpose. This view neglects the fact that it is the flexibility of a trust that renders it to many uses. The other concern is that a business trust has the attributes of a limited company and its trustees enjoy the advantage of limited liability without incorporation and without the essential protection of creditors which requires the maintenance of capital. This is a glaring deficiency of a business trust and the inapplicability of the doctrine of disclosure which may cause financial loss to third parties contracting with it. Wunsh (1986 : 563) says unwary trust beneficiaries may also be seriously prejudiced by the lack of clear rules for their protection.

The Margo Commission also quoted the Standing Advisory Committee on Company Law and stated that the latter raised concerns at the increasing use of business trusts to avoid compliance with company law principles. Further, the Minister of Finance in his 1998 budget speech also noted the increase in the use of trusts for carrying on business activities with a view to avoiding tax. In order to combat abuse by business trusts, the Margo Commission proposed that such trusts be taxed like companies. This proposal may lead to undesired consequences as some of the so-called business trusts are akin to partnerships.

It is also apparent on even a cursory review of the writings of our legal experts in the South African Law Journals and articles presented by academics and practitioners at seminars that trusts play an increasing significant role in commerce today. In recent years, we have witnessed the proliferation of vehicles such as trusts and trust companies that hold significant shareholding in other companies.

STATEMENT OF THE PROBLEM

In essence, the problem that will be investigated in this study pertains to the community's perception of the business trust. Some of the questions that will be explored are:

- is a business trust a pure trust or an institution sui generis?
- are business trusts close substitutes for companies?
- should a business trust be taxed as a company as a matter of principle and ignore the already established principles of taxation of trusts?; and
- if so, should the proposed tax treatment apply to both private and public trusts?
- would taxing business trusts like companies reduce tax abuse?
- despite the proposed alignment of the tax treatment of business trusts and companies, is a business trust still a viable vehicle for carrying on business?

1.4 AIMS OF THIS STUDY

The objective of this study is to examine the concept of business trust as an alternate vehicle for conducting a business. This study has been accentuated by the arguments between the proponents of a business trust and those who do not regard a business trust as a suitable form of business entity.

The intention of this work is not to catalogue all points of similarity between various forms of business trusts in common use but rather is to provide an in depth analysis of a business trust and to explore some commonly encountered issues that the business trust faces. The most important and contentious issue is whether a business trust is a 'true trust' or a new legal form of business entity. The validity of a business trust structure has invited much debate between its proponents and those who view the business trust as a

‘snam trust’. These contentious issues may be resolved by obtaining an understanding of the true nature of the business trust and how it has evolved from its inception to the present time.

Further, the Margo Commission cited in its report the abuse of trusts for tax purposes and recommended the conduit-pipe principle is not appropriate for the so-called trading or business trusts and such trusts should be taxed like companies. As discussed in this work, this recommendation could have adverse tax consequences.

The aims of this study are therefore to:

- undertake an empirical investigation into the perceptions people have regarding the business trust.
- establish whether business trusts are being abused.
- establish whether or not the tax treatment of business trusts and companies should be aligned and what effect this will have on traditional trust structures.

1.5 ELUCIDATION OF CONCEPTS

To clarify and effect a better understanding of the topic under investigation, the following concepts need to be elucidated:

- **Beneficiary:** A person or persons named in the trust instrument who will benefit from the trust property. Beneficiaries may be either income or capital beneficiaries.
- **Bewind trust:** Is a trust in which the real right of ownership of the trust assets vests in the trust beneficiaries but the management and control over these assets vest in the trustees. Since the trustees do not hold title to the benefits in their own names, their capacity is that of an agent in relation to the trust assets (Kourie and Ryder : 224).
- **Consensus ad idem:** Meeting of minds or an agreement to the same thing.
- **Discretionary trust:** In a discretionary trust, ownership and control vest in the trustees in their representative capacity. However, the trust beneficiaries have no right to claim the trust benefits, except and until the trustees have exercised their discretion (Kourie and Ryder : 225).
- **Ejusdem generis:** Is a canon of construction providing that when general words follow the enumeration of persons or things of a specific meaning, the general words will be construed as applying only to persons or things of the same general class as those enumerated. Therefore, the words mean ‘having the same meaning as’.
- **In casu:** Means in the case under consideration.
- **Inter vivos trust:** Is a trust which is formed during the lifetime of the founder for the benefit of a third party.

- **Inter vivos:** Between living persons (from one living person to another).
- **Novus actus:** Means a new intervening act.
- **Ostensible authority:** The doctrine of ostensible authority (estoppel) requires that there be a culpable misrepresentation which precludes the representor from relying on the true state of affairs if the other party acting on the representation was prejudiced (Cilliers, 1992 : 186).
- **Settlor:** Sometimes called the founder or creator, is a person who creates a trust by transferring his assets to the trust to be controlled and administered by another person for the benefit of another person(s).
- **Stipulatio alteri:** A contract for the benefit of a third party.
- **Sui generis:** Of its own kind; peculiar to itself.
- **Tertium quid:** Something related in some way to two things, but distinct from both.
- **Trustee:** A person who is entrusted with the management and administration of the trust property for the benefit of a third person or persons.
- **Turquand rule:** In order to limit the third party's duty to make inquiries within reasonable bounds and to restrict it to matters which were granted publicity, the British courts formulated the Turquand rule. In terms of this rule an outsider contracting with the company in good faith is entitled to assume that the internal requirements and procedures have been complied with (Cillers, 1992 : 185). This rule is undoubtedly necessary as persons who deal with the company cannot, however, be expected to know of irregularities which may take place in the internal management of the company (*Mahony v East Holyfield Mining Co* (1875) LR 7 HL 869. The rule is not simply that a particular person is entitled to assume that the necessary acts of internal management have been performed but a legal presumption arises that all aspects of the internal management of the company have been properly carried out (*Mine Workers' Union v Prinsloo*).
- **Ultra vires:** Acts beyond the power of the company, that is to say, where a company engages in transactions not authorised by its memorandum of association.
- **Vested trust:** Is a trust in which ownership and control of the trust assets vest in the trustees in their representative capacity on behalf of the trust and the beneficiaries have only personal rights to claim their portion of the trust benefits from the trustees (Kourie and Ryder : 224).

1.6 RESEARCH METHODOLOGY

The research with regard to this study will be conducted as follows:

- the available literature relevant to the topic will be studied.
- the comparative study of the treatment of business trusts for tax purposes in other jurisdictions will be made.

1.7 FURTHER COURSE OF THE STUDY

In chapter 2 a brief discussion of the common law of trusts and their nature and historical origin and the influence of English Law and Roman Dutch Law on the South African Law of Trusts will be canvassed briefly. The objective is to provide a basic comprehension of the concept of a business trust.

In chapter 3, the concept of the business trust will be discussed. The nature and origin of business trusts will be examined. An attempt will be made to establish the extent to which trusts are used for commercial purposes in South Africa. The limitations and problems areas in the use of business trusts will be explored.

Chapter 4 will deal with the current tax implications of trusts and how these impact on business trusts. The recommendation of the Margo Commission to align the taxation treatment of business trusts and companies will be explored in order to determine whether there are compelling reasons for changing the current tax regime. A comparative study with regard to the taxation of trading trusts in the United States of America and in Australia will also be undertaken.

In chapter 5 other tax statutes will be explored to determine their effect or impact on business trusts.

1.8 SIGNIFICANCE OF THE STUDY

The study will assist those individuals planning to utilise the trust structure as a vehicle for carrying on business. It will also highlight the limitations and other perceived problems of using the traditional trust structure as a business vehicle. The study is expected to assist the legislature in addressing the problem areas that the Margo Commission overlooked with a view to paving a way for further development of the trust law and, perhaps, the recognition of the business trust in the Trust Property Control Act.

1.9 CONCLUSION

In this chapter the researcher has set out the aims and objectives of the research project and the underlying motivation for undertaking this study. In the following chapter the nature and the historical development of the traditional trust structure will be discussed. This will be followed by an in depth analysis of a business trust and its attendant tax implications.

LEGAL NATURE AND HISTORICAL DEVELOPMENT OF TRUSTS

2.1 INTRODUCTION

This chapter is not intended to be a detailed treatise of the law relating to trusts but the objective is to introduce the salient aspects thereof as part of our legal framework of ownership of property and recently of carrying on a business. As this subject is extensive and complex, not all aspects of trusts will be canvassed. The writer will discuss only those aspects of trust that provide an insight into common law and taxation of trusts and the practical application of these principles in the use of trusts as a trading vehicle.

2.2 ORIGIN AND HISTORICAL DEVELOPMENT

2.2.1 Origin

The trust is a distinctly and a uniquely British institution and has been adopted in many civil law jurisdictions such as the United States of America, Canada, Australia and New Jersey, to name a few. From their medieval origins trusts have developed into an extremely diverse and complex means of property ownership and management. The legislation enabling and controlling trusts, their beneficiaries and trustees is equally diverse and complex. A trust is descriptive of a relationship of legal ownership and use of property. The uniqueness is that the legal owner, namely the trustee, of the property does not, nor cannot, benefit from the use of the property. Contrary to the legal logic, the legal owner of the property is under an obligation to deal with the property exclusively in the interest of the beneficiaries, in accordance with the terms of the trust instrument. Fullerton (2001 : 4) asserts that the trustee is, therefore, estopped from benefiting in any way from his position as trustee of the trust.

2.2.2 Historical development

It is not known when and where the English Law Trust was first used in South Africa (Van der Westhuizen, 1997 : 3), but the first reported judgment in which a trust was mentioned was decided in 1833, according to (Honoré, 1992 : 15). Van der Westhuizen (1997 : 5) submits that: “Unlike in other civil law jurisdictions such as Switzerland, the trust experienced no undue problems in making itself acceptable in the somewhat foreign South African surroundings”. This view confirmed what was said by Sir Amos that “(t)he English trust has everywhere planted itself like a cuckoo in the nest of the civil law ...”, (Oliver, 1990 : 7) quoting Poncet N and Meakin IL.

Honoré (1992 : 6) agrees that although the concept of trust may have found its way to South Africa from England and Scotland, “it is another matter to assert that the rules of South African Trust Law are derived

from English Law. Only certain facets of English law have been recognised in the South African law of trusts and that other facets originate in a mixture of Roman-Dutch and indigenous South African rules. He further says thus of the South African law of trusts:

“There is nothing in them flatly inconsistent with Roman-Dutch principles; analytically they can be reconciled with and shown to be natural developments of such ancient institutions as the fideicommissum, the fiducia, the stipulatio alteri, the Dutch administrator and so on”. (Honoré, 1992 : 17).

Van der Westhuizen (1997 : 3) agrees that the process of reconciliation between the English law and the Roman-Dutch law or the South Africanising of the trust law is still far from completion. That this is so there are differences of opinion on the development of the South African law of trust. Amongst the prominent writers on the South African Law of Trusts there are those that flatly deny that the English Law of Trusts forms part of our Trust Law. Others do agree that certain terminology had been adopted from the English Trust Law but not the trust law itself. However, there is some consensus that the Roman Dutch Law, to a certain extent, found its way into our law of trusts. According to Joubert (1987 : 42) referred to in Pretorius v CIR 1984 2 SA 619 (T), the English law of trusts does not form any part of our law. Coertze who, in his doctoral thesis, ‘Die trust in die Romeins-Hollandsreg’ said of the South African Law of Trust:

“(d)ie wasdom en ontwikkeling van die *Treuhand* – idee in ons reg het plaasgevind onder invloed van die Engelse reg. Die Engelse terme *trust* en *trustee* is geadopteer maar nie die Engelse trustreg nie. ‘n Eie trustreg is deur ons regspraktyk en deur ons Howe ontwikkel maar dit is nog ver van voltooi” (Van der Westhuizen, 1997 : 3).

Despite the fact that more than 45 years have lapsed, there are still many issues regarding the trust which are in the process of development; these include inter alia, whether a testamentary trust and more particularly an inter vivos trust ought to be regulated by the trust law in general or by the law of succession; what the real legal nature of an inter vivos trust is; the definition of a business or trading trust and the legal nature of this form of enterprise, and the whole question of the legal personality of the trust, to mention a few (Van der Westhuizen, 1997 : 3).

The writer concurs that the South African Law of Trusts still has a long way to reach finalisation since there are still many issues that are still in the process of development. Given the fact that the Trust Property Act has made no attempt to address the legal aspects of trusts in South Africa, it is left to our courts to wrestle the problem and resolve all these pending issues. Until such time, confusion will still prevail as to whether a trust can in fact conduct business operations.

Nature of trusts

A trust comes into being when, property is transferred by a settlor to a trustee to be managed and administered in terms of the deed of trust for the benefit of the beneficiaries. Such property does not form part of the assets of the trustee but is a separate fiduciary patrimony not available for the trustee's creditors. The transfer of property is either by way of a donation or sale but it may also be pursuant to a contract.

Trusts were originally created for estate planning in order to preserve and conserve property while at the same time pegging the value of the donor's estate. Although the classical conservation and protection of property, have, over the years, been an important objective with the trust in South Africa, it is only during the latter half of this century that practitioners have started to use the traditional trust figure, with or without certain adaptations and innovations also for business purposes (Van der Westhuizen, 1997 : 4). Van der Westhuizen cites the Massachusetts Trust as an example of these adaptations and innovations where the beneficiaries provide the trust capital in return for which they receive share certificates as proof of their pro rata interest in the venture. As a form of business entity the trading trust compares very favourably with other forms of business entities.

Due to its flexibility, the trust can be put to many uses. Urquhart (1998 : 5.2) says that: "At the broadest a trust may be formed for any lawful purpose, which immediately highlights the potential for using the trust as a business vehicle. No authority is required from the state....for the formation of a trust, a factor which appears attractive when the use of the trust as a business vehicle is considered".

2.3 DEFINITION OF A TRUST

There is not a generally accepted definition of a trust by various authors locally and internationally. The Trust Property Control Act defines a trust as follows:

A "trust" is an arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed (1) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or (2) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument.

Van der Westhuizen (1997 : 6) says the trust under (1) is called the trust in the narrow or strict sense. It will have a narrow sense when the beneficiaries do not have a vested right in the income and capital of the trust and the trustee has discretionary powers to deal in the income and capital of the trust in a manner he deems fit for the benefit of the beneficiaries while the one under (2) is known as the trust in the wide sense, also called the bewind trust. It will have the bewind structure when the beneficiaries provide the trust capital themselves or by guaranteeing the loans made against the security of their own property, in return for which they receive share certificates (sometimes the share is stated in the trust deed without issuing a certificate) as proof of their pro rata interest in the venture, and as proof of their vested rights in the trust capital. Once the capital has been repaid, they cease to be the beneficiaries.

Honoré (1992 : 3) states that: “[I]n the narrow or strict sense a trust exists when the creator of the trust,hands over the control of an asset which, or the proceeds of which, is to be administered by another (the trustee or administrator) in his capacity as such for the benefit of some person (beneficiary) other than the trustee or for some impersonal object”.

Olivier (1990 : 4 and 108) submits that trusts in the narrow sense refer to the legal institution where an intermediate person, the trustee, holds property as owner thereof in accordance with the expressed wishes of another person, the settlor or founder, not for his personal benefit but for the benefit of named or ascertainable beneficiaries or for an impersonal object.

The trustee, therefore, has the legal ownership of trust assets, but he does not acquire any beneficial interest thereto. His position is that of an official of the trust fund similar to that of a director of a company except that the latter does not acquire ownership of the company property but controls and administers it for the eventual benefit of the company shareholders. The author submits that the term “trust” does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act, 66 of 1965.

The most outstanding feature of these definitions is that reference is made to the ownership of the trust property by the trustee on behalf of another person and not for his own benefit. If there is one theme to these definitions, it is that they all deemphasize the complexity that may be created when the trustee becomes insolvent by clearly preventing the trustee from merging the trust property with his personal assets.

2.4 FORMATION OF AN INTER VIVOS TRUST

An inter vivos trust is formed by means of an agreement between the founder and the trustees whereby property is transferred to the latter for management and control for the benefit of the persons named in the

trust instrument, *Crookes v Watson* 1956 1 SA 277 (AD). The trust instrument is lodged with the Master of the High Court for registration. No trustee can act in the capacity of a trustee until a written authorisation is obtained from the Master. Security can be requested by the Master from the persons appointed as trustees but in certain circumstances exemption may be granted.

According to Honoré (1992 : 6), the creation of a valid trust requires the following essential attributes:

- the founder must intend to create a trust;
- expression of intention must be such that a legal obligation is created;
- the property subject to the trust must be defined with reasonable certainty;
- the object of the trust must be defined with reasonable certainty; and
- the object of the trust must be lawful.

Honoré (1992 : 4) says that an inter vivos trust in a narrow or strict sense would be created if the settlor relinquished control of his assets by transferring them to the trustee. He quickly points out that for the formation of a trust by means of a contract, the founder cannot set up a trust by transferring assets to himself as sole trustee, though he may do so by a transfer in trust to himself and another. He further supports this view by adding that once a trust has been created it will not be extinguished merely because the founder becomes sole trustee, for he will then own the trust assets only in an official capacity, subject to the limitations of the trust deed.

Olivier (1990 : 19 and 29) takes a different view that, based on his criticism on the equation of the inter vivos trust with the stipulatio alteri, that it is actually the founder who acts unilaterally and that there is no consensus ad idem between the founder and trustee as to the contract of the trust deed. Van der Westhuizen (1997 : 12) is of the opinion that until this uncertainty is clarified, it is advisable from a practical point of view that the founder refrains from being the sole trustee when the trust is formed.

Confirming Honoré's view, in *Crookes v Watson* 1956 1 SA 277 (AD), the learned judge held that the settlor may also be the trustee but as qua trustee, he should administer the trust assets for the benefit of some person, the beneficiary, other than himself. The judge further submitted that the trustee might also be a beneficiary of the trust, though he may not be the sole beneficiary if he is also the sole trustee. In these circumstances the trustee should display a certain degree of independence since if he were bound by the instructions of another, he might be an agent rather than trustee.

Van der Westhuizen (1997 : 12) asks the question whether the time has not arrived for the inter vivos trust to be described as having a legal nature sui generis as in the case of the testamentary trust. Van der Westhuizen

warns that “Until this uncertainty is clarified, it is advisable from a practical point of view that the founder refrains from being the sole trustee when the trust is formed.”

With regard to the structuring of an inter vivos trust, Honoré (1992 : 92) states that “it has been said that a trust inter vivos is a contract for the benefit of a third party.... But on reflection it is plain that the point made is simply that the method of creation of a trust inter vivos is by way of a contract and that the contract usually contains a stipulation in favour of the beneficiary, who by accepting acquires an indefeasible right under the trust”.

Le Roux J, in Pretorius v CIR 1984 2 SA 619 (T) referring to the judgment in Crookes v Watson 1956 1 SA 277 (AD) stated that in the trust the beneficiary must accept the benefit of an agreement before the trustee and the settlor are bound to perform their agreement in his favour (as opposed to the beneficiary obtaining rights on the mere execution of the agreement). With regard to inter vivos trusts, the court held that: “One of the main differences between a trust and this type of contract seems to be that the trustee is the holder of an office which is subject to the general supervision of the courts and not merely a contracting party.”

Basically the inter vivos trust is an agreement and all the rules of the law of contract therefore find application. Unilateral actions by a founder or where the trust deed is signed only by the founder is therefore invalid (Honoré, 1992 : 116), (Olivier, 1990 : 20 and 38). Van der Westhuizen (1997 : 13) submits that from the foregoing it appears that an inter vivos trust is not a true stipulatio alteri but a contract sui generis, that is, of its own kind.

In conclusion a distinction should be drawn between the intention to create a trust in the narrow sense and the intention to create a bewind trust. The intention must be shared by the founder and the trustees as it is perhaps one of the determining factors to distinguish between a business trust and an ordinary partnership (Van der Westhuizen, 1997 : 24(3)).

2.5 TRUST AS A SEPARATE ENTITY

On its formation, a trust as a separate entity does not acquire legal personality, notwithstanding that it exists apart from its founder who may well be one of the trustees and its beneficiaries. The important consequences of the fact that a trust is a separate entity existing apart from its founder and beneficiaries are as follows:

- The founder nor the beneficiary is not qualified by virtue of being a party thereto to act on behalf of the trust, unless he contracts thereto.
- The claims of the creditors against the trust are limited to the assets of the trust.

- The sequestration of the estate of either the founder or the trustee including that of the beneficiary does not lead to the sequestration of the trust, provided the trust is a trust in the narrow sense and it's a discretionary trust. Conversely the sequestration of the trust will not necessarily entail the sequestration of the estates of the founder, beneficiaries or the trustee.
- The trust is assessed apart from the estate of the founder, beneficiaries or the trustee on income retained in the trust. The trustee is liable for the tax of the trust on a representative capacity.
- The profits of the trust do not belong to the beneficiaries unless they have a vested right in the income of the trust or with regard to a discretionary trust, the trustee has made a distribution.

Notwithstanding the extensive use to which trusts have been put in South Africa, the legislature has not yet accorded the inter vivos trust a legal personality status. This is not surprising since our law of trusts is still in the development phase and much of the work is left in the hands of our courts, practitioners and academics to grapple with. Whether any particular entity can acquire legal personality must be determined in the light of the laws in force in each legal system (Cilliers and Benade, 1982 : 5).

Van der Westhuizen (1997 : 25) submits that the legality of an inter vivos trust is not determined by the Master or any other state authority. It is left to those interested in the matter to establish that the trust is unlawful or invalid (Honoré, 1992 : 143).

2.6 CONCLUSION

In this chapter it has been shown that there are divergent views with regard to the development of the South African Law of Trusts. Although trusts have existed for centuries in English law, the South African law of trusts still lacks clarity in several key areas. This is due to the fact that the South African law of trusts is an amalgamation of English law and indigenously-developed principles, and is still evolving, and in particular to the fact that the use of a trading trust as an alternative business structure to a limited company, is still relatively recent phenomenon in which the applicable legal principles are still uncertain.

Although a trust is not a legal person, an inter vivos trust due to its flexibility, is sometimes formed purely for carrying on business for profit. In the following chapter, the writer will explore the business trust concept in order to establish whether a pure trust can be used successfully as a commercial vehicle.

CHAPTER 3

BUSINESS TRUSTS

3.1 INTRODUCTION

When considering the commencement of business or investment, one needs to consider which vehicle will be best suited to the circumstances. The success of any business may depend upon choosing the correct form of an organisation or business structure. Factors to be taken into account invariably include the number of participants in the business, how the business is to be operated from a management and control point of view, statutory formalities to be complied with, achieving limited liability for participants, the requirement of perpetual succession and, importantly, income tax considerations.

The trust is an amazing figure of trust law which lacks legal personality and the trustees of which enjoy limited liability. The flexibility of a trust is its hallmark; it can be used for whatever purpose the founder may think of, including carrying on business. There is no other vehicle that can provide as much freedom with respect to income and capital allocation and retention, yet still provide a degree of limitation in respect of individual liability. It has been shown that the major advantage of a business trust is that business profits can be allocated to the beneficiaries in any proportion. This flexibility enables efficient utilisation of marginal tax rates. As it will be seen in the following chapters, a business trust with a company trustee or beneficiary could be useful where the founder wishes to achieve flexibility, discretion, and privacy in respect of income and capital of the business, lower tax liability in respect of income 'parked' in the beneficiary company, as well as a measure of limited liability for the business assets.

This chapter will focus on the understanding of the business trust concept and the reasons why this new form of business entity has proliferated globally. A business trust is an 'entity' comparable to other business entities such as partnerships, close corporations and companies, although in certain circumstances it may possess the characteristics of both the partnership and the company.

3.2 THE BUSINESS TRUST CONCEPT

The trust is a versatile business and estate planning tool and only one's imagination limits the purposes for which trusts may be created. In this chapter the words business or trading trust will be used interchangeably. Honoré (1992 : 14) states that the flexibility of trusts contributes immensely to their popularity and the multifarious purposes to which they are put.

5.2.1 Nature of the business trust

A trading trust is simply a trust which trades or is in business. It is a form of unincorporated business organisation created by a trust deed under which property is held and managed by trustees for the benefit and profit of beneficiaries designated in the trust deed. A trading trust is favourably comparable to other forms of trading entities such as sole proprietorships, close corporations, companies and partnerships and is managed by its trustees and as a company is managed by directors. Honoré (1992: 74) says the trust makes available a form of organisation intermediate between a partnership and an incorporated company or close corporation. The main difference between business trusts and corporations (including companies) is that, through succession of trustees and the trust assets gives it the advantage of continuity, a trust does not outside statute possess juristic personality. It is subject to statutory regulation under the Trust Property Control Act which is less stringent than that imposed by the Close Corporations Act of 1984 and much less so than under the Companies Act of 1973 (as amended).

In general, a trading trust is not a legal separate juristic person distinct from its trustees. Because a trust is not a separate legal entity, in the same sense as a company, the business is actually undertaken in the names of the trustees of the trust, and it is often not apparent that the trustees are in fact acting as trustees of a trust. For example, Marc Smith and Jill Brown might be trading under the name "Smith & Brown" in a retail business. However, they may in fact be acting as trustees of the Brown Family Trust, but this may not be disclosed to any third parties who do business with Smith & Brown.

Honoré (1992 : 14) states that the flexibility of trusts contributes immensely to their popularity and the multifarious purposes to which they are put. Olivier (1990 : 240) concurring says a trust is an excellent instrument to employ in the field of business, especially when a group of people wish to pool their resources with the object of acquiring a business venture for their joint benefit. For example, many private hospitals are owned by trusts which are partly funded by the beneficiaries who pool together financial resources. This concept has over the years been used successfully by farmers and by a group of people for acquiring blocks of flats for conversion into sectional titles.

Trusts which have been created for estate planning purposes often have features of a business. Wunsh (1986 : 561) warns that it is, therefore, important to distinguish the trading trust from the traditional estate planning trusts. A trust will be perceived as a business trust if it used for carrying on a business for profit, including the owning and letting of property, as distinguished from one designed to protect and conserve the assets.

The trust instrument for a trading trust may look very much like that for a standard family trust, except that it will probably give the trustees specific powers regarding the establishment of a business, and the general day

to day aspects of running a business. Apart from those specific powers, the trust instrument will have a founder, trustees and beneficiaries, as would a trust deed for a family trust. The trustees of a business trust might be individuals, or, more commonly, a private limited company might be appointed as the trustee. As it will be seen later in this chapter, the appointment of a company as the trustee can be confusing for a third party who is dealing with the business, as the business operator will be identified as the limited liability company, and again, it may not be disclosed that this company is in fact acting as a trustee of a trading trust.

The business trust is unfamiliar to many people and is often viewed with suspicion. The business trust as such lacks tangible substance. It enters into transactions by means of its trustees acting in a representative capacity. In spite of the business trusts imperceptibility in a physical sense, the community is only too conscious of the effect of business trust presence. Pitcavage (1999 : 6) submits that there is a perception that pure trusts, which include business trusts, have been used by the wealthy for centuries to hide their fortunes. Because of their association with wealth, people frequently project a mysterious conceptual aura around them in their thinking. Stripped of all legal veil, business trusts are merely agreements between people.

The Margo Commission expressed a serious concern on the proliferation of trading trusts and the possible abuse of such trusts, yet the nature of these trusts is unfamiliar to many people. Steele (1999 : 4) quoting Youdan Timothy, notes that a failure to appreciate the fundamental nature of the trust concept can lead to misconceptions regarding liabilities and obligations in the context of business trusts. Supporting this view Flannigan (1982 : 182 – 184) says thus of the misconceptions:

“The business trust is not a *sui generis* concept but rather the usual characteristics of a business trust – in which list he includes “centralised management, continuity of existence despite the death of trustees or beneficiaries, freely transferable interests and limited liability of beneficiaries” – “are all either demanded or allowed for by basic trust law”.

It is interesting to know that in Canadian law, while a business trust is not, a *sui generis* concept, there are common features in many forms of business trusts. For example most business trusts provide for a fixed scheme of distribution and also give the trustees unlimited powers to delegate trustee functions or to remove certain traditional trustee functions from trustees’ express duties and to vest them in one or more other entities (Cullity, 1989 : 6). Further, Cullity (1989 : 181) asserts that there are common features in many forms of business trusts; and, consequently, business trusts tend to give rise to certain recurring legal questions that are encountered less frequently, if at all, under family trusts, for example, questions of beneficiary liability are rarely encountered in commercial settings.

3.2.2. Origin and historical development of business trusts

Trusts have been used in the United States of America for hundreds of years, particularly in connection with property holdings. When unconstrained by the need to conform to specific rules and regulations, the trust became an immensely powerful instrument that could serve any number of useful purposes. Their flexibility was virtually unlimited. A historic example of the power and flexibility of trusts in action was given by 'Massachusetts Trusts' which were contractual trusts.

Massachusetts had a statute which forbade corporations to own land. Trusts were permitted to own land, and while corporations were developing elsewhere, trusts showed a parallel development in Massachusetts. Hence business concerns organised as trusts, came to be called Massachusetts Trusts (McNaughton, Hartley and Schwartz, 1970 : 61). The Massachusetts Trusts were formed mainly to circumvent a state prohibition against organisation of corporations that dealt in real estate. The Massachusetts Trust was a private agreement whereby property was conveyed to trustees to be held and managed for the benefit of the holders of transferable certificates issued by the trustees. These certificates, functionally similar to shares of stock in a corporation, entitled the holders to share in the income from the property, thereby obtaining some of the advantages of incorporating while sidestepping the regulatory burdens and restrictions placed upon corporations. The beneficiaries provided the trust capital, in return for which they then received share certificates as proof of their pro-rata interest in the venture (Olivier, 1990 : 117 – 119) and (Wunsh, 1986 : 563).

In the United States of America, a famous early business trust was the Standard Oil Trust which was formed in 1882 with the objective to centralise management in order to deal with 51 corporations which were owned by John D Rockefeller and his associates individually. All the shares held by Rockefeller and his associates were vested in nine trustees who were empowered to manage the trust property according to the terms of the trust instrument. Flannigan (1984 : 380) says the corporations continued to carry on independent businesses. The court held that the Standard Oil Trust had been created by a trust instrument and became controlled by an association. The court further held that the object of the Standard Oil Trust was to establish monopoly in restraint of trade, contrary to public policy (Wunsh, 1985 : 10), and was prohibited from subjecting itself in any way to the trust agreement. This development was the precursor to what is now known as anti-trust laws, the first of which was the Sherman Anti-trust Law. Thus, big business groups became unable, in many circumstances, to take advantage of the benefits offered by business trusts. Notwithstanding the enactment of the anti-trust laws smaller businesses were not affected, said Wunsh in the seminar presentation where he noted as follows:

“Businesses continued to be organised in the USA as trusts because they were not subject to the existing corporate legislation nor taxed as corporations but legislative and judicial developments have limited their use”.

The most important judicial development to which Wunsh refers was the case of *Morrissey v Commissioner of Internal Revenue* in which “.... the Court determined that the United States Congress had amended its revenue code to a degree sufficient to apply the corporate taxation schemes to these trusts, thereby removing the last substantial reason for utilising a business trust instead of a corporation for carrying on a business” (Flannigan, 1984 : 382).

Despite the implementation of anti-trust laws, businesses continued to be organised as trusts because they were not taxed as corporations nor were they subjected to the then existing corporate legislation. Judicial and legislative developments limited their use. Business trusts are still being used extensively in the United States of America. Each state has its own laws relating to the taxation of business trusts.

Trading trusts are not unlawful in the United States, but the manner in which they are used may be (McNaughton, Hartley and Schwartz, 1970 : 62). McNaughton, Hartley and Schwartz further submit that courts often declared trading trusts to be partnerships (thus avoiding limited liability of shareholders) if the wording of the trust deed was such as to reserve to the shareholders the right to replace the trustees and to control the management. Courts have also held trusts to be corporations (thus increasing regulation of taxation) if the wording of the trust deed had the effect of limiting the liability to trustees.

The above statement made by McNaughton, Hartley and Schwartz is supported by the following passage in the American case of *Goldwater v Oltman* (1930) 71 ALR 871, quoted by Wunsh (1983 : 382).

“If the trustees are subject to being removed by the shareholders and are dependent upon them for election, it is apparent that the ultimate control of the organisation rests in the shareholders”. In such circumstances the organisation would be treated as a partnership and not as a true trust.

Olivier (1990 : 117) supports the above statements and states that the concept of a business trust is very similar to a partnership in which partners combine their funds and efforts in a joint ‘profit-making’ venture. The partnership concept is built into the trust. The difference is that all assets vest in the trustees who have plenary powers to deal with the trust property. The interests of the beneficiaries are reflected in their share certificates, which are negotiable.

Flannigan (1984 : 375) noted in his article that an American commentator estimated that over ninety percent of assets held in trusts in the United States are in business trusts as opposed to personal or family trusts. In England, there were two businesses that were organised as contractual trusts and which could be classified as business trusts, namely, The London Stock Exchange (1802) and Lloyds of London (1811). Wunsh, in "Trust – Their Practical Tax and Estate Planning Application", says trusts set up in England in the 19th Century met with early success. When a few began to default on their obligations, the question was raised whether they were legal. This issue arose in connection with the provisions in the companies legislation which corresponds with section 30 of the South African Companies Act, 1973 which requires registration of all 'associations of more than twenty persons that carry on business for profit'. The first case to give recognition to a true business trust was the Submarine Cable Trust which challenged the legal contentions, and in *Smith v Anderson* the court vindicated the position of the Cable investors.

Flannigan (1984 : 375) says in Canada a proliferation of vehicles such as business trusts have been witnessed and notes that trusts have been used for over two hundred years as a form of business organisation. This is not to suggest that the use of trusts in commercial settings is a new phenomenon (Steele, 1999 : 1).

In Australia trading trusts have been used for more than twenty years. Trading trusts are also becoming popular in New Zealand. The increasing use of trading trusts and the awareness of the problems experienced by the Australian Authorities have prompted the New Zealand Law Commission to propose that changes should be made to rules surrounding trading trusts. The concerns in New Zealand related to the uncertainty surrounding the rights of trustees of trading trusts to relinquish their rights to be indemnified from the trust assets and the lack of statutory regulation as to how trustees of trading trusts go about conducting their business. The first concern is not applicable in South Africa as the liability of trustees of a trust is limited to the available trust assets. With regard to the second concern the New Zealand Commission proposed the imposition on the trustees of a trading trust, where the trustee is a limited liability company, the same obligations, in relation to distributions to beneficiaries of the trust, as are imposed in relation to dividends and other distributions by companies, under the Companies Act of that country. These obligations would require that the company satisfy a solvency test, before making a distribution from the trust. (Guardian Trust Financial Services).

It is not known when the 'Massachusetts Trust' was first used in South Africa, but the first reported judgement in which the validity of a business trust was accepted but not confirmed was in *Goodricke and Son (Pty) Limited v Registrar of Deeds, Natal* 1974 (1) SA 404 (N). This case was followed by the case of *Pretorius v CIR* 1984 2 SA 619 (T). "The court was prepared to recognise the legality of a trust which was settled with the express purpose of trading, namely engaging in a Sectional Title Scheme. The trading trust was successfully employed to save transfer duty. In *CIR v Pretorius* 1984 (2) SA 619 (T), the court did not

have to address directly the question of the validity, or otherwise, of the trading trust in South African Law. These cases will be discussed further under the validity of business trusts. Davis (Taxpayer, 1986 : 78) says there appears to be no firm Appellate Division recognition of the validity of the trading trust. Davis, further states that “the Appellate Division decision against granting Pretorius an exemption from transfer duty did not disturb the Court a quo’s finding as to the validity of a trading trust and submits that on the strength of the Court a quo’s decision, as well as Goodricke’s case, that a carefully drafted trading trust deed is valid in our law”.

The historical development of the trust in general and the business trust specifically, as well as its growth in popularity in South Africa, has caused trustees and practitioners alike, to consider the obvious eventuality, namely, of also utilising the trust as a trading entity. Considerations implemented led to the development of specific usages, which in turn played and are still playing a role as a trust law-creating medium and the concept of ‘trade usage’ in this sense, refers to the commercial practice to utilise the ordinary or private trust as a trading enterprise (Van der Westhuizen, 1997 : 4).

Van der Westhuizen (1997 : 4) further submits that whether the trade usages have reached the stage of validity, that is, it is long established, reasonably certain and that it has been uniformly observed over a long period of time, is perhaps still lacking confirmation. Referring to the cases of Goodricke and Pretorius van der Westhuizen says the validity of the business trust was accepted but quickly adds that among South African jurists there is but little consensus on the true meaning of the business trust. Van der Westhuizen, quoting Wunsh, Olivier and Theron, says this is causing legal uncertainty, and even a division into two schools of thought, namely those in favour of the business trust as a separate business entity, and those who do not want to recognise it (yet) as such.

In the light of what has been stated in the preceding paragraph, Van der Westhuizen (1997: 4) says “.....the South African business trustis in the process of development and therefore experiencing its fair share of legal uncertainty”. He quoted Hahlo where the learned author wrote: “When it comes to trusts in our law, even the most elementary propositions cannot be regarded as settled”.

The Standing Advisory Committee on Company Law had this to say with regard to business trusts:

“There are no statistics, but without a doubt there has been an upsurge in recent years in inter vivos trusts formed for purely business purposes. Compared to a company this legal form can provide tax benefits. Moreover, it is ‘flexible’ – meaning that the Companies Act (and particularly section 38) is not applicable, so that the rules applicable are largely determined by the contents of the trust deed. Finally, in effect limited

liability is obtained in that the trustee is only liable for the trust debts to the extent that trust assets are available”.

Honoré (1985 : Preface) supports this view and comments thus:

“The use of trusts for business purposes – no new phenomenon, since testators long since saw the advantage of setting up a trust to carry on their enterprises after their death – raises complex issues of control. It should not be assumed without thorough investigation of the past record and future possibilities of business trusts that there is no room for a *tertium quid* between the commercial and the incorporated company.”

The Margo Commission (1987 : 213) also took note of the extended and increasing use of trusts as vehicles for conducting business operations and said, “...serious concern has been expressed at the extensive use which is being made of the so-called trading or business trusts. It has become clear that special treatment must be accorded to those trusts”. These so-called business or trading trusts are usually structured in such a way that the participants enjoy the advantages of limited liability (Margo Commission, 1987 : 214).

The South African Law Commission, in Working Paper 3, showed a great deal for concern with the growing use of business trusts in the Republic of South Africa, and referred to Honoré where he said of the business trusts:

“Since a trustee acting in his capacity as such is liable only to the extent of the trust assets, it seems that a business carried on by trustees enjoys a form of limited liability independent of the Companies Act. It may be that this point will call for the attention of the legislature”.

Although the classical conservation and protection of property have, over the years, been an important objective with the trust in South Africa, it is only during the latter half of the century that practitioners have started to use the traditional trust figure, with or without certain adaptations and innovations also for business purposes (Olivier, 1990 : 117 – 119) and (Wunsh, 1986 : 563). To date no attempt has been made to provide any ‘solution’. Whether the concern expressed is justified is doubtful (Urquhart and Davis, 1998 : 5-15). Wunsh (1986 : 563) says “I should point out that although business trusts provide scope for the avoidance and reduction of duties and taxes, despite the dangers adverted to by the Law Commission and the Standing Advisory Committee on Company Law, there is no evidence of prejudice to or losses by the public as a result of the use of trusts for business purposes”.

3.3 WHAT IS A BUSINESS TRUST

A business trust is a term that enjoys something of a mystique and refers to nothing more than a broad category of trusts utilised for purposes other than the classic investment/administrative type function often associated with the trust (Honoré, 1992 : 74). A business trust is a conventional or traditional trust created solely for carrying on a business. As will be canvassed later in this chapter, a trust can be used for a variety of purposes, including carrying on of a business, due to its flexibility. Whether a trust can be used as a vehicle for conducting business, it is a problem which has not yet been finally settled.

Business trusts have long established themselves in many foreign jurisdictions but the problems posed by this form of business entity are far from being finally settled. Whether a business trust is perceived as a valid business entity in South Africa is not yet clear. Save for the cases of *Goodricke* and *Pretorius* as well as *ITC 1483* (1990) 52 SATC 306 and very limited specific regulation, the only sources of law on the business trust, currently in South Africa, are the legal writings of academics and practitioners, which, in any case, only have persuasive value when it comes to the creation of trust law. Among South African jurists there is but little consensus on the true meaning of the business trust. This is causing legal uncertainty, and even a division into two schools of thought, namely those in favour of the business trust as a separate business entity, and those who do not want to recognise it (yet) as such (Wunsh, 1986 : 561), (Olivier, 1990 : 116) and (Theron, 1991 : 277) cited by (Van der Westhuizen, 1997 : 4).

3.3.1 Definition of a business trust

Various authoritative writers and academics on the law of trusts have been struggling for decades to come up with a clear and precise definition of a business trust. The difficulty of capturing the trust concept in a single definition is clear from the wide variety of definitions by various authors locally and worldwide (Van der Westhuizen, 1997 : 10). The business trust is not susceptible to an intrinsic description. The United States despite having embraced business trusts since the formation of the first business trust, the 'Massachusetts Trust', has not resolved this problem. Instead, each State has its own definition of what it perceives as a 'business trust'.

Youdan (1995 : 3) also notes that: "There is no technical definition of a business trust. The term is used to cover a variety of types of trust". The types of trust mentioned by Youdan also include trusts which engage in trade or business. Flannigan (1984 : 375) defines a business trust as follows:

"The business trust may be viewed as a union between the unincorporated joint stock company and the trust. It is a true trust but it has an internal structure (e.g., a board of trustees manages with exclusive management authority, freely transferable trust interests, annual meetings of beneficiaries) very similar to that of a joint stock company. Like the joint stock company (and the partnership), the business trust is set up and regulated

under terms dictated by its members. Because of the imposed trust, it is a contract to carry on a business in which the benefit from that business is separate from the management of the business”.

Steele (1999 : 3) criticises Flannigan’s definition of a business trust as clearly quite narrow as it distinguishes between the many commercial applications of the trust concept and what he terms a ‘business trust’. Steele draws attention to another Flannigan’s article, Business Applications of the Express Trust at page 635, where the learned author used the term ‘business trust’ to refer to any trust created to facilitate a particular commercial transaction or to further a particular commercial objective.

Van der Westhuizen (1997 : 6) says “the business trust can be described as any trust (in the narrow sense or wide sense) which is primarily used for carrying on a business for profit”. Further, he quickly adds that: “the business trust is not really susceptible to an intrinsic description and can therefore only be defined at the hand of certain external factors or in terms of surrounding circumstances. On its own, these are also not conclusive but are merely indicative of the purpose for which the trust was created. It is therefore not a separate kind of trust, but the terms ‘business’ or ‘trading trust’ merely refer to one of the uses or application possibilities of a trust”.

In South Africa, the question whether a trust is a business trust or not, has more to do with the so-called classification of trusts between private trusts and public trusts and has no specific meaning, even for tax purposes (Van der Westhuizen, 1997 : 7). He submits that the Income Tax Act only contains a definition of a ‘trust’ and the stipulations of the said Act are applicable to all trusts whether trading or not, wide or narrow.

The Margo Commission was tasked to investigate the extent to which trusts are used for commercial purposes. In its report, citing the growing use of trusts for business purposes, proposed the following definition of the business trust:

“...a business trust is one which in the opinion of the Commissioner is used for carrying on business for profit, including the owning and letting of property for profit...” (Margo Commission, 1987 : 215).

The Margo Commission further furnished deeming provisions for determining business trusts to be as follows:

- the interest of a beneficiary is transferable; or
- the beneficiaries and trustees establish their association by voluntary, consensual and contractual
- means excluding mere acceptance of a benefit stipulated between settlor and trustee.

Wunsh (1985 : 30) has submitted that if the definition of a business trust as recommended by the Margo Commission is taken, then it is patent that a trust 'designed to protect and conserve assets' could well fall within the definition.

The Margo Commission (1987 : 214) provided the features of a business trust to substantiate its definition of such a trust and stated that, in the common law trusts there is a gratuitous transfer by one person to a trustee for the benefit of another, and the trust is more concerned with investment than with business operations, quoting (Crane and Bronberg). In the opinion of the writer, nothing can prevent a person from making a gratuitous disposition to a trustee of a private business trust (trust in a narrow sense) for the benefit of the beneficiaries. This would be the case for example where a father transfers the family business to a trust to prevent a vagrant child from laying his hands on the trust funds until he has reformed. The Commission further neglected that the term 'investment' has a wide meaning. There could be a 'passive' and an 'active' investment. A passive investment would for instance comprise investing funds in a bank and deriving interest without having been involved in the production of such interest income. In an active investment, a person deliberately sets out to make a profit on such investment and employs various commercial means that will facilitate the production of such profit, *African Life Investment Corporation (Pty) Ltd v CIR* 1969 (4) SA 259 (A), 31 SATC 163. Under such circumstances, a trust would be effectively carrying on business for making a profit and would be deemed to be a business trust in terms of the Margo Commission definition of a business trust.

Secondly, the Margo Commission recognised that in a business trust relationship, the beneficiaries often hold transferable certificates which are issued and transferred in the same manner as the shares in a company. The writer submits that in a private business trust the transferability of interest may not be a relevant issue. Wunsh (1990 : 19) is of the opinion that mere transferability of the interest of a beneficiary as being such a criterion is far-fetched.

Thirdly, the Margo Commission stated that in a business trust trustees have a right to fill their own vacancies, and that there is delegated centralised management. This view suggests that the trustees themselves do not manage the business trust entirely, but certain authority is delegated to persons employed by the trustees. However, it is not clear whether the trustees retain control of the business trust. The report does not refer to a situation where trustees are under the control of the beneficiaries as this may have different tax implications. That is, the association of beneficiaries may be construed to be a partnership.

3.3.2 Attributes of a business trust

The definition of a business trust proposed by the Margo Commission clearly excludes protective and conservative trusts since these types of trust are formed for the protection or conservation of property for the benefit of beneficiaries rather than for commercial purposes. The definition and the attributes of a business trust provided by the Margo Commission do not resolve the problem as to how a business trust can be distinguished from a traditional trust. That this is so the Margo Commission used the phrase 'at the discretion of the Commissioner'. Given the fact that the Commissioner has been given powers to determine whether a trust is a business trust or not does not only compound the problem but also creates a situation where a truly protective trust may be deemed by the Commissioner to be a business trust. Whether the decision of the Commissioner is subject to appeal or not is an open question which can be decided upon by the courts. The writer concurs with Wunsh (1990 : 20) when the learned Judge said that many so-called business trusts would be vulnerable to attack on the ground that they are not really trusts (control or consensual character, partnership, principal and agent). Many of them are, on analysis, associations and could be vulnerable to attack under sections 30 and 31 of the Companies Act.

Chernside (1978 : 720) says that "in a number of representative cases the courts have observed or commented upon the features which distinguish the Massachusetts or business trust from the ordinary or private trust. One such distinction is functional; the business trust is a device to indirect business for profit, whereas the traditional trust is designed to conserve and protect property. Another distinction lies in the manner in which the trust relationship is created; investors in a business trust enter into a voluntary, consensual and contractual relationship, whereas the beneficiaries of a traditional private trust take their interests from the donor or settlor".

Henn (1968 : 319) says "a troublesome problem ...is distinguishing an ordinary 'trust' from an organisation technically cast in the trust form but having the corporate characteristics of an association and therefore taxable as a corporation". In the United States Treasury Regulation 301, referred to by (Henn, 1968 : 319 – 320), it is provided that "generally speaking , an arrangement will be treated as a 'trust' if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint venture enterprise for the conduct of business for profit".

The most important characteristic of a business trust and the most important distinction between such a trust and an ordinary trust established in terms of a will or inter vivos trust, lies in the fact that the business trust is organised not as a means of effecting a gift or transfer but as a device of profit-making through the combination of capital contributed by a number of investors (Olivier, 1990 : 117).

In this section of the work, it has been shown that due to its ease of adaptability to many uses, the business trust is not susceptible to an intrinsic definition. The precise statutory definition of a business trust is all that is required. Urquhart, Meyerowitz and Davis (1987 : para 30) are of the view that a statutory definition of a business trust will be all that important. The authors further say that "...once a trust is accepted as part of South African law, there is considerable difficulty in establishing a clear demarcation between forms of trusts."

Davis's view is further supported by the fact that in America, business trusts have long been recognised as trading vehicles and subjected to tax as corporations but the American courts have admitted that the distinction is anything but clear, and is often fraught with difficulties of interpretation which the courts have been called to decided upon.

As the Margo Commission provided a definition of a business trust, the writer will analyse this definition and its attributes to highlight any pitfalls that might be present. To be able to do so, the attributes of a business trust as advanced by Wealth International Limited will be canvassed briefly in the following section of this work. The Delaware Business Trust will also be visited to ascertain any similarities or dissimilarities with the Margo Commission definition of a business trust.

Wealth International Limited (2000 : 4) submits that if a contractual trust (which includes a business trust) possesses certain 'corporate attributes' it can be classified as a corporation and taxed under statutory provisions regulating corporations. This is viewed as a possible pitfall from using a trust as a primary business legal entity. The corporate attributes cited by Wealth International Limited are:

- centralised management;
- continuity of life;
- limited personal liability of trustees; and
- easy transferability of trust beneficial interest.

Interestingly, the attributes cited by the Wealth International Limited, are similar in all respects to those suggested by Flannigan, which were discussed earlier in this chapter.

Wealth International Limited, further notes that as long as a contractual business trust possesses fewer than three of the above attributes, it will theoretically not be taxed as a corporation. To avoid being treated as a corporation, a contractual trust can easily be written such that it lacks both continuity of life and easy transferability of beneficial interest. However, it is submitted that easy transferability of beneficial interests,

such as where beneficiaries hold stock certificate-like 'units of beneficial interest,' as opposed to being explicit parties to the trust document itself, is an invitation to be classified as a corporation.

It is worth noting that from the attributes suggested by Wealth International Limited and Flannigan, the only attribute that the Margo Commission mentioned in its report is that of 'transferability of beneficial interest'. Also elsewhere in this work, mention was made that some authoritative persons have indicated that business trusts are characterised by having a management board (centralised management) as well as limited personal liability of trustees. It is submitted that in the light of advancement in this area of business trusts in other countries, the recommendations made by the Margo Commission should not be implemented without modification.

The writer of this work proposes that the South Africa should learn from the Governing Authorities of the Delaware State in America. Confronted with problems with regard to the true nature of the business trust, lack of a statutory regulation as to how the trustees of business trusts go about conducting their business and the limited liability of trustees, the Delaware Authorities promulgated the Delaware Business Trust Act (DBTA), now called the Statutory Act, in 1988. This model has been copied by various countries and is perceived as a very significant piece of legislative intervention into the business trust area. As Delaware Business Trusts are being encountered with increasing frequency in cross-border transactions, it is worthwhile describing certain key features of this business trust.

The principal purpose of the DBTA is to recognise the business trust as an alternative form of business organisation. The DBTA applies to any business trust whenever created that elects to be governed by the legislation by filing a 'certificate of trust' with the Delaware Secretary of State. This certificate is required to set out the name of the business trust, the name and address of at least one trustee that is resident in Delaware, the date on which the certificate is to take effect, and any other information the trustees determine to include therein. The DBTA expressly states that the legislation is not intended to affect the validity, powers, rights or obligations, of 'common law' business trusts created before the enactment of the DBTA (Steele 1999 : 22).

The DBTA defines a business trust as follows:

“ 'Business Trust' means an unincorporated association which (1) is created by a governing instrument under which property is or will be held, managed, administered, controlled, invested, reinvested, and/or operated, or business or professional activities for profit are carried on, by a trustee or trustees for the benefit

of such person or persons as are or may become entitled to a beneficial interest in the trust property,and (2) files a certificate of trust pursuant to sectionof this Act” (Steele, 1999 : 22)

A further proviso is that such ‘association’ shall be a business trust and a separate legal entity. Steele further asserts that in deeming a business trust to have legal personality, one of the fundamental objectives of the DBTA is making the business trust a closer substitute for a business corporation. Steele further says that in terms of section 3801 (a) of the DBTA, a business trust may be organised to carry on any lawful business or activity, whether or not conducted for profit. The primary requirement is that at least one of the trustees be a resident of Delaware, if the trustee is a natural person, or have a principal place of business under Delaware law.

3.4 ANALYSIS OF ATTRIBUTES PROPOSED BY THE MARGO COMMISSION

3.4.1. Carrying on a business for profit

The Margo Commission proposed that one of the criteria for determining whether a trust is a business trust or not is ‘carrying on a business for profit’. The author submits that this approach could lead to trusts formed purely with the intention to protect and conserve trust assets for the benefit of beneficiaries being inadvertently cloaked with a corporate veil and treated as business trusts. Most of these trusts have properties from which they derive rental income. The rental income may be incidental to the holding of such properties. Further, the receipt of such rental income would not on its own provide absolute evidence or be conclusive that such trusts are in fact carrying on business for profit. This would be the case where, for example, a rental producing property is held as a passive investment until the coming of age of one of the beneficiaries or the fulfilment of any other condition stipulated in the trust instrument. This view is supported by the decision that was reached in *COT v Estate G* 1965 (1) SA 780 (SR AD), 27 SATC 9 where it was held that when an investment takes the form of the purchase of immovable property the acceptance of rent is as natural an incident of the investment as the acceptance of interest on a loan of money, and that this act of investment does not cause the carrying on of business.

To determine whether a trust is carrying a business for profit is not that easy. The expressions ‘business’ and ‘carrying on business’ are not defined in the Act, although the word ‘trade’ is defined to include ‘business’. Carrying on a ‘trade’ is not the same as the carrying on of a business. In *CIR v Stott* 1928 AD 252, 3 SATC 253, it was held that whether a person is carrying on business is an inference from facts, and this inference is a matter of law. Therefore, the objectives with the trust, or the intention of the founder when creating the trust, or the intention with which the trustees administer the trust, which these words actually indicate, has a subjective content which can only be inferred from the cognisable surrounding circumstances (external factors) such as the trust deed, the way it was created, the nature of the relationship

between the founder, trustees and beneficiaries as well as the trustees inter se, the rights (and obligations such as contributions to the trust fund) of beneficiaries, the transferability of these rights and the extent to which it has vested or not in the assets in trust as well as the nature of the transactions by the trustees with these assets, the degree of repetition of activity with the assets in trust, to mention but a few” (Van der Westhuizen, 1997 : 6-7). Although these surrounding circumstances or factors may sometimes be glaring, it may still be difficult to establish the true intention, especially when it is to be deduced from a trust deed where the intention is neatly concealed and wrapped in layers of words and phrases (Van der Westhuizen, 1997 : 7).

There is authority that “to constitute a business there must either be a definite intention at the first act to carry on similar acts from time to time if opportunity offers or the acts must be done not once or twice but successively, with the intention of carrying it on, so long as it is thought desirable” (*Modderfontein Deep Levels Ltd v Feinstein* 1920 TPD 288). In *Smith v Anderson* (1880) 15 ChD 247 there is authority for the view that a man who lets portions of a building would not be carrying on the business of letting property in the ordinary commercial meaning of that expression. Although the letting of a single property would amount to a ‘trade’ something more would be required in order to hold that a person who lets a property was carrying on business (ITC 136 (1928) 45 SATC 203). What is this ‘something more’? This question was answered in ITC 1001 (1962) 25 SATC 190 where it was held that the letting of property can amount to the carrying on of business if some continuity is shown and a profit making motive revealed.

It is submitted that the letting of property regularly or systematically may amount to the carrying on of a business. However, there must be some evidence of an intention of holding the property as business asset to be exploited for the purpose of gain before a business trust could be said to be carrying on a business for profit.

3.4.2. Transferable interest

As was mentioned elsewhere in this work, there are two types of business trust, namely a private and a public business trust. It was mentioned that a private business trust may be formed by members of one family or members of two closely-knit families and more akin to a private company. Members of a public business trust may be drawn from a wide circle of persons. This type of business trust is similar to a public company. The issue of transferability of beneficial interest will be discussed based on these two types of business trust.

Davis, Meyerowitz and Davis (1987 : para 30) are of the view that a number of trading trusts presently existing will instead of transferring interest, add to the already existing class of beneficiaries. The writer

submits that this is only valid in the case of private business trusts although there may be limited or restricted transfers of interest amongst members. In most cases there would be variation of interest rather than transfers of such interest. Ordinary trust beneficiaries can freely cede their rights under a trust (Honoré, 1992 : 77). The trust instrument could contain restrictions imposed by the founder on the trustees of a private business trust to restrict or prevent the transferability of interest of the beneficiaries.

3.4.3. Establishment of association by voluntary, consensual and contractual means

The Margo Commission recommended, without providing reasons, that for a business trust to be taxed as a company the trustees and the beneficiaries must have established an association by voluntary, consensual and contractual means. The question is, in a trust structure is the consensual agreement between the trustees and the beneficiaries? Urquhart, Meyerowitz and Davis (1987 : para 30) assert that, “presently the consensual agreement is between the founder and the trustee as opposed to trustee and beneficiary as suggested by the Margo Commission”.

The writer concurs with Urquhart, Meyerowitz and Davis and submit that it is the contract between the settlor and the trustee(s) that brings a business trust into existence and not the contract between the trustee and the beneficiaries. If a special contract has been entered into between the trustee(s) and the beneficiaries, their rights and duties are determined by reference to that contract and not the main contract. However, the trustee(s) and the beneficiaries may incorporate the provisions of the trust instrument (a contract) in their contract in express terms or such a result may be inferred from the surrounding circumstances. In either event the contingency provided for in the trust instrument will then be governed by such provisions by virtue of the special contract. The contract between the settlor and the trustee(s) does not bind the beneficiaries contractually inter se to comply with the provisions thereof as do the memorandum and articles of association, in so far as they concern the rights and duties of members. Even if the trust instrument provides that a beneficiary may sell his interest only after he has offered it to his fellow beneficiaries, it is inconceivable that that provision renders the business trust to be treated as a company.

In terms of section 30 of the Companies Act, no association consisting of more than twenty persons shall be formed for the purpose of the acquisition of gain unless it is registered or formed in pursuance of the provisions of the said Act or some other law. At a glance this section indicates that if more than 20 persons pool together their resources in a business venture for profit, they are somewhat compelled to pursue their business through the medium of a registered company (Olivier, 1990 : 124). This clause is wide enough to include business trusts. There are divergent theories whether an association is between the trustees and the beneficiaries or between the trustees and the founder of the trust. Wunsh (1986 : 573) points out that if a business trust is treated as an association, and in particular, if the beneficiaries or trustees are to be taken into account to consider the number of people forming the association, then problems could arise. There is a

view that a group of trustees receiving profits of a business trust to distribute among the beneficiaries is not an association for the purpose of a rule limiting to twenty the number of persons who may carry on business in association without being incorporated, *Smith v Anderson* (1880) 15 Ch D 247 (CA). It should be noted that the type of trust that was considered in the aforementioned English case differs substantially from a business trust, where the participants, in effect, join together in a business venture using the trust as a vehicle. In this case the beneficiaries were strangers to one another, and it was held that the trustees were not carrying on business for gain, but were holding investments.

Honoré (1992 : 75) adds that this decision extends to the trustees of a trading trust there will be no limit on the possible number of trustees of such a trust. Further, it would cause no hardship to appoint fewer than twenty trustees, even if they were regarded as forming an association. Theron (1990 : 679) and (1991 : 283) points out that the number of trustees should be limited to 20. Honoré further submits that the beneficiary of a business trust would not ordinarily count as an association but there might be circumstances in which they decided to join together in order to provide the capital of the trust. In that case they might be regarded as forming an association. Even so they would not be carrying on business through the trustees, since unless the trustees were possessed of a sufficient degree of independence the assignment would be a partnership rather than a trust.

There is no clarity on whether the beneficiaries can form an association. Further, the Margo Commission recommendation refers to an association formed by trustees and the beneficiaries rather than by the founder and the trustees. In these circumstances, it is not clear how the establishment of an association by means of a contract or any other means between the trustee(s) and the beneficiaries will determine the corporate status of a business trust. This is particularly so where the beneficiaries did not contribute towards the capital of the business trust but the founder. Honoré's view is that the beneficiaries of a trading trust would not necessarily form an association, but in circumstances where as beneficiaries they contribute the capital into the trading trust they might be regarded as forming an association. He quickly adds that in these circumstances the arrangement would be a partnership rather than a trust as they would not be carrying on business through the trustees.

In the light of the problems highlighted in the preceding paragraph, it is not yet clear how an association between the trustee(s) and the beneficiaries can metamorphose the character or nature of a business trust to a company. Does this mean that where the number of trustees is limited to less than twenty persons, a business trust will not be treated as a company, even though it pursues a gain? If so, will it be treated as a partnership or a trust? Freer (1986 : 166) poses the question whether or not a private trading trust (which appears to be proliferating in South Africa today), is nothing more than a partnership in another form.

3.5 BUSINESS TRUST MODELS

Business trusts can be divided, for convenience, into two basic models, namely the 'private' and 'public' business trusts, (Urquhart, 1985 : 70). The public business trust is used extensively in Australia and the United States of America. In South Africa public business trusts are limited to unit trusts which are governed by the Unit Trust Control Act 54 of 1981, and many businesses are conducted through a private business trusts.

3.5.1 Private Business Trust

Davis (Taxpayer, 1986 : 70) describes the private business trust as a fairly small, closely knit group of individuals carrying on business (whether this be by way of investment or more active trading) through the medium of a trading trust. This type of business trust has as its basic structure, either a bewind or the trust in the narrow sense. It will have the bewind structure when the beneficiaries provide the trust capital themselves, either in cash or by the guaranteeing of loans made against the security of their own property, in return for which each of them receives a share certificate as proof of his pro rata interest in the venture, and as proof of his vested right in the trust capital (Van der Westhuizen, 1997 : 8).

Van der Westhuizen further points out that where the beneficiaries have vested rights and the same persons who are beneficiaries are also controlling the trust as trustees, there are very little, if any, differences between this kind of venture and the ordinary partnership. He further refers to the judgement in *Pezzutto v Dreyer* 1992 3 SA 379 (AD), where it was held that "In essence ... a partnership is carrying on a business (to which each of the partners contributes) in common for the joint benefit of the parties with a view to making a profit".

The private business trust will have the structure of the trust in the narrow sense when the intention of the founder(s) and or trustee(s) is to use this kind of trust primarily for the sake of making a profit (Van der Westhuizen, 1997 : 9). Other variations of this type of trust are beyond the scope of this work and will not be discussed. The characteristics of the private business trust model as provided by Davis are:

- the trustees are likely to be the partners in the enterprise (the word being used in a wide sense), forming a tightly knit group;
- the income which the 'partners' require in their personal capacities may be distributed to them by way of salary or remuneration for services rendered;
- the balance of the annual income may be distributed to designated beneficiaries, which may very well be family trusts; and
- the structure is something similar to a partnership.

3.5.2 Public Business Trust

The public business trust model indicates a business trust akin to a public company. Wunsh in “Trusts – Their Practical Tax and Estate Planning Application” defines a public business trust as “... trusts carrying on business activities where the beneficiaries are drawn from a wider circle and are not related, where it is contemplated that there will be transfers of interests between the beneficiaries. These are really in the nature of unit trusts, that is, the beneficiaries acquire units in the trust which are often evidenced by certificates, and transfer their interest, evidenced by the certificates, in much the same way as they would transfer the shares of a company”. However, where the general public is not involved as income beneficiaries, although they may be contributing to the trust fund in exchange for their pro rata capital benefit, a business trust can be classified as a ‘private business trust’ (Van der Westhuizen, 1997 : 5). The characteristics of a public business trust according to (Davis, Taxpayer 1986 : 71) are:

- the venturers are from a wide circle, unrelated to each other, and likely to change over the course of time. The business trust may in this guise be functioning as a means of mobilising public capital, although this is not necessarily so;
- the class of beneficiaries is therefore not only large but also subject to change;
- the beneficiaries are likely to be divorced from management, which will be carried on by the trustees in a way analogous to a board of directors in a company;
- the trustee may in fact be a company performing the office of trustee through employees acting as professional managers; and
- the interest of a beneficiary is likely to be evidenced by a transferable certificate.

This kind of trust arrangement corresponds in all respects with what is provided for in the Unit Trust Control Act where a ‘unit trust scheme’ is defined as “any scheme or arrangement in the nature of a trust in pursuance of which members by a management company are invited or permitted as beneficiaries under the trust, to acquire an interest or undivided share (whether called a unit or by any other name) in one or more unit portfolios and to participate proportionately in the income or profits derived there from”. In the said Act a ‘unit portfolio’ is defined as “a group of securities in which members of the public are invited or permitted by a management company to acquire units pursuant to a unit trust scheme, and includes any amounts in cash forming part of the assets pertaining to such unit portfolio”.

3.6 OWNERSHIP, CONTROL AND MANAGEMENT

In this chapter it was mentioned that in most of the definitions of a business trust, the classification of business trusts based on the ownership, centralised control and management features quite often. The trust structure determines the ownership, control and management of the trust property and the vesting of it (Van der Westhuizen, 1997 : 13). The analysis of the private business trust clearly shows that the issue of ownership and control determines to a certain extent whether the trust is a business trust or a partnership.

van der Westhuizen (1997 : 14) referring to the court case of *Estate Kemp v McDonald's Trustee* says if the structure corresponds with that of the trust in the narrow sense, ownership, management and control of the trust property are vested in the trustees for administration purposes, but qua trustees they have no beneficial interest in it. However, this depends on any conditions imposed or rights reserved by the founder.

The ownership, control and management of a business trust deserve a closer look. Honoré (1992 : 4 – 6, 158) and Olivier (1990 : 108) concur that if the trust structure corresponds with that of the *bewind*, that is, where contributing beneficiaries are involved, the ownership of the trust property is vested in the beneficiaries. The same does not apply to control and management. The fact that the whole body of beneficiaries hold all the shares, and therefore the ownership, does not of necessity mean that the full control also vests in them. Here the trustees are only administrators of the trust and in that capacity they also have control.

The issue of ownership raises a question whether or not there is any relation between the business trust and its beneficiaries. It is generally accepted that the trust instrument constitutes a contract between the settlor and the trustee(s) and the beneficiaries to the extent that the provisions thereof affect the beneficiaries in their capacity as beneficiaries.

It is submitted that, in a popular sense, a business trust may in every case be said to carry on business for and on behalf of its beneficiaries, but this certainly does not in point of law constitute the relation of principal and agent between them or render the beneficiaries liable to indemnify the trust against the debts which it incurs.

In conclusion, currently the question whether a trust is a business trust or not, has more to do with the so-called classification of trusts between private trusts and public trusts and has no meaning, even for tax purposes. When ownership is conferred upon the beneficiaries and a trustee is appointed merely to administer the trust property, the wording of the conferment is normally, but not always, indicative of the ownership of the trust property. The aspects of vesting, vested rights and conditions (suspensive and resolute) are paramount to determine the dominion of the trust property (Van der Westhuizen, 1997 : 11).

3.7 VALIDITY OF BUSINESS TRUST

In the United States a contractual trust is not illegal if formed for the express purposes of avoiding taxation (*Weeks v Sibley* (DC), 269 F 155). Dignity of contract cannot be set aside because a tax benefit results either by design or accident (*Edwards v Commissioner*, 415 F2d 578, 582 10th Circ. (1969)). Although the courts appear to confirm the validity of a business trust, it has been criticised by legal experts and

accountants as having no merit at all and some have adopted a nickname for business trusts: the “con trusts”. Sommers R, referred to by (Pitcavage, 1999 : 21) says thus of the validity of trading trusts:

“There is nothing in the Internal Revenue Code or its regulations”. He further points out that, “neither the Internal Revenue Service nor any court of law has ever upheld the use of these trust arrangements as an honest tax planning device. In fact, every taxpayer who has been caught using one of these trusts has been hit with all the taxes, interest and penalties owed under the Code”. That this is so, Sommers submits that the lack of key principles of a legitimate trust could cause the Internal Revenue Service and potential creditors to ignore the form of a transaction or organisation and look to its substance. “When the form of a transaction does not alter economic relationships, the Courts will disregard the form and apply the tax law according to the substance of the transaction”. The first and most fundamental key principle of a legitimate trust, according to Sommers, are that if income is generated, somebody or some entity must pay tax on it. The burden may be on the individual or on the trust, but it is there, nevertheless, and people cannot manipulate trusts to make income simply ‘disappear’. The second principle is that in legitimate trusts there is a true separation of control between grantor (settlor) and its assets. According to these trusts, attempt to establish the appearance of a trust, yet provide the settlor with a way to maintain complete control over the assets and the income those assets generate.

Pitcavage (1990 : 20) says the extent to which the pure trusts (which includes business trusts) was being used in the 1970’s alarmed the Internal Revenue Service, but it could do little to stop its promulgation. In fact, the Internal Revenue Service could disallow improper deductions related to trusts, and assess appropriate penalties, but did not have the power to actually declare them illegal. The Tax Court could not rule on the validity of trust schemes – only on the validity of deductions. The Internal Revenue Service could only warn taxpayers not to be taken in by such schemes and promised “vigorous enforcement action against taxpayers who use such sham devices ... as well as the promoters of such schemes”.

In 1997 the Internal Revenue Service in its Notice 97-24, indicated that it would begin a crackdown on what is termed ‘abusive trusts’. These include amongst others a ‘business trust’ in which a business is transferred to a trust in exchange for ownership certificates. In passing it is worth mentioning that other trusts that were to be crackdown included equipment/service trust in which equipment is placed into a trust to rent or lease to a business trust at inflated rates and the other was a family trust, in which property is transferred to a trust, converting personal expenses into deductions.

Despite the wide promulgation of Notice 97-24 in newspaper articles and various professional journals, the persisting major concern amongst the community, is that while current law is good at describing different

types of legitimate trusts and business arrangements, it is not all effective in establishing in clear language what is not a legitimate trust arrangement.

The question of the validity of a trading trust in South Africa was only considered in two court cases. Firstly, in *Goodricke and Son (Pty) Ltd v Registrar of Deeds, Natal* 1974 1 SA 404 (N), four persons entered into a deed of trust in terms of which each undertook to contribute a specified amount and pay it into the trust. The trustees were the four beneficiaries and, in addition, a company which, as long it was a trustee, was to carry out the powers and duties of the trustees. The intention was that the trustees were to apply the contributions to making a loan to a third party, which was to be secured by a mortgage bond over certain property registered in the name of that third party.

The Registrar of Deeds declined to register the bond on the ground, *inter alia*, that the trustees were agents and partners, and that, the mandate to the company being revocable by a simple majority, the trustees were agents of one another. The Judge further contended that the agreement really constituted a partnership or joint venture for the mutual advantage of the four beneficiaries. However, the Judge said that it was debatable whether or not the agreement was to be regarded as one of partnership or a joint venture and held that "... there is no desire to form a partnership or joint venture, but a clear intention to execute the deed of settlement in favour of a trust with various beneficiaries".

The above decision reached in that case shows that the Judge regarded a trading trust as completely different from a partnership. Another important aspect of this case is that it recognised that a transfer by beneficiaries of their interest in the trust could take place without any registration being effected in the Deeds Registry and without any transfer duty being payable. The latter observation is debatable as the definition of property in the Income Tax Act includes the beneficial interest in the trust.

The nature of the trading trust was next addressed in the case *Pretorius v CIR* 1984 2 SA 619 (T). The detailed facts of this case are not vital but briefly it concerned the use of a trust to acquire a block of flats and a claim for exemption from transfer duty by the sectional titleholders. The Commissioner maintained that the sectional titleholders were purchasers rather than beneficiaries and they, therefore, could not claim the exemption. What is important is that the Court was prepared to recognise the legality of a trust which was settled with the express purpose of trading and that the trading trust was successfully employed to save transfer duty (*Davis, Taxpayer* 1986 : 67).

The Commissioner appealed to the Supreme Court against this decision. The Court in the *Pretorius* case, unfortunately, did not have to address directly the question of the validity of the trading trust in South

African law. There is, therefore, still no firm Appellate Division recognition of the validity of the trading trust. Davis (Taxpayer, 1986 : 68) points out that the Appellate Division decision against granting Pretorius an exemption from transfer duty did not disturb the Court a quo's finding as to the validity of a trust. It is submitted that on the strength of the Court a quo's decision, as well as Goodricke's case, that a carefully drafted trading trust deed is valid in our law.

Whatever the position is in theory, it is clear that practitioners, and Revenue, regard the trading trust and partnership as being very different in nature, and do not merely treat the trading trust as a specialised form of partnership (Freer, 1986 : 169).

3.8 LIMITATIONS AND PROBLEM AREAS

Each and every business entity has its own limitations and problems. Similarly, there are limitations to the application of the business trust as a business entity as well as certain problem areas which a person contemplating using a trust as a business vehicle should consider before committing himself. These limitations and problems emanate from other statutes and from the Trust property Control Act.

3.8.1 Section 30 of the Companies Act

The Margo Commission listed as one of the criteria for a business trust to be classified as a company, the formation of an association between the trustee(s) and the beneficiaries. As was discussed earlier in this chapter, section 30 of the Companies Act places a limitation on the number of trustees and stipulates that no association consisting of more than twenty persons shall be permitted for the purpose of carrying on any business, unless it is registered as a company under the said act. There is an uncertainty whether the said limitation relates to trustees or beneficiaries. Olivier (1990 : 123) is of the opinion that the limitation of twenty refers to the beneficiaries.

3.8.2 Offer to the public

Another important prohibition is found in the Companies Act, section, 143, in terms of which no person shall offer any shares of any company or body corporate which is not a company to the public otherwise than in accordance with all the provisions of the said act, van Rhijn TAR and Strydom EML (1991 : 63). Further, section 37 of the Unit Trust Control Act prohibits any scheme that is analogous to a unit trust scheme in that "no person shall do any act or enter into any agreement or transaction for the purpose of establishing, carrying on or managing any scheme, other than a unit trust scheme ..., in pursuance of which members of the public are or will be invited or permitted for valuable consideration to acquire an interest or undivided share in an asset or more groups of assets and to participate proportionately in the income or profits derived there from".

it is submitted that the said Companies Act provisions refer to a greater extent to public business trusts than to private business trusts, as the former has its basis an involvement of the general public to become income beneficiaries of the existing business trust or a business trust still to be formed. Van der Westhuizen (1997 : 9) is of the opinion that where a private business invites the general public to be involved in the trust as beneficiaries and the latter receive a proportionate share of the income or profits, the private business trust will be invalid. He further mentions that two acts do not completely prevent the involvement of the general public in the private business trust. Section 143 of the Companies Act is inapplicable where the beneficiary's interest does not constitute a share or is not transferable or, where the trust is created in such a way that it cannot be defined as a company. Where the general public is invited only as capital beneficiaries section 37 of the Unit Trust will not apply (Theron, 1991 : 268).

From the foregoing it is clear that a public business trust can in no way accommodate a privately owned business, if the private business trust exceeds the said and other limitations. The consequence is that the private business trust can become a public business trust which will then have to comply with all the abovementioned requirements (Van der Westhuizen, 1997 : 12) and (Wiechers, 1992 : 146). It is submitted that this view accords with that of a private company which if it fails to comply with the requirements applicable to such a company, is required to file its financial statements, just like a public company, with the Registrar of Companies.

3.8.3 Trust Property Control Act

A further limitation is that a trustee is not permitted to conclude any agreement in his capacity as such, prior to being authorised to do so by the Master of the High Court in terms of section 6(1) of the Trust Property Control Act. Any agreement so concluded is invalid. This restriction, it is submitted, is twofold. Firstly, is in the public interest to provide proper written proof to outsiders of incumbency of the office of trustee, *Simplex (Pty) Limited v Van der Merwe* 1996 1 SA 111 (WLD), referred to by (Honoré, 1992 : 179). Secondly, the trustee as such is not the agent for the trust. Any contract entered into before authorisation by the Master of the High Court will not be binding on the trust, but will be personally binding on the trustee. Further as the trust is not a legal person, it cannot ratify any contract entered into by someone purporting to act as the trust's agent or trustee before its formation. The reason is that an agent cannot act on behalf of a non-existing principal. In terms of the Trust Property Control Act the Master of the High Court may require a trustee to furnish security.

Trustees are expected in the performance of their duties and in the exercise of their powers, to act with the care, diligence and skill, which can reasonably be expected of a person who manages the affairs of another. A trust instrument may not exempt a trustee or indemnify him against liability for breach of trust where he

fails to show the degree of care, diligence and skill required of a trustee (Honoré, 1992 : 75) and (Olivier, 1990 : 70).

3.8.4 Lack of disclosure requirements

Another potential problem area is the absence of any disclosure requirement for the business trust when dealing with the general public, especially with regard to its limited liability. Honoré (1992 : 75) says it is relatively difficult for those doing or contemplating business with a trading trust to discover the terms of the trust instrument or the names of the trustees. The problem is compounded by the fact that the trust instrument is not a public document which may be easily accessed by the public. However, section 6(1) of the Trust Property Control Act renders invalid all transactions entered into by the trustees before being authorised to do so by the Master of the High Court. Goldblatt J referring to (Honoré, 1992 : 179) says he is of the view that section 6(1) is not purely for the benefit of the beneficiaries ... but in the public interest to provide written proof to outsiders of incumbency of the office of trustee. The whole scheme of the Act is to provide a manner in which a Master can supervise trustees in the proper administration of trusts properly and s 6(1) is essential for such purpose. By placing a bar on trustees from acting as such until authorised by the Master, the Act endeavours to ensure that trustees can only act as such if they comply with the Act. This ensures that the trust deed is lodged with the Master and that security, if necessary, is lodged with him before trustees start binding the trust's property".

It is well known that key issues in company law are more settled than in the law of trusts. In chapter 2 it was mentioned that a trust is not a legal persona in its own right, except for purposes of the Income Tax Act. The legal consequences of companies acting 'ultra vires' are well documented in section 36 of the Companies Act. The Trust Property Control Act does not contain equivalent statutory provisions applicable to business trusts and other traditional trusts that act outside of the objects clause in the trust instrument. The principles such as the 'ostensible' authority and the Turquand Rule relating to the authority of directors to enter into transactions that bind the company are not enshrined in the Trust Property Control Act. In the (PricewaterhouseCoopers Synopsis : 6) the writer mentioned that people doing business with a trust may find themselves in a legal quicksand when they try to enforce their rights, where they would have been on firm ground if they had been dealing with a company or close corporation.

The legal uncertainties highlighted above are well illustrated in an unreported court case of *Standard Bank of South Africa v Suzette Koekemoer and Others*. In that case, the trust deed authorised the trustees to procure the trust to borrow money, and prohibited the trust from on-lending such money to persons who were not beneficiaries of the trust. The trustees borrowed the money from the bank and in contravention of the prohibition in the trust deed loaned it to one of the trustees who was not a beneficiary of the trust. When the bank attempted to recover the loan from the trust, the trustees claimed that the loan agreement between the

bank and the trust was unenforceable, because the borrowed moneys had been used in a manner prohibited by the trust deed. The argument was that the bank had had sight of the trust deed, knew that the trust intended to on-lend the borrowed money in a manner prohibited by the trust deed, and that this rendered the loan agreement unenforceable. The Supreme Court of Appeal pointed out that the party with which the bank had concluded the loan agreement was the trust and held that the loan agreement was, therefore, enforceable and ordered the trust to repay the loan. It is submitted that this judgment is reassuring to persons who do business with trusts. What is disturbing is that the court also held (without deciding the point) that to render the agreements unenforceable at least 'actual knowledge' by the bank of the prohibition would have to be established. What the court meant was that even though the trust document had been given to the bank and had read part of it, it could not be assumed that it knew or had been expected to have known that the money would be lent to a non-beneficiary in contravention of the prohibition in the trust deed. It is submitted that this finding is unconvincing. Despite this void created by the court, the judgment puts certain concerns to rest regarding the dangers of doing business with a business trust. Therefore, the practical implications for those doing business with a trust are that if they do not read the trust deed in its entirety before they enter into a transaction with the trust, dire consequences may arise in that they would not know whether the envisaged transaction falls within the authorised business of the trust or whether the trustees with whom they are dealing have authority to act on its behalf.

3.8.5 Capital Maintenance

The capital of a company provides a cushion for creditors and should always be maintained. Honoré (1992 : 74) says like a shareholder in a company or member of a close corporation a trustee obtains limited liability but the trust is not subjected to the duty imposed on companies of maintaining their capital for the protection of creditors or the requirement for the acquisition of a members interest in a close corporation. Therefore, the trading trust has no obligation to maintain its capital as in the case of a company. Wunsh, in *Trusts – Their Practical Tax and Estate Planning Application*, submits that if a trustee acts in breach of his duty he will be liable to the creditors, because he would be acting unlawfully not only in breach of his duty to the creditors but also in breach of his duty to the beneficiaries. He would also be liable to the beneficiaries.

In the light of the preceding statement, the author submit that the legislature should incorporate in the Trust Property Control Act, the legal aspects of a trading trust which include amongst others, the doctrine of disclosure. The doctrine of disclosure requirements should extend throughout the Act and apply to the trading trust in every phase of its existence, from formation till its sequestration. It is further submitted that, the effect of the operation of the doctrine of disclosure will not only safeguard the interests of the trading trust, but also those of creditors and other persons dealing with the trading trusts.

3.2 GROWING INTEREST IN USE OF BUSINESS TRUSTS

In this section of the work, the writer will canvass the extent to which the trust structure is used for business purposes in South Africa and the reasons why it is preferred to other forms of business structures.

The extent to which the trust is employed to serve commercial purposes is unknown and probably unknowable. Notwithstanding its limitations it appears, although not confirmed by scientific research, the apparent use of the trust structure for commercial purposes has found favour amongst its users internationally because of its perceived advantages which include the separation of legal title, the absence of significant statutory regulation and the default fiduciary status of the trustees. The advantages of the trust ensure that it will be employed, in one way or another, in many commercial transactions. Further, there is no requirement for settlers or trustees to register this legal form or to disclose its existence in any general way.

In South Africa, there are schools of thought with divergent views regarding the extent to which business trusts are used for carrying on a business. One school of thought says there is a growing interest in the use of trading trusts as a business entity, but there is still confusion about the way such a trading trust operates. Others say there is a limited use of trading trusts as vehicles for carrying on a business. Notwithstanding these divergent views, a trading trust has several advantages over other business entities, despite continual amendments to the Income Tax Act, which seek to tighten control over the conduct of trustees and trusts generally.

Although there may be indications of an increase in the number of inter vivos trusts created for trading purposes, figures show that far less inter vivos trusts are created annually than close corporations (Van der Westhuizen, 1997 : 1).

Compared to a company, the advantages of using a trust to operate a business include some of the following:

- A trust has limited liability, in that neither the trustees nor the beneficiaries would be liable for obligations incurred by the trustees on behalf of the trust despite not being subject to the Companies Act. This assertion will be canvassed further in chapter four.
- The protection of beneficial interest in the event of the insolvency of the trustee is another significant attraction of the trust concept.
- The proposed legislation on the taxation of trading trusts as a company has not yet been promulgated. This means that trading trusts still enjoy the benefits of the conduit pipe principle which applies when income is distributed by a trust, that is, this income is considered to be income of the beneficiaries, and it retains its character.
- As profits are distributed at the trust level, distributions by a trust are deductible in the hands of a trust and are not treated as a dividend and therefore no secondary tax on companies will be levied.

- A trust is not obliged to prepare financial statements and does not need to be audited.
- There are no restrictions on the use of trust capital to finance the acquisition of interests in the trust.
- There is no limitation on the qualification of persons who may act as trustees.
- The provisions dealing with winding-up do not apply.

In order to make use of the advantages enumerated above, it will be prudent for the trustees opting to use the trust structure as a trading vehicle to operate the trust in a businesslike manner and attend to the necessary paperwork to demonstrate that the trust has substance, lest the creditors overturn the legal form of a trust if it is no more than a sham.

3.10 CONCERNS ON THE USE OF BUSINESS TRUSTS

Divergent views and concerns have been raised whether or not a trust structure can be used for carrying on a business or whether it is a new legal entity or a true trust. Further concerns relate to the growing use of business trusts, its lack of legal personality, and the possible abuse of such trusts.

Flannigan (1982 : 184) observes that: “This is not to say that the practical differences between the usual form of business trust and an ordinary trust cannot be used to classify or segregate the business trust for particular purposes. The only point made here is that such differences as do exist do not support the position that a business trust is a new distinct legal form. It is simply the recognised flexibility of trust law which allows for the pursuit of a business in the trust form”. “The business trust, like any trust, is not a legal entity, unless made so generally or for certain purposes by legislation. A trust is a relationship or an obligation. The trust *per se* has no status as an entity which can acquire rights and obligations. Rather, the trustee is a principal with respect to trust property and operations. The trust itself is simply an obligation on the trustee, the legal person, to deal with particular property for the benefit of others”.

Steele (1999 : 3) says although lacking a precise definition, the important point to emphasise is that the ‘business trust’ is a trust. Accordingly, a business trust must satisfy all of the elements for the creation of any valid trust. He cites the following:

- a manifestation of an intention to create a trust on the part of the settlor.
- a description of the subject-matter of the trust in sufficiently clear terms so that the trust property is ascertained or capable of being ascertained;
- the persons entitled to benefit from the trust must be described in sufficiently clear terms that the trust obligation may be properly performed; and
- a valid created trust also requires a constitution, that is, the constitution refers to the vesting of the settlement property in the trustees.

well-known writers on the subject of trusts concur that the traditional *inter vivos* trust figure, which is used primarily to protect and conserve trust assets is now used extensively for commercial purposes with or without little modification. It is common cause that special rules, which have been developed over the years by our courts, apply to the traditional trust. The uncertainty, which has to be resolved, is whether these principles or rules have equal application to trusts used for commercial purposes. The uncertainty whether these rules apply on an equal footing to business trusts is, in the opinion of the writer, exacerbated by the lack of the understanding of the nature of the business trust and that its features are somewhat similar to those of a company.

Estey (1997 : 337), while acknowledging that a business trust is not 'a new distinct legal form', comments that the difficult issue that remains "is the extent to which traditional trust law principles ought to be applied, without modification, to business trust".

To confirm his view, Estey cites the following passage from Cullity (1996 : 122 – 123):

"While these principles apply to business trusts as well as to family trusts, attempts to deprive them of their full force in business trust arrangements are very common. One of the main reasons is that the intended functions of a trustee of a business trust are often more like those of a custodian than those of an *inter vivos* or testamentary family settlements. Very commonly, the 'business' of a business trust, will be conducted and controlled by a manager who, in order to preserve the appearance of a trust relationship and perhaps, to ensure compliance with statutory restrictions on corporations acting as trustees, will be described as the agent of the trustee..... Many of these business arrangements appear to be trust only in a very thin and formal sense".

Lord Brown-Wilkinson in *Target Holdings Ltd v Redferns* had to consider whether rules or principles created for traditional trusts were equally applicable to bare trusts employed in commercial settings. While accepting that a business trust was useful for commercial purposes, he indicated that one needed to differentiate between 'specialist' and 'basic' rules and only basic rules would be applied to business trusts. Thus in the course of his reasons for judgement he said, "[In] my judgement it is in any event wrong to lift wholesale the detailed roles developed in the context of traditional trusts and then seek to apply them to trusts of quite a different kind. In the modern world the trust has become a valuable device in commercial and financial dealings. The fundamental principles of equity apply as much to such trusts as they do to the traditional trusts in relation to which those principles were originally formulated. *But in my judgment it is important, if the trust is not to be rendered commercially useless, to distinguish between the basic principles of trust law and those specialist rules developed in relation to traditional trusts which are applicable only to*

such trusts and the rationale of which has no application to trusts of quite a different kind. (emphasis added)".

The learned judge did not provide any guidelines as to how these rules of trust law should be distinguished. The significance of this judgment is that 'specialist rules' of traditional trust law may be jettisoned in the context of commercial trusts and only basic rules need to be considered. Steele (1999 : 5) says that: "The difficult task that lies ahead will be to distinguish between those rules of trust law that are 'specialist' in nature and ought only to be applicable to traditional trusts and what Lord Browne-Wilkinson terms 'the basic principles of trust law'" The writer submits that since under normal circumstances a discretionary trust is used as a commercial vehicle and that it possesses all the essentials for a valid trust in terms of the trust law, there appears to be no compelling reasons for distinguishing between specialist and basic rules applicable to traditional trusts and then to ignore the former when a business trust is used for commercial purposes.

The proliferation of business trusts in South Africa led to the investigation being undertaken by the Standing Advisory Committee on Company Law to determine the extent to which these trusts were being used for business purposes. In its statement published on 8 February 1985 the Committee stated that "There are no statistics, but without a doubt there has been an upsurge in recent years in the inter vivos trusts formed purely for business purposes. Compared to a company this legal form can provide tax benefits. Moreover, it is 'flexible' (Wunsh, 1986 : 562).

The South African Law Commission, in working paper 3, states that: "Many of the advantages of a company may be enjoyed through a trust without compliance with the protective and administrative provisions of the Companies Act. The use of business trusts is apparently on the increase and the possibility that these trusts may be abused does exist". Wunsh (1986 : 561) had the following to say concerning the possible abuse of business trusts:

"I should point out that although business trusts provide scope for the avoidance and reduction of duties and taxes, despite the dangers adverted to by the Law Commission and the Standing Advisory Committee on Company Law, there is no evidence of prejudice to or losses by the public as a result of the use of trusts for business purposes".

The writer concurs with the learned Judge that there is no evidence of prejudice to or losses by the public but that some members of the public have crossed the Rubicon and taken advantage of the flexibility of the traditional trust structure and embarked on transactions or schemes that alter the incidence of tax. These

schemes range from the sale of business to a trust the beneficiaries of which are other family trusts with different beneficiaries to diversion of income derived from personal exertion of the settlor to a trust the beneficiaries of which are children of the founder. The abuse of trusts adverted to by the Law Commission will be discussed further in chapter five under tax avoidance.

It is submitted that a judicial willingness to approach commercial trust issues in a more pragmatic and practical way and with an application of the context from which they arise is desirable and commendable. It is a known fact that traditionally trusts have been and are still formed for protection and conservation of trust property. It is this notion or usage that is embedded in the minds of many people that a trust figure cannot be used for anything else other than for the protection of trust property. The mere fact that a trust figure is used to pursue a business venture, does not translate it into something equivalent to a company. However, that may be so in the case of a public trading trust where the beneficiaries form a voluntary association and enter into a contractual and consensual agreement to provide trust capital in return for pro rata interest in the trust capital property. Even in these circumstances the beneficiaries may have formed an association among themselves thus rendering the trading trust arrangement a partnership. It is submitted that in other cases there is 'something more' that is required to metamorphose the nature or character of a trust so as to render it a 'new legal entity' similar to a company. The totality of the facts should be considered such as the manner of formation, intention of the founder, and the extent to which trustees are controlled by the beneficiaries. The list is not exhaustive.

In the light of the confusion that exists, one of the greatest problems with the trust as a business entity is perhaps to get a clear definition of it. In view of want of legal certainty, it may be the time now again for a review of the entire subject of the law of trusts by the South African Law Commission (Van der Westhuizen, 1997 : 4).

In conclusion, the writer concurs with Flannigan that a business trust is not a new distinct legal form. It is the flexibility of a trust that enables trustees to utilise the trust arrangement for commercial purposes in the furtherance of the wishes of the settlor contained in the trust deed. The enjoyment of limited liability and the avoidance of the provisions of Company Law applicable to companies are all incidental to the use of trusts for commercial purposes. It is submitted that the status quo will remain the same unless changed by legislation.

3.11 SIGNIFICANT DIFFERENCES BETWEEN BUSINESS TRUSTS AND OTHER ENTITIES

3.11.1 Ease of establishment

Business trusts can be relatively inexpensive to establish and simpler to administer than companies. However, adopting the trust structure can introduce trust law formalities that are not always well understood or complied with.

3.11.2 Complexity of arrangements

A range of legal issues can arise when the trust is not administered strictly in accordance with trust law, Trust Property Control Act or trust instrument. The operation of tax measures introduced to address tax abuse by trusts, such as the ring-fencing of trust loss, can further increase the complexities involved in using trusts for carrying on business. Further, there are numerous issues in the trust law that have not yet been settled.

Complexity and administrative costs of business trusts are increased when a corporate trustee and/or corporate beneficiary is introduced. In such instances, not only does a trust instrument have to be established, but company constitutions may be required as well. These companies also will have to comply with obligations under the Companies Act, for example, relating to disclosure requirements.

3.11.3 Ability to raise finance

Borrowing can be complex and expensive in the case of business trusts, as lenders may require their legal advisors to examine and report on both the constitution of the trustee company (if there is one) and the trust instrument. Furthermore, unlike companies, business trusts cannot raise investor capital.

3.11.4 Liability for debts

Business trusts afford beneficiaries a degree of asset protection, as trustees are in certain instances required to furnish security before they conduct business through the trust. Further, the claims of creditors against the trust are limited to the available assets of the trust.

3.12 CONCLUSION

It has been shown that a business trust is not a new legal entity, but its flexibility lends the trust to many uses including the carrying on of business for profit. Further, this study has revealed that it is not easy to capture precisely the definition of a business trust. The consequence may be that a trust formed purely for protecting and conserving assets may inadvertently be classified as a business trust. Despite the introduction of new stringent tax provisions in the Income Tax Act regulating the taxation of trusts, there are views that the use

or trusts for business purposes has not abated. In the following chapter, the tax implications of business trusts will be canvassed.

TAX IMPLICATIONS OF BUSINESS TRUSTS

4.1 INTRODUCTION

The traditional trust structure has been utilised since the 19th century for commercial settings in order to take advantage of the tax benefits offered by a trust and to circumvent various restrictions imposed on other entities, such as the company. Trusts, sometimes called settlements, have been part of the legal and tax system for many years and much law and tax legislation has been formulated over the years. The reasons for using trusts for commercial purposes are as valid today as they have always been. The increasing use of trusts for commercial purposes prompted the inauguration of the Margo Commission to research the possible abuse of trusts, which included among other things 'income splitting' and tax avoidance. The Commission proposed that business trusts should be treated as a company for income tax purposes and be subjected to taxation at a rate applicable to companies, and the beneficiary regarded as a shareholder of the company. The attributes advanced by the Margo Commission neglect the fact that many business trusts are more akin to partnerships than companies (Honoré, 1992 : 76).

Pursuant to the recommendations of the Margo Commission, the Minister of Finance, in the 1998 Budget Speech, accepted the recommendations but no amendments have been made to the Income Tax Act to tax trading trusts like companies. Instead numerous amendments have been made to the Act to regulate the taxation of trusts including trading trusts and to minimise the use of trusts to avoid tax. For example section 25B(4) was inserted in the Income Tax Act to ring-fence losses incurred by the trust; and the income retained in the trust was subjected to tax at a rate of 35% of taxable income not exceeding R100 000 and a rate of 45% on the amount of taxable income in excess of R100 000. Although the recent legislation has eroded the advantages of a trading trust, interestingly, the measures taken by the Minister to discourage taxpayers from using trusts as a business vehicle do not prohibit income-splitting which, it is submitted, will continue to be practised by taxpayers unless drastic changes are legislated.

As the use of trusts for business purposes has not abated despite the erosion of tax benefits by the introduction of the straight-line tax applying to income taxable in the hands of the trust and the ring-fencing of trust losses, it would be naïve to conclude that the Income Tax Act will not be amended in the future to curb the use of trusts as business entities. The tax benefits of the trust depend on whether the tax anti-avoidance provisions find application or not. Van der Westhuizen (1997 : 1) warns that it is unwise to select the trust structure for its possible tax benefits because with changing tax legislation such benefits may not last long. Countries like Australia, New Zealand and the United States of America are still introducing new

legislation to counter the abuse of the so-called business trusts notwithstanding the fact that business trusts are not new in those jurisdictions.

The purpose of this section of the study is to investigate the feasibility of aligning the tax treatment of business trusts and companies and to examine the tax implications of the recommendations made by the Margo Commission and to ascertain the impact this will have on the existing traditional structure. A brief comparative study of taxation of trading trusts in other jurisdictions, particularly in Australia and the United States of America, will also be made in order to determine the tax treatment of such trusts in those countries.

The understanding of the tax implications of the recommendations of the Margo Commission will necessitate the discussion of the current tax regime pertaining to the traditional trusts in order to appreciate the effect the recommended tax treatment will have on trading trusts. The writer will consider briefly only those topics in the Income Tax Act that are within the scope of this work.

4.2 INCOME TAX ACT PROVISIONS

4.2.1 Income Tax Act definition of a trust

Before the amendment of the Act in 1986, the lack of a definition for a trust created many problems, especially in determining whether the trust or the trustee should be subjected to tax on income earned by the trust. In the case of *Thorne & Molenaar NNO v Receiver of Revenue* 1976 (2) SA 50 (C), the court after noting that the word 'trust' was not defined in the Act and must thus be accorded its ordinary meaning stated that:

"It is, I think, to be deduced from the authorities that in general a trust is created by contract, very often by a contract of donation..... It is created in respect of defined property for the benefit of a third person, the latter being accorded a right against the trustee to enforce the trustee's compliance with his obligations towards the beneficiary concerned.....".

In the *Friedman & Others NNO* 1993 1 SA 353 (AD), the judge said " 'Trust' is not defined [in the Income Tax Act]. It must therefore be given its common law meaning, viz an entity whose assets and liabilities vest in its trustee for purposes of administration".

Notwithstanding that a trust is not susceptible to an intrinsic definition, the trust is treated as a 'person' in the Act and is defined as "..... 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". The definition of a person, in the same section,

includes any trust. Van der Westhuizen (1997 : 52) says, the legal personality given to trusts in terms of the Income Tax Act was introduced after the court ruled in 1991 in the case of Philip Frame Will Trust v CIR 1991 2 SA 340 (W), 53 SATC 166 that a trust has no legal personality. Consequently, the definition of a trust also includes a business trust.

4.2.2 Meaning of representative taxpayer

The concept of a trust has always been accepted by the tax authorities (Huxham and Haupt, 2002 : 525). The rules applicable in the taxation of trusts are unique and differ substantially from those applicable to other business entities. Depending on the provisions of the trust instrument, trust income may be taxed in the hands of the founder, beneficiary or in the hands of the trust. Where income is taxable in the trust, the trustee or any other person entitled to the receipt, management, disposal or control of such income of the trust is a 'representative taxpayer'. As a result the trustees of a business trust will be regarded as a representative taxpayer even though the trust capital has been contributed by the beneficiaries.

What does the term 'representative taxpayer' actually mean? In this regard, Van der Westhuizen (1997 : 53) citing Estate Smith v CIR 1960 3 SA 375 (AD) says "the words 'trustee' and 'representative taxpayer' as used in the Act contain some duplication and must be read together. Only if the requirement of paragraph (c) of the Act is present can a trustee qualify as a representative taxpayer, namely that the income in question must be in respect of income the subject of any trust". This requirement was confirmed in the case of Mount Moreland Town Lands Board 1929 AD, 73 SATC 1 where it was held that "A representative taxpayer must not only represent the real taxpayer but must also represent him in respect of a specific sum that he holds or controls on the taxpayer's behalf".

In the case of Thorne and Molenaar mentioned above the court was required to decide the issue whether a trustee in an insolvent estate was liable to pay income tax upon income accruing to the estate, whether in the capacity of a representative taxpayer or in any other capacity. The judge rejected the claim by the Receiver of Revenue that a trustee could be subjected to tax on the income derived by the estate in his personal capacity and found that "If he were to be taxed upon the receipt of the money, it could only be because he was a representative taxpayer"

The court further stated that for a trustee to comply with the description of a representative taxpayer, he would have to receive the income of the insolvent estate either as the income 'of a person "under legal disability"' or as the income the subject of a trust. The court found that the income derived by the trustees could not be said to be the income of a person under legal disability. Further held that merely because a person fell under the definition of 'trustee' did not necessarily mean that he was a representative taxpayer;

that, as defined, the term 'trustee' could therefore not 'be taken to be correlative to the term 'trust'; and that for a trustee to be a representative taxpayer he had to be a trustee in respect of the income the subject of a trust.

It is evident that in view of the fact that the trust is itself a 'person', the trustee is the representative taxpayer vis-à-vis the trust in respect of the trust income taxable in the hands of the trust. It, therefore, follows that the provision applies, and only applies to a trustee if there is income subject to a trust. It further follows that only if there is income subject to a trust, that the trust needs to be registered as a taxpayer.

The inference that can be drawn from the above discussion is that a trust, including the business trust, is regarded as a person for income tax purposes and the trustees as a representative taxpayer regardless of who contributed to the trust fund.

4.2.3 Provisions of section 25B

In his 1998 Budget Speech, the Minister of Finance said he had reason to believe that trusts were extensively being used for purposes of "income-splitting so as to reduce the rate at which income is ultimately taxed". Concern was raised by the Minister that section 25B was used to channel losses incurred as a result of expenditure and allowances in the trust to their beneficiaries, who then set off these losses for tax purposes thus becoming a popular way of structuring financial transactions. As a result section 25B was overhauled drastically.

The crux of section 25B(1) is that any income 'received by' or 'accrued to' or in favour of a trustee of a trust fund, is, subject to the provisions of section 7, deemed to be the income which has accrued to the beneficiary where such income has been derived for the immediate or future benefit of an ascertained beneficiary who enjoys a vested right to such income otherwise be deemed to be the income of the trust fund. Where the trustee has exercised a discretion vested in him in terms of the trust deed, and the beneficiary has acquired a vested right, such income, is deemed to have been derived for the benefit of such beneficiary, section 25B(2).

Section 25B(1) applies where there has been no donation, settlement or other disposition and subject to tax income earned by the beneficiary where he has a vested right to such income. Where there is no vesting of income, the trust is taxed on such income. Section 25B(2) applies to discretionary trusts and tax the income in the trust where trustees have not exercised their discretion which may result in the income vesting in the beneficiary. Where such discretion has been exercised and the beneficiary has acquired a vested right to income, such income is taxed in his hands.

Section 25B(3) provides that where income has been received by a trustee but vests in a beneficiary, any deduction or allowance made in the determination of the taxable income derived by way of such income which vests shall, to the extent to which such income is deemed to be the beneficiary's, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by the beneficiary. Such deduction is limited to the income accruing to the beneficiary (Section 25B(4)).

The essence of the sub-sections referred to above is that where income has been received by or accrued to the beneficiaries, deductible expenditure and allowances should be apportioned among the beneficiaries to the extent that net income of the trust has vested in them. Section 25B(4) limits the deductions and allowances to the income of the beneficiaries. Naidoo (2000 : 64) in his unpublished work on business trusts said section 25B(4) could be circumvented by a person seeking to deduct the loss suffered by the trust by not becoming a beneficiary, or by earning income from a different source. The writer does not concur with this view because section 25B strictly applies to income and expenditure and allowances of trusts and beneficiaries and not any other person.

Where the aggregate of deductions and allowances exceeds income of the beneficiaries, section 25B(5) limits the deduction of expenditure and allowances to the income earned by the trust and section 25B(6) provides that where the aggregate of the deductions and allowances contemplated in section 25B(3) exceed both the income contemplated in sections 24B(4) and (5) such excess may be set-off against the income of the beneficiaries derived from the trust in the immediately succeeding year of assessment. Accordingly sections 25B(4) to (6) ring-fence the losses made by the trust, that is, prevent the distribution of such losses to the beneficiaries.

4.2.4 Provisions of section 7

Section 7 overrides the provisions of section 25B. It is an anti-avoidance provision aimed at taxing in the hands of the donor any income which has resulted from a donation, settlement or other disposition (*Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55). The beneficiaries are taxed on any income received by them from the trust, unless section 7(3), (4) and (6) apply whereas the trust is taxed on any income not distributed by the trustees, unless section 7(5) and (7) apply (Huxham, 2002 : 539).

Section 7(1) applies where the beneficiary has a vested right in the income retained in the trust, meaning that the beneficiary is certain to get the income at some time in the future. In *CIR v Polonsky* 1942 TPD 249 12 SATC 11 it was held that income which vested in an income beneficiary, and had not been paid to him but invested by the trustees for his benefit, had accrued to him and accordingly should be taxed in his hands.

Section 7(1) refers to 'vested' income. The question is what is the meaning of the word 'vested' and when does it take place.

According to Olivier (1990 : 138), a person has a vested right if he is the owner of such right, which means that he has all the rights of ownership including the right of enjoyment. He further states that the word 'vested' draws a distinction between that which is certain and that which is contingent; in this sense it is not necessary for the vested right to be equivalent to ownership. In *Jewish Colonial Trust Limited v Estate Nathan* it was stated that a personal right against the trustee is sufficient to be a vested right in this sense. Honoré (1992 : 471) confirmed the above opinion and said the word 'vested' with regards to the beneficiary can have different meanings, that is, "a right is firstly said to have vested in a person when he owns it: ...When 'vested' is used in this sense it is not however necessary that the right of enjoyment should accrue to the person in whom the property is vested. Property may vest in someone purely for purposes of administration" (*CIR v Sive's Estate* 1963 (3) SA 847 (A)). If a person has a contingent right to income, it is not certain that he will ever receive the income, and therefore, he cannot be taxed on it (*Van der Westhuizen*, 1997 : 58).

Section 7(3) deems income to be received by a parent if it has been received by or accrued to a minor child of that parent or has been spent on his maintenance, education or for his benefit or has been invested for him as a result of a donation, settlement or similar disposition made by that parent. It is clear that the provision of this section does not affect donations between grandparents and grandchildren. For example, if a father makes a donation to his minor child, the income received by or accrued to his child will be taxed in his hands. If the parents of a minor child are married in community of property, half of the donation will be deemed to have been made by the mother, accordingly half of the income received by or accrued to the minor child will be deemed to have been received by or accrued to the mother and taxed in her hands.

The provisions of section 7(3) pose a problem where a minor beneficiary earns income from the reinvestment of income which arose by reason of a donation made by the parent. The case of *Kohler v CIR* 1949 4 SA 1022 (T), 16 SATC 312 concerns the income received by the beneficiaries of the taxpayer from a re-investment of income which accrued 'by reason of' a donation made by the taxpayer. The court held that the words 'by reason of' should be interpreted as referring to the proximate and not to a remote cause and held further that "Once income has (actually or by deeming) accrued to or been received by.....and has been capitalised, its subsequent earning or product is attributed not to the source from which the original income was derived but to the advantageous employment ofnew capital....". The reason for the finding was that the causal connection was interrupted by a novus actus, viz the reinvestment of the original income.

The Judge further held that as a matter of law, upon a proper construction of section 7(3), it is only income derived in the first instance by a minor from sums donated by his parent that could be included in a parent's

income, and therefore that the provision does not apply to income received by the minor from the use of the income so derived. In *CIR v Widan* 1955 1 SA 226 (A), 19 SATC 341 the reasoning in Kohler's case was not accepted. The Court held that 'income upon income' was as a result of the original donation. The Judge interpreting the phrase 'by reason of' said: "there must be some causal relation between the donation and the income in question and that in ascertaining whether such causal relation exists one must look not necessarily to the cause which is proximate in time but to the real efficient cause of the income being received. If the real efficient cause is the donation by the parent, then section 7(3) applies". The Court admitted that the real efficient cause is a matter to be ascertained on all the facts and circumstances of the case and difficult cases may conceivably arise. The Judge held that the income from the second company was by reason of the donation because the original donation was intended to produce income, which would be used to acquire the shares in the second company. The whole arrangement was a scheme of donating income-producing assets to the taxpayer's children. The decisions in Kohler's and Widan's case relied on the general principles of causation as established in English law (Hales, 1994 : 54). Both these cases dealt with the meaning of the phrase 'by reason of' in section 9(3), the predecessor of section 7(3).

Urquhart and Davis (1998 : 6-10) say section 7(4) provides a stop-gap mechanism for dealing with a rather crude technique of circumventing section 7(3) whereby one parent donates income-producing assets or income to the children of another in exchange for a reciprocal donation by the parent of those children. In terms of this section the income is deemed to be that of a parent who made a donation, settlement or other disposition.

Section 7(5) applies in instances where income accrues to the trust and is not distributed to the beneficiaries because of the existence of a stipulation in the trust deed regarding the income which prohibits the payment to the beneficiaries until the happening of some event. Such income is taxed in the hands of a person who made a donation, settlement or other disposition to the trust which gave rise to that income. Where the income is not paid out, but vests in the beneficiaries, section 7(5) cannot apply. If the income has not arisen 'in a consequence of' the donation, settlement or other disposition and is retained in the trust, the trust will be taxed on that income. Although it is not necessary for the person who made the donation or disposition to have made the stipulation or imposed the condition in order for section 7(5) to apply to him, a particular donor will only be taxed on the income arising in consequence of his donation or disposition while somebody else could have made the stipulation (Huxham, 2002 : 540).

A closer look at section 7(5) reveals firstly, that it is only income which, but for the stipulation would have been received by or accrued to the beneficiaries. Secondly, that income must have been derived 'in consequence of' the donation, settlement or other disposition. The phrase 'in consequence of' has caused much debate amongst tax consultants and the Commissioner for Inland Revenue (Clegg, 1993 : 60). If the

phrase 'in consequence of' is accepted by the Courts as having the same meaning as 'by reason of', it is evident that in order for section 7(5) to apply there must be a close link between the original donation, settlement or other disposition and the income so derived. Hales (1994 : 51) says these differing approaches originated from the differing interpretation of the decision in the cases of *Widan* and *Kohler*. He further says that conflicting views exist among tax commentators as to whether the decision in *Widan's* case overrides the decision in *Kohler's* case. The finding in *Widan's* case is not in conflict with *Kohler's* case as it was based on the peculiarities of the case (Huxham, 2002 : 542).

The purpose of section 7(6) is to counter the avoidance of tax which is achieved by being in a position to decide annually in whose hands the trust income is to be taxed. A donor could set up a trust and each year vary the beneficiaries and direct trust income to the beneficiaries with the lowest marginal tax rate. This section seeks to prevent this manipulation of tax by directing that, where income accrues to a beneficiary by reason of a donation, settlement or other disposition which contains a stipulation that the right to receive the income thereby conferred may, under powers retained by the person by whom that right is conferred, be revoked or conferred on another, such income shall be deemed to be that of the person who conferred the right.

It is submitted that section 7(6) cannot apply where no income accrues to the beneficiary but section 7(5) may find application. Silke (2003 : §12.21) submits that section 7(6) can be invoked only where the beneficiary has a vested right to the income subject to a power of revocation being reserved by the donor. Silke further submits that where the power to revoke is reserved to trustees of which the donor is one, and it is clear that the donor cannot revoke without the authority of the remaining trustees, section 7(6) cannot be invoked by the Commissioner. However, it is still debatable whether section 7(6) refers to a vested right or to a contingent right (Van der Westhuizen, 1997 : 60). Huxham (2002 : 525) submits that if the right only refers to vested rights, it would render the subsection absurd. This view is confirmed by Meyerowitz (2003 : 16.151 – 16.154) and Honoré (1992 : 380 – 383).

Section 7(7) applies to investment income such as rental. In terms of the section, the donor is taxed on the income if he cedes it to someone else but retains the underlying property, or he gives the underlying property to someone else but retains the right to regain the property in the future. This section is considered important where a business is donated to a trust but the donor retains the right to regain the business in the future if his wishes are not complied with. It is submitted that in that instance section 7(7), can be invoked by the Commissioner.

In December 2000 section 7(8) was introduced to deem a sale of an asset at less than its market value to be a donation. This section does nothing more, than confirm the decisions reached by various courts that a sale at less than market value is a “similar disposition”.

Notwithstanding all the anti-avoidance provisions, Broomberg and Kruger (1999 : 15) note that a trust still remains a viable alternative to the company as the possible contracting party. The learned author cites the non-payment of STC on distributions from a trust and the application of the conduit-pipe principle as examples.

4.3 TRANSFER OF BUSINESS TO A TRUST

Most entrepreneurs place much of their effort into meeting the daily demands of running their own business and then neglect to plan for what will happen to the business when they are no longer there to manage it. Such a business could possess assets that represent a substantial value of their estate. Continuity of business interests could be of paramount importance for a person who wishes his dependants to benefit from the business. Planning should ensure that the business could continue uninterrupted. Beneficiaries of an estate are likely to receive far less if a business is sold on the basis of fixed assets, stock and debtors rather than as a going concern. To ensure continuity of the business, the entrepreneur may either donate or, alternatively sell it to the trust formed specifically for carrying on the business for the benefit of the beneficiaries named in the trust instrument. Each method of disposal of the business has its own tax implications.

4.3.1 Donation of business and assets or shares to the business trust

The founder of a business trust may either donate the business and its assets to the said trust, or if the shares are held in the company owning the business, such shares may be donated to the trust. In either case the donation will have to take place at market value. This would necessitate the valuation of the business and its assets or shares as at the date of making the donation. Donation of assets to the trust, including business trusts, is not considered to be desirable because it creates an immediate cash outflow in the form of donations tax (Huxham, 2002 : 531). Huxham further submits that if the rate of the estate duty is likely to increase above 20%, it may be advantageous to donate the assets or shares and incur donations tax.

4.3.2 Sale of business and assets or shares to the business trust

The normal income tax consequences of the purchase and sale of business are beyond the scope of this work. The discussion will focus on the tax consequences of selling for an inadequate consideration the business assets or shares to the trust and whether or not the non-charging of interest on sale of assets to the trust on loan account constitutes a gratuitous disposal giving rise to a donation.

The founder contemplating the sale of a business or shares to the trust may effect the sale for due consideration in cash or on loan account. The reason the sale must be at full market value is that, donations tax will arise in respect of a disposition for an adequate consideration. Where a person sells shares to a trust at market value, the sale of the shares to the trust does not constitute a donation (CSARS v Woudridge 1999 (4) All SA 519 (C) 62 SATC 1). It is submitted that this decision would also cover the sale of any other asset to the trust.

When a person sells an asset to a trust, whether family or business trust, the issue of the adequacy of consideration and the potential liability to donations tax become important. Section 58 of the Income Tax Act provides that property is deemed to have been disposed of by way of donation if it was disposed of for a consideration which, in the opinion of the Commissioner, is 'an inadequate consideration'. The problem posed by section 58 is that it gives no indication of what factors are to be taken into account in determining whether consideration for a disposition is 'adequate' or not. The opinion of the Commissioner is all that is required. What then is an 'inadequate' consideration?

It is submitted that the Act does not lay down a fixed rule that anything less than market value is an inadequate consideration. It is noted that in ITC 1599 (1997) 58 SATC 88 the court held that, in the context of donations tax, the criterion for determining whether consideration was 'adequate' was the market value of the property that had been disposed of in comparison with the counter-performance given by the recipient. The court rejected the proposition that a particular relationship between the donor and the donee, or the control that the donor would be able to exercise over the donee (as here, where the donor was a trustee of the trust), justified a price lower than market value as being 'adequate'.

To reduce any risk of donations tax, the seller must have an independent valuation of the business including assets and shares done; where possible, Revenue approval should be obtained for the transfer values; and the loan should be repayable on demand (Urquhart and Davis, 1998 : 11-3). It seems doubtful that where assets are sold at market value the sale can attract donations tax since a sale at market value is not a gratuitous disposal as no element of liberality is present. In terms of section 58 of the Income Tax Act, a donation will only arise where property has been disposed of for an inadequate consideration. In those circumstances the amount of the donation will be the difference between the market value of the said property and the value of the said consideration.

The loan account may or may not carry interest but it is advisable to have no interest rights attached to the loan. Huxham (2002 : 531) submits that the interest charged on the seller's loan account will increase the seller's estate by the amount of interest every year which means that the growth will not have been frozen.

Further, the interest will be taxed in the seller's hands. The learned author says the creation of a loan account with a fixed date of repayment and agreed interest rate should be avoided. The reasons advanced for this submission is that the interest rate may be too low or the founder of the business trust may waive his right to interest. This submission is based on the definition of a donation which means "any gratuitous disposal of property including any gratuitous waiver or renunciation of a right" in terms of section 55(1) of the Income Tax Act. A waiver of a right is a donation, but if no right is created in the first place, there can be no donation. If the interest is too low or the right to interest is created and then waived there is a possibility that donations tax equivalent to the present value of either the inadequate interest or the waived interest, capitalised over the term of the loan, may arise. The problem may be resolved by having a call loan account with no specified interest terms.

The assets may be sold to the business trust on non-interest bearing loan account. The question which needs to be asked is whether the non-charging of interest may not be said to constitute a donation by the founder of the business trust. In *CSARS v Wouldge* 1999 4 All SA 519 (C), 62 SATC 1, the court held that the non-charging of interest on the loan was a gratuitous disposition. A similar decision was reached in the earlier case of *CIR v Berold* 1962 3 SA 748 (A), 24 SATC 729 where it was held that so long as the taxpayer did not charge interest on the purchase price of the assets which had been sold to a company, and so long as he refrained from claiming payment of the amount due, was making a continuing donation to the company. Urquhart and Davis (1998 : 13-11) concur with this view but submit that if a lender can charge interest but refrains from doing so, there may well be a donation, as a donation for donations tax purposes includes any 'gratuitous waiver or renunciation of a right'. On the other hand, it is submitted, where no interest is charged and the lender cannot alter in any way the interest conditions in the sale agreement, there will be no donation. Urquhart and Davis further submit that this is the current practice which is followed by the South African Revenue Service in terms of which the mere provision of an interest-free loan is not regarded as giving rise to a donation for 'estate duty' purposes. The question which the learned author did not answer, is whether a similar practice applies where the main purpose of selling a business to a trust was not to reduce estate duty but to ensure continuity of the business for the benefit of future beneficiaries. May be this question may be answered by referring to the recommendation made by the Katz Commission where it said "no specific anti-avoidance measures be introduced to counter the use of interest-free loans in estate planning" which, in the opinion of the writer, includes the minimisation of estate duty and ensuring the enjoyment of the fruits of the estate after death by the heirs.

Having discussed the tax implications of a donation and a sale of assets to a business trust, it is deemed necessary to consider briefly the meaning of 'donation, settlement or similar disposition in terms of the current tax regime as it applies equally to trusts formed purely for carrying on a business.

4.4 MEANING OF DONATION, SETTLEMENT OR OTHER DISPOSITION

4.4.1 Donation and settlement

The court decisions reached in many cases involving trusts have contributed tremendously in elucidating the interpretation of the phrase 'donation', 'settlement' and 'other disposition'. These words are fundamental in the taxation of trusts where a beneficiary is in receipt of income arising by reason of a donation of an asset to the trust.

The phrase 'donation, settlement or other disposition' is prevalent in all the subsections of section 7. Section 7 is applied 'if any person has made any donation, settlement or other disposition'. Accordingly before this section can apply this requirement must be satisfied.

Huxham and Haupt (2002: 540) say the terms 'donation' or 'settlement' have not provided the Courts with a problem. These words are unambiguous and denote a gratuitous disposition of property. In terms of the Roman Dutch Law, a donation is regarded as a disposal of property for no consideration. A donation involves the gratuitous disposal of property out of liberality or generosity of the donor (*Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55). Although similar to a donation, a settlement is distinguished from a donation in that it is a gratuitous disposal of property subject to specific terms and conditions. A settlement involves an element of bounty, (*Bulmer v IRC*). The confusion created by the words 'donation' and 'settlement', was resolved in the case of *Ovenstone*, where the court highlighted the meaning of 'donation' and 'settlement'. In discussing the meaning of 'donation' the Judge stated that "In a donation the donor disposes of the property gratuitously out of liberality or generosity, the donee being thereby enriched and the donor correspondingly impoverished, so much so that, if the donee gives any consideration at all, therefore, it is not a donation".

The Judge further deliberated on the meaning of 'settlement' and said that: "In a 'settlement' the property is usually disposed of upon specific terms and conditions set out in a deed of settlement, to or through the medium of a trustee or trustees for the benefit of some person ...".

On the other hand it has been argued that a 'settlement' need not be gratuitous and that, even if effect is given to the *ejusdem generis* principle, 'other dispositions may be for a consideration which falls short of the full value of the property disposed of, (*Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55). Considering the applicability of the *ejusdem generis* rule, the judge pointed out that because there is an element of liberality or beneficence in most settlements, 'settlement' could not include a transaction made for full value in money or money's worth, (*Joss v SIR* 1980 SA 674 (T), 41 SATC 206). The term, 'donation', is therefore

qualified by the term 'settlement' for the purpose of this section and therefore refers to dispositions involving at least an appreciable element of liberality or generosity (Huxham, 2002 : 541).

It is, therefore, clear that in terms of the judgement, the words 'donation' and 'settlement' mean a gratuitous disposal of property and involve an element of liberality or generosity. Do the words 'other disposition' have a similar meaning as donation or settlement?

4.4.2 Other Disposition

There has been for quite a long period of time uncertainty as to the true meaning of the words "other disposition" in the phrase 'donation, settlement or other disposition'. This uncertainty was caused by the decision reached by the court in *Barnett v COT* 1959 (2) SA 713 (FC), 22 SATC 326, a Rhodesian case, where it was held that 'disposition' was not restricted to dispositions encompassing gratuity, but also included any transfer, transaction, plan, scheme or arrangement. This decision implied indirectly that the words 'other disposition' encompassed disposals of property for due consideration (full value). The decision reached in this case deviated significantly from the decisions reached in *ITC 551* (1943) 13 SATC 254 and *ITC 642* (1947) 15 SATC 238 where it had been held that the words 'other disposition' included only gratuitous dispositions. In *Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55 the Court found that "any donation, settlement or other disposition – excludes any disposal of property that is a wholly commercial or business one ...; it covers any disposal of property made wholly gratuitously out of liberality or generosity; it also covers any disposal of property made under a settlement or other disposition for some consideration but in which there is an appreciable element of gratuitousness and liberality or generosity".

The Judge further alluded to a situation where a disposal is partly gratuitous and partly for consideration and said, "if the consideration is merely illusory, simulated, or minimal, the disposal will, of course be regarded as wholly gratuitous. On the other hand, merely because the settlement or disposition contains some element of bounty or gratuitousness, that is insufficient to render section 7(3) applicable...".

In *Joss v SIR* 1980 SA 674 (T), 41 SATC 206, the court held that 'other disposition' does not include transactions made for full value in money or money's worth and that there had to be an element of liberality. Regarding the applicability of the *ejusdem generis* rule, the Judge went on to say that "I think the *ejusdem generis* rule is of application and that transactions for full value in money or money's worth are excluded from 'other dispositions in sub-sections (3) and (4) of the Act".

He further said "Once one accepts that the notion of 'settlement' is inextricably bound up with motives of liberality...it seems to me that this is a case where 'other disposition' cannot possibly, by a proper

application of the *ejusdem generis* rule, be construed literally and as widely as the respondent would have us do”.

In *Ovenstone*, the court confirmed the applicability of the *ejusdem generis* rule and held that the words ‘other disposition’ should be interpreted *ejusdem generis* with ‘donation’ and ‘settlement’, that is, having the same meaning as ‘donation’ and ‘settlement’.

It is evident from the decided cases discussed above that the phrase ‘donation, settlement or other disposition’ does not include any disposal of property for due consideration but includes any disposal of property made under a settlement or other disposition for some consideration but in which there is an appreciable element of gratuitousness, liberality or generosity, (*Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55).

4.5 TAXATION OF TRUST INCOME

A trust may derive income from many sources, such as dividends and interest from investments, rent from letting of trust property or even profits where a trust is trading. Income from various sources is treated differently for tax purposes. For example, in *CIR v Armstrong* 1938 AD 353 10 SATC 1 the court was called upon to decide, whether the dividends that had been distributed to a beneficiary by the trustees had to be accorded the similar tax treatment as dividends received by the beneficiary directly. In other words, that they were exempt from tax in terms of section 10(1)(k). This issue arose because the Commissioner for Inland Revenue had sought to tax the beneficiary on the total dividends received from the trust and had disregarded the nature of the receipt. The court held that income that is subject of a trust retains its identity until it reaches the parties in whose hands it is taxable. A trust is a mere ‘conduit pipe’ through which the income flows, and the income retains its identity in the hands of the beneficiaries.

As a consequence, when the accrual of the income is to a beneficiary, any exemption from tax provided in the Act applying to the income will be available to that beneficiary (*Silke*, 2003 : §12.16). Even where a beneficiary received an annuity from a trust, the income would still retain its identity so that if the trust had only dividend income, the full annuity received by the beneficiary would constitute the receipt of a dividend provided it accrued to the beneficiary in the same year of assessment as it accrued to the trust, (*SIR v Rosen* 1971 (1) SA 173 (A), 32 SATC 249). This decision was nullified by section 10(2)(b), which provides that the dividend exemption in section 10(1)(k) is not applicable to any portion of an annuity. As a consequence the dividend will be taxed in the hands of the beneficiary. Notably, a beneficiary who receives interest from the trust, the interest retains its identity and the beneficiary is entitled to the interest exemption in terms of s 10(1)(h).

4.0 PROPOSED TAX TREATMENT OF BUSINESS TRUSTS

The tax treatment of trusts has been an uncertain area for many years, with speculation concerning tax avoidance through trusts and the recommendation, and subsequent shelving, of complex tax proposals of taxing trading trusts like companies.

The literature reviewed by the writer reveal that legislators in numerous foreign jurisdictions have been and are still grappling with the problems relating to the taxation of business trusts. Accordingly, the problem of deciding what principles should be applied to the taxation of business trusts is not unique in South Africa (Margo Commission, 1987 : 214). It has been established that the problem does not pertain so much as to how the business trust should be taxed but the fundamental issue is how a trading trust is to be distinguished from a traditional trust figure formed purely for the protection or conservation of trust property. The features of a business trust which distinguish it from a conventional estate-planning or common law trust were canvassed in chapter three. It is worth noting that the Australian Revenue Office did not concern itself with the features of a business trust but with its widespread abuse to evade tax.

The Australian Revenue Office confronted with the similar problem as stated above, commissioned a Board of Taxation in 2002 to look into the possibility of taxing discretionary trusts, which are also used extensively to carry on a business, like companies. The Board focused its enquiry on identifying 'tax abuse in the discretionary trust area' because the use of discretionary trusts seemed to be the main issue of community concern about trusts. The Board also deemed it necessary, while looking for solutions to the perceived problems, the identification of the principles which could protect legitimate small businesses and farming arrangements.

The Board did not address matters specifically affecting other kinds of trusts such as public trading trusts as the latter are taxed as companies in Australia. It would appear, although not specifically mentioned, that the Board's focus was on discretionary private business trusts. Since income-splitting can be achieved through various kinds of entities (of which trusts are only one kind), the Board did not examine or commented on the tax aspects of income-splitting and noted that the Australian Government did not intend to prevent trusts from being able to split income among beneficiaries in the new tax system then proposed.

In Australia the arguments in favour of taxing discretionary trusts like companies fell into the following four broad categories, which differ significantly from the proposals advanced by the Margo Commission:

- Discretionary trusts are close substitutes for companies;
 - As a matter of principle discretionary trusts should be accorded the same tax treatment as companies;
- and

- Taxing discretionary trusts like companies would reduce tax abuse.
- If there is no need to tax discretionary business trusts like companies, are there nevertheless any other changes that should be made to the tax treatment of discretionary business trusts?

The Board of Taxation did not focus on the characteristics of the discretionary business trusts to determine whether the latter should be accorded a corporate tax status, instead the investigation was results-based. In other words the investigation concerned itself with the effect the change in the method of taxation of discretionary trusts would have had on small businesses and the farming community. The considerations mentioned above are further discussed below.

4.6.1 Should discretionary business trusts be taxed like companies because they are substitutes for companies?

The mere fact that a business trust shares certain common characteristics as a company such as limited liability does not make a business trust a close substitute for a company. While business trusts and companies have some similarities, they also have important differences. For instance, business trusts have much more limited access to equity finance than do companies. This suggests that, at least for larger businesses, business trusts may not provide the same advantages as companies, and are therefore unlikely to be used as substitutes for companies. In the case of small businesses, limited liability or tax saving may not be a particularly important factor in the choice of a business entity. There are a number of factors that determine the choice of entity structure, and limited liability is not necessarily the most important. For instance, estate planning and intergenerational transfer of assets are often the prime drivers of choice, says the Board of Taxation in its 2002 Report.

The attribute that the interest of the beneficiary is transferable is far-fetched and can apply to any 'protective trust' which carries on business including owning and letting of property. It was mentioned in the previous chapter that there are two types of business trust, namely the private and public business trust. In a private business trust the beneficial interest may not be freely transferable or the provisions of the trust instrument may prohibit such transfer. It is submitted that where the transfer of beneficial interest is restricted and the beneficiaries act in concert, it is more correct to equate a business trust with a partnership than a company.

In the Taxpayer (1992 : 48) it was submitted that the definition of a business trust should as far as possible equate it with the characteristics of a company. The characteristics of a company, which separate it from a partnership, are its legal personality, ownership separate from its shareholders and limited liability. The business trust does not possess legal personality nor does it own property or enjoy limited liability. The trust property is owned by the trustees, (trust in a narrow sense), who enjoy limited liability towards the debts of

the business trust. However, it is unlikely that a trustee or a trust formed by the beneficiaries for the purpose of carrying on business would allow a situation where the beneficiaries do not assume the responsibility to make good the debts of the trust. That would be so, because in the bewind trust the trustees have control but not ownership of the trust property. Even in a partnership, some of the partners may have limited liability and restricted transfer of partnership interest. If a business trust is to be defined by equating it with a company, the result would be to sweep in every 'protective' trust which engages in traditional trust business such as the letting of property, and to exclude every 'non-protective' trust which does possess the characteristics of a company, (Taxpayer, 1992 : 50).

4.6.2 Should discretionary business trusts be taxed like companies as a matter of principle?

South African tax laws apply to a wide range of different entities, and there are many similarities, and many differences, among the various entities. The Board of Taxation in its Report submitted that the appropriateness of the various tax outcomes resulting from the use of business trusts should be assessed by the legislature not by comparison with the tax outcomes available from the use of other entities but by reference to the traditional tax policy of equity, efficiency and simplicity. It is submitted that taxing business trusts like companies would not necessarily improve equity or efficiency. The reason is that although according the same tax treatment to income earned through business trusts and through companies could improve equity and efficiency in some respects, but it would also potentially introduce offsetting inequities and distortions because it would exacerbate current differences in the tax treatment of income earned through business trusts and income earned through other entities (such as partnerships) that retain a flow-through tax treatment. It should always be borne in mind that business trusts are in fact 'pure trusts' that have been put to commercial use. Therefore, any move to tax business trusts like companies would reduce the degree of integration that the current law can potentially achieve for trust beneficiaries. This means that taxing business trusts like companies would prevent the flow-through of tax preferences and the retention of the character of income distributed to the beneficiaries and could potentially have equity impacts. For the reasons advanced, the Board of Taxation submitted that taxing business trusts like companies as 'a matter of principle' the efficiency and equity of the tax system would not necessarily be improved by aligning the tax treatment of business trusts and companies.

The Board of Taxation further submitted that any proposal to tax business trusts like companies could impose significant costs on the economy and on those individuals who have structured their affairs under existing rules. The burden of these transitional costs would fall most heavily on small businesses and farmers as it is this group that utilises trusts mostly for commercial purposes. Further, a key difference between the taxation of companies and trusts is that amounts that are not assessable in the hands of the trustee are not taxed on distribution to beneficiaries whereas such amounts are treated as dividends subject to secondary tax on companies. If this tax-preferred income were to become taxable on distribution, income

earned through a business trust would be taxed differently to income earned by an individual directly; this would be a departure from the integration objective which leads to potential equity and efficiency concerns as mentioned above. It is submitted that to the extent that flow-through taxation has the potential to further integration, it has the potential to deliver superior outcomes in terms of equity and efficiency.

The Board of Taxation recommended that there were no compelling arguments for broad-based reform to more closely align the tax treatment of business trusts and companies and that the legislature should retain the current flow-through of distributions by business trusts. The writer concurs with the Board that whether or not businesses trusts and companies share similar characteristics they are different entities governed by different statutes and as such cannot be accorded the same tax treatment.

4.6.3 Should discretionary business trusts be taxed like companies to reduce tax abuse?

The question, which is often asked, is would the company tax model reduce tax abuse? Under the current tax treatment of trusts, including business trusts, assessable income earned through a trust and distributed to beneficiaries is taxed as if beneficiaries had earned the income directly. Any undistributed income of the trust is taxed in the hands of the trustee at the rates applicable to trusts. Distributed amounts are taxed either in the hands of the founder or beneficiaries depending on the application of section 25B and 7 of the Income Tax Act. Consistent with the tax law, amounts that are non-taxable in the hands of the trustee may be distributed to beneficiaries tax-free. The major concern here is that the flow-through tax treatment allows for the tax-free distribution amounts that are untaxed due to tax abuse. For instance, an amount could be distributed directly to a beneficiary and not disclosed in the books of a trust and consequently in its tax return. Such amount would remain untaxed, presuming the beneficiary also fails to include it in a tax return. Consequently, critics of the flow-through model suggest that trusts allow for the benefit of such tax abuse to be passed on to individual beneficiaries.

The Board of Taxation commented that until amounts not shown in the trust's or company's return are distributed, and reported in an individual's tax return, the company model does not provide any greater integrity than the flow-through taxation model applicable to trusts. The Board argues further that the funds retained in a company may be used to advance the personal interests of shareholders in the same way that such funds retained by a trust may be used. The example advanced by the Board was that the deemed dividend rules, which treat certain amounts paid by private companies as dividends, may apply to certain disguised distributions. The writer does not believe that the company model provides sufficient additional integrity such as to justify a move to tax trusts like companies. As a general rule, tax abuse should be addressed at its source through better enforcement action to limit tax abuse opportunities.

4.6.4 Are there other forms of tax abuse available through the use of trusts which treating trusts like companies would reduce?

Over the years, a number of amendments have been made to the taxation treatment of trusts, to address specific tax planning opportunities such as recognising a trust as a legal person with a view to taxing income retained in the trust and ring-fencing of trust losses to mention a few. Surprisingly, the legislature has not interfered with income-splitting a tax planning opportunity, which is practised by many taxpayers. Inter vivos trusts which include business trusts have long been recognised as the ideal entity for income-splitting purposes due to the flexibility with which trust income can be distributed in a given tax year to family members on the lowest marginal tax rates.

The Australian Commission of Social Security (ACOSS) in its Report on the use of discretionary trusts to avoid tax identified other well-documented strategies used by high income-earners to avoid tax by the use of these trusts, and these are:

- trust stripping practices in which the income of trusts is made to appear to be the income of a tax exempt body such as a charity although it was effectively controlled by the taxpayers concerned.
- trafficking in tax losses where there has been a change in beneficial interest; and
- the use of complex networks of trusts to re-characterise income, for example to convert ordinary business income to capital gains. ACOSS suggests that in the case of trusts, there should be an effective mechanism (such as the company income tax) to ensure that trust income is brought to tax in a timely manner. What ACOSS is referring to is a form of withholding tax which will ensure that the Fiscus collects its revenue expeditiously instead of waiting until the trust income has been distributed to the beneficiaries.
- revaluation of trust assets and distribution of income arising from the revaluation as a tax free capital gain to beneficiaries. The capital gains tax provisions apply to the sale, disposal, or deemed disposal of an asset.

Invariably the targeted anti-abuse rules are difficult to apply in some circumstances where taxpayers employ very complex arrangements. In these cases, it can be almost impossible to trace the ultimate source of funds and consequently it can be very difficult to identify tax abuse techniques and enforce the rules.

The conclusion that was reached by the Board of Taxation regarding the possible abuse of trusts was that in the light of implementation of trust integrity measures over several years, concern about the abuse of trusts for tax planning does not of itself warrant fundamental change to the tax treatment of discretionary trusts. The writer supports this view and submits that the Income Tax Act contains all the armoury there is to counter possible abuse of trusts in South Africa. Wunsh (1990 : 16), quoting the Margo Commission where it said that the practice of splitting income by the creation of multiple trusts creates an obvious loophole in the system with progressive tax rates, said “one is not aware of this abuse being meaningful”.

4.6.5 Possible concerns with the consistent entity tax regime

The recommendation by the Margo Commission on the taxation of business trusts would have, if it had been implemented, raised a number of technical and practical problems in addition to concerns about the policy to tax business trusts like companies. The possible practical problem would have been about the determination of the contributed capital of the business trust in the transition period to the new tax regime as this would have included prior taxed amounts which would have been difficult to identify. Another practical problem would have been the likely lack of documentation to determine the tax status of trust assets.

The first concern noted by Wunsh (1990 : 20) was that 'many so-called business trusts would be vulnerable to attack on the ground that they are not really trusts (control or consensual character, partnership, principal and agent). Many of them are, on analysis, associations and could be vulnerable to attack under sections 30 and 31 of the Companies Act. This view is supported by the Board of Taxation of Australia that expressed concern that potentially all trusts with a trust deed that provided even a limited discretion for the trustee to allocate trust income or capital could be subject to the new tax regime and many trusts would incur costs reviewing trust deeds to determine their status. It is interesting to note that the Margo Commission proposed that business trusts be taxed like companies but did not propose any transitional measures.

4.7 DISTRIBUTIONS MADE BY A BUSINESS TRUST

4.7.1 'Dividend concept'

Distributions of income and capital to shareholders in a company are governed by strict rules and are generally in proportion to shareholding. It is submitted that this does not apply to a business trust unless the beneficiaries have pooled their resources in return for pro rata shares in the corpus of the business trust. Generally the income and capital can be distributed to any one of the trust beneficiaries in any proportions and without bearing tax in the first instance. As will be seen later in the following sub-section, if a company derives a capital profit from the sale of an asset there are limitations on it distributing such capital profit tax free to shareholders. These limitations do not apply to a business trust which is able to distribute capital profits tax-free to its beneficiaries.

In terms of the current tax regime, distributions made by a trust are deductible in arriving at the taxable income retained by a trust. The alignment of the tax treatment of business trusts and companies as recommended by the Margo Commission, would have resulted in distributions to beneficiaries being analogous to a dividend payment. This essentially means that the "conduit pipe principle" would have not been applicable to business trusts and 'dividends' received by the beneficiaries would have been tax-free in their hands. In any event, the Margo Commission proposed that the 'conduit-pipe principle' should not apply to business trusts.

In Australia concern was raised that there is a tendency by discretionary trusts conducting business to make loans to the beneficiaries instead of distributing available accumulated income. In that country discretionary trusts are used as conduits for transferring trust income to the beneficiaries. Discretionary trusts pay tax at 30% and the tax credit is then passed on to the beneficiaries. The Australian Tax Office recommended the implementation of a profit-first-rule where a trust having revenue reserves has distributed capital income to beneficiaries in order to avoid tax in the hands of those beneficiaries. The beneficiaries would be taxed on the capital income to the extent of the available revenue reserves.

4.7.2 Secondary tax on companies

In South Africa, companies pay Secondary Tax on Companies (STC) on net dividends paid to the shareholders. The question that should be answered is whether the taxation of business trusts like companies would subject to STC distributions made to the beneficiaries. In a business trust a beneficiary may have either a vested or contingent right. It is submitted that a 'dividend' will arise instantly where a beneficiary has a vested right to the trust income and in the case of discretionary business trust only when the trustees have exercised their right or the event stipulated in the trust instrument has taken place will a beneficiary having a contingent right be deemed to have acquired a right to income, and therefore in receipt of a 'dividend'. It is further submitted that in a business trust undrawn profits may be allocated to the capital beneficiaries in terms of the provisions of the trust instrument. The amount so appropriated can either be distributed by way of a cash payment, be paid by way of an in specie distribution of assets, or be credited to the beneficiaries' loan accounts. Whichever method is chosen is irrelevant because STC becomes payable as a result of the declaration of the 'dividend' and not as a result of the payment. If the conduit-pipe principle is maintained, it is submitted that the STC should be paid only on the exempt portion of the 'dividend' distributed by the business trust.

In a trust there are income and capital beneficiaries. Problems may arise on the distribution of capital income to beneficiaries entitled thereto. In terms of section 64B(5)(c) of the Act, a capital profit distributed by a company by way of dividend, while it is a going concern, is subject to STC. By way of contrast, if the company after realising the capital profit, distributes it by way of dividend in the course of, or in anticipation of liquidation, winding up or deregistration, it will not be subject to STC, provided that the company is liquidated, wound up or deregistered within six months of the date on which the dividend was distributed. The question is, will the distribution of capital profit on 'winding up' of the business trust be regarded as a dividend and be subjected to STC?

Another problem may arise where, for instance, a loan is made to a beneficiary by the business trust that has revenue reserves instead of making a distribution to such beneficiary. It is submitted that the loan will not avoid a STC liability, as it will be deemed to be a dividend, attracting STC in terms of section 64C.

Having discussed that fundamental changes in the current tax regime with regard to business trusts are not warranted, the writer will consider whether the current tax treatment of such trusts could be changed to improve tax efficiency outcomes.

The writer submits that if business trusts were to be subjected to tax like companies, the possible solution would be to tax the income of such trusts in a manner similar to non-property unit trusts. Non-property unit trusts receive dividend and interest income. The business trust can also receive business income, which may be in the form of rental income and may be taxed on income it receives and also act as a conduit for the beneficiaries. The exempt portion of the dividend distributed by the business trust may be subjected to secondary tax on companies, but only on the 'net amount'.

4.7.3 Interest on loan raised to make distributions to beneficiaries

In certain circumstances, trustees may need to borrow money to fund a corpus distribution, especially if the distribution effectively comes from a revaluation reserve. The question that needs to be answered is whether or not interest incurred on the money borrowed is deductible for tax purposes. The current position in the Income Tax Act is that interest incurred on funds borrowed to finance a dividend distribution is not deductible as it would not have been incurred in the production of income in terms of section 11(a) of the said Act (*COT v AB (Pvt) Ltd* (1921) 1 SATC 77). The provision in the Act does not consider the distributions made by trusts and accordingly the principles of interest deductibility applying to borrowings raised to finance such distributions by trusts are not clear. Consequently it is uncertain whether a trust can claim a deduction of interest expenses where amounts are borrowed then distributed to beneficiaries. However, it would appear, based on the decision reached in the case of *AB (Pvt) Ltd*, that the principle enunciated in that case is equally applicable to distributions made by a business trust.

It is submitted that if trusts have been and are allowed to claim deductions of interest costs that are not sufficiently connected to the income-producing activities of the trust, this may lead to inappropriate taxation outcomes. To achieve equity and a consistent tax regime, it is submitted that a deduction should not be allowed for interest on borrowings used to finance a non-taxable distribution to a beneficiary of a business trust. The writer notes that rulings on interest deductibility no matter how clear they may be, in practice it may be difficult to enforce particularly if taxpayers arrange their affairs through complex structures because of the fungibility of funds. Until such time that the legislature clarifies and publishes his views about the deductibility of interest on borrowings used to finance non-taxable distributions to beneficiaries, this will remain a grey area.

4.8 ANALYSIS OF MODELS FOR TAXATION OF BUSINESS TRUSTS

It was recommended by the Margo Commission that business trusts should be taxed using the corporate tax model and by implication that the current conduit-pipe principle be discarded. An understanding of the difference between these two tax models and their pitfalls is important.

4.8.1 Conduit-pipe tax model

The present system of taxation of trusts in South Africa is based on the 'conduit-pipe' principle in which trust income is taxed in the hands of the beneficiaries and retains its character. Some argue that this model should apply to the taxation of all entities, that is, the shareholders and beneficiaries should be regarded as the ultimate taxpayers and their respective entities regarded as conduits through which income flows to them. According to ACOSS (2002 : 16), this system presents a number of practical problems such as:

- the difficulty in tracing the character, sources and ultimate recipients of income flowing through complex entities such as large public companies, or networks of entities.
- bringing the income of entities to tax in a timely way in the hands of those individuals who are ultimately entitled to it. This may create cash-flow problems for the individuals concerned. On the other hand if this is not done, they will unfairly benefit from a deferral of tax on the income of the entity. The writer submits that this would be the case where the dates of accrual and actual payment to those individuals do not coincide. The business trust may be cash-strapped and has to borrow money in order to make payments to the beneficiaries.

In this regard the Margo Commission warned that the adoption in South Africa of the 'shareholder' as the dominant taxpayer would create serious problems. The most serious problem was and is still that in South Africa the threshold tax rate for individuals is lower than the company tax rate and this could result in the need to pay a great number of refunds to shareholders.

4.8.2 Corporate tax model

To overcome the problems with the flow-through tax model and to prevent the abuse of trusts, it has been recommended that business trusts be taxed in like manner to companies. ACOSS (2002 : 17) submits that the economic functions of discretionary trusts (including business trusts) are diverse and it is not clear whether they parallel those of private companies. ACOSS further states that in the absence of an entity level tax, an alternative mechanism is needed to protect the revenue from the abuse of discretionary trusts for income tax avoidance and evasion purposes. The entity level tax, according to ACOSS, has the effect to force the distribution of trust income to beneficiaries so that it may be brought to tax on a timely basis. It is submitted that the entity level tax does not prevent the use of trusts to avoid and evade tax.

4.8.5 Introduction of withholding tax and capture of tax concessions within the trust

It is generally believed that the introduction of a general withholding tax on trust income and the capturing of tax preferences (concessions) within the trust would bring the tax treatment of discretionary trusts (including business trusts) more into line with that of companies. This suggestion neglects the fact that although a business trust may have similar characteristics as a company, the trust structure is totally different from that of a company. However, it is argued that this system would facilitate the collection of revenue by the fiscus and also prevent trust stripping which involves re-characterisation of income into capital income before it is distributed to beneficiaries.

Another concern relates to the capture of tax concessions (allowances) within the entity. The writer submits that if the withholding tax principle is applied to business trusts, the flow-through of tax preferences to beneficiaries should not be permitted. This will ensure consistency with the tax treatment of companies.

4.9 BUSINESS TRUST AND TAX AVOIDANCE

While trusts can provide an effective and ideal vehicle for carrying on business, businesses need to be sure that the proposed structure does not fall foul of the general anti-avoidance provisions under section 103(1) of the Income Tax Act. Trusts have in the past prescribed themselves as a very useful device for avoiding both income tax and estate duty. Their use also holds out advantages regarding, for example, transfer duty on the transfer of immovable property and stamp duty on the transfer of interest in a business trust. At this stage it is important to distinguish tax avoidance from tax evasion.

Tax evasion, in contradistinction to tax avoidance, means the deliberate, dishonest act of inflating expenditure or suppressing income with a view to reducing a tax burden. Tax avoidance on the other hand, concerns itself with reducing potential tax liability using the provisions or loopholes in the Act. In other words, tax avoidance includes transactions that directly or indirectly alter the incidence of income tax or liability to pay tax or directly or indirectly avoid, reduce or postpone a liability to tax. Thus if a taxpayer adopts a new business structure through which to run a business which has been conducted through a different structure, he needs to consider the tax consequences that may follow the change. In general the taxpayer will need to be able to justify the structure on genuine commercial grounds. This is particularly the case where a taxpayer chooses to adopt a trading trust structure, having personally adopted another structure.

Many business people, including practitioners, believe that a new business activity can be structured in the most tax efficient manner without falling foul of the general anti-avoidance provision. They say this is true only to the extent that the taxpayer can justify the structure on genuine commercial grounds if asked to do so

by the Inland Revenue Department. It is further argued that this is particularly so where a taxpayer chooses to adopt a trading trust structure, having previously adopted another structure to carry on his business.

While many individuals use family trusts to organise their personal affairs, the use of trading trusts for business activities is not as common in South Africa compared to other jurisdictions such as Australia and the United States of America. Nevertheless, as their use becomes more widespread, some businesses are being restructured as trading trusts to unlock the benefits which a trading trust structure offers. Not surprisingly, the Commissioner has also taken a keen interest in trading trust structures, particularly where a taxpayer has restructured an existing business as a trading trust. It is all too easy for the Commissioner to point out the tax savings that have arisen as a result of the restructure, and very difficult for the taxpayer to discharge the burden of proof in terms of section 82 of the Income Tax Act that these tax savings were 'merely incidental' to the restructuring process. However, there is no common law element in tax legislation, and no obligation on any taxpayer to pay more than the amount properly due in terms of the legislation (Accountancysa, 2004 : 14). There is no duty upon taxpayers to arrange their affairs so as to enable the Commissioner "to put the largest possible shovel" into their stores (Ayshire Pullman Motor Services and D M Ritchie v IRC 14 TC 754).

The view mentioned above was confirmed in CIR v Conhage (Pty) Ltd 1999 61 SATC 391 when the Judge held that, "within bounds of any avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. The legitimacy of tax avoidance is well established, and is epitomised in the often quoted words in the case of IRC v Duke of Westminster (1936) AC 51 TLR 467, 19 TC 490 where it was held that "every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be". This principle has also been endorsed by the South African courts. In CIR v Sunnyside Centre (Pty) Ltd 1997 (1) SA 68 (A) it was held that "a taxpayer is entitled to order his affairs so as to pay the minimum tax". If, for example, the same commercial result can be achieved in different ways, a taxpayer may enter into the type of transaction which does not attract tax or attracts less tax. But, when it comes to considering whether by doing so he has succeeded in avoiding or reducing the tax, the court will disregard a 'simulated transaction' and will give effect to the true nature and substance of the transaction and will not be deceived by its form".

It, therefore, follows that as long as the taxpayer is in compliance with the provisions of the taxing Act, he will incur "no legal penalties and strictly speaking no moral censure by being astute enough to minimise his tax burden (Levine v IRC (1928) AC 217 13 TC). It is submitted that the court will consider the nature of the transaction to ensure that its substance does not obscure its form if the two are different.

In a New Zealand case *V20 (2002) 20 NZTC 10,233*, the Taxation Review Authority considered whether or not the restructure of a dentistry practice constituted a 'tax avoidance arrangement'. In that case, two dental surgeons practising in partnership were having serious personal and business problems. One of the dentists wished to restructure the partnership to limit his liability against his business partner and to avoid possible claims by the spouses of both partners. After taking advice, he settled a family trust with a company as trustee, that is, a trading trust. The dental partnership was then dissolved, and the dentist sold his share of the practice to the trading trust. The dentist became an employee of the trading trust and, from that point on the trading trust and the other dentist shared costs and retained their own income. Income derived by the trading trust was distributed amongst the beneficiaries, including the dentist himself, which resulted in tax savings over the tax years under investigation.

Although the dentist maintained that the restructure had taken place for non-tax reasons, it was held that there was a tax avoidance arrangement – although for one of the tax years in dispute there was no tax avoidance because the savings were merely incidental. While the Judge was not prepared to make a ruling as to whether the tax savings resulting from the other tax year were 'merely incidental' without further evidence on whether the tax savings resulting from the trading trust structure were similar to those which would have arisen if the dentist had adopted a corporate structure, the interim decision raised a number of interesting points, as follows:

- The Judge seemed to suggest that tax avoidance is a results-based test. A lot of emphasis was placed on the conclusion that the 'effect' of the arrangement was the reduction in income tax, and therefore, tax avoidance although he seemed to agree that the 'purpose' of the scheme was not tax avoidance. It is submitted that this is contrary to the South African jurisprudence on the tax avoidance provisions which require that all four requirements of section 103(1) must be present before the Commissioner can invoke this section.
- The Judge also criticised the Commissioner for assessing the dentist by comparing what he would have earned had he continued in partnership with the other dentist. The Judge submitted that the Commissioner should have compared the savings achieved under the business trust structure with those that would have arisen under a 'commercially acceptable' corporate structure with a view to determining whether or not any tax savings arising from the business trust were 'merely incidental' and therefore not tax avoidance. Here, it is submitted, the Judge completely disregarded the business context in which the transaction was concluded.
- The salary earned by the dentist from the business trust following the restructure received the Judge's careful examination. His Honour stated that if a fair market-related salary was not paid, there was an effective assignment of personal exertion income by the dentist to the business trust which must be tax avoidance.

In the above case, the Commissioner reconstructed the arrangement as if it had not occurred. In South Africa the Commissioner, if he is satisfied that tax avoidance has taken place, is empowered in terms of section 103(1) to disregard the arrangement and assess the taxpayer as if the scheme has not taken place.

In ITC 1714 (1996) 63 SATC 507, a case heard by the Gauteng Special Court, the taxpayers owning a partnership business in which they personally derived profits disposed of their partnership business to a trust whose beneficiaries were further trusts in which taxpayers' wives and minor children were the beneficiaries. In the new structure, neither taxpayer had any claim to the profits derived by the business which they had previously managed as partners. The taxpayers set up four trading trusts and an administrative trust to service the four trading trusts. Although one of the taxpayers managed the administration of the trading trusts he had no right to the profit earned there from as the profits were vested in his wife and minor children. The issue before the court was whether the scheme in question had the effect of avoiding or postponing liability for the payment of tax or of reducing the amount thereof. The court held that the scheme in question had the effect of avoiding or reducing tax and that the abnormality requirement in s 103(1)(b) was present on facts in *casu*.

In the case of *Meyerowitz v CIR* 1963 AD 25 SATC 287 the taxpayer had a right to a share of profits from a publication. In terms of an agreement he ceded this interest to a company jointly owned by his wife and himself. A trust was then formed for the benefit of his children, to which the company ceded its rights. The result was that the income from the publication no longer flowed to the taxpayer but instead to his children. The Court found that the taxpayer had diverted income from himself to his children and that this had been done for the sole or main purpose of avoiding tax involving the abnormality that the fruit of a taxpayer's labour had accrued not to him but instead to his children by way of a trust.

It has been confirmed by the Supreme Court of Appeal that before section 103(1) can be successfully employed by the Commissioner against a taxpayer, the four prerequisites as set out in its provisions must co-exist. In the absence of any one of them, the raising of this provision by the Commissioner will not be successful. These four prerequisites are as follows:

- The existence of a scheme or transaction.
- Which results in a saving (avoiding or reducing) in one of the taxes levied in terms of the Income Tax Act. These taxes being normal tax (including capital gains tax), secondary tax on companies, withholding tax on royalties, and donations tax.
- If the scheme was in the context of business, that is, it was not employed for bona fide business purposes other than the obtaining of a tax benefit; or if it was not in the context of business, it contained the required abnormal features, being the method in which the transaction was carried out; or the scheme (business context or not) resulted in abnormal rights and obligations being created.

➤ The sole or main purpose of the scheme being to avoid any type of tax collected by the Commissioner.

The provisions of section 103(4) give the Commissioner the power to presume that the 'purpose' prerequisite is present. If the Commissioner is satisfied that there is a 'scheme' that 'saves' an Income Tax Act tax and that lacks the business purpose requirement or has the required 'abnormal' features, he may raise the provisions of section 103(1) against the taxpayer. Truly speaking, the provisions of section 103(1) should only be considered once it has been established that the form and the substance of the transaction are the same.

In the case mentioned above, it would seem that there are two separate sets of transactions. Firstly, the sale of the share of the business of the partnership to the trading trust. Secondly, the distribution of the income earned by the trading trust to other beneficiaries including the taxpayer. Prior to selling his share of the partnership, the taxpayer earned income for his own account and for his own benefit. Thereafter he earned a taxable income from the trading trust which apparently was less than the income he would have earned from the partnership thus resulting in a saving of tax. It is submitted that the taxpayer had diverted income from himself to the other beneficiaries (including himself) and that this had been done for the sole or main purpose of avoiding tax, (Meyerowitz v CIR 1963 AD 25 SATC 287).

It is worth noting that in the above-mentioned case, the learned Judge placed a lot of emphasis on his conclusion that an 'effect' of the arrangement was the reduction in income tax and, therefore, tax avoidance even though he appeared to agree that tax avoidance was not a 'purpose' of the arrangement. Stephen Tomlinson says while the judgment does not contain much analysis, there seems to be a suggestion that tax avoidance was a results-based test and this was contrary to most of the jurisprudence on the tax avoidance provisions.

The sale of the share of the business of the partnership to the trading trust would be a transaction 'in the context of business'. Therefore it must be decided whether this transaction was carried out 'in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit'.

Both transactions resulted in a 'tax benefit', as defined in section 103(1)), arising. The question is, were these transactions carried out for a 'bona fide business purpose other than the obtaining of a tax benefit'? It would seem from the summary of the case in question that the sole reason for the sale of the share of the partnership was to limit a liability against the co-partner and to avoid possible claims by the spouses of both partners. No other non- 'tax benefit' purposes are apparent from the case as to why the taxpayer sold his share of the

partnership business. The bona fide business purpose criteria is present (*CIR v Louw* 1983 (3) SA 551 (A), 45 SATC 113). A similar decision was reached in the earlier case of *SIR v Geustyn, Forsyth & Joubert* 1971 (3) SA 567 (A), 33 SATC 113.

In that case the judge held that “Generally speaking, there is nothing abnormal in transferring an existing partnership business to a company: indeed, such a transaction may.....fairly be regarded as relatively commonplace in the commercial world.....the erstwhile partners regarded as considerable the advantage to be derived from incorporation as contrasted with partnership.....”.

The writer submits that if a trading trust is universally accepted as an unincorporated business entity, based on the decisions reached in Geustyn and Louw cases, the sale of a business to the trading trust would not fall foul of section 103(1) of the Act being a transaction carried out in the context of business. This would be so in the absence of any abnormal features. Accordingly it would be unnecessary for the taxpayer to raise the ‘purpose’ defence as he would be able to pass the normality test.

As the settlor cannot be the sole beneficiary in a trading trust, it would be impossible for him to discharge the burden of proof imposed upon him by section 82 of the Act that the transaction was carried out in the context of business or that the main purpose was not to avoid tax, for any income distributed by the trading trust to other beneficiaries would be regarded as diverted income which would have been taxed in his hands. Stephen Tomlinson asserts that while it is easy to maintain that a trading trust structure has been adopted for ‘creditor protection purposes’ or because a trading trust offers a high degree of flexibility in profit distribution, these commercial considerations must be real, not imaginary. The example cited is that it is not very likely that the Commissioner would believe a taxpayer who states that a trading trust has been formed for creditor protection when the taxpayer has failed to protect his lifestyle assets by, for example, transferring them to a family trust.

In *Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55 it was said that “even if the purpose or effect of [a] scheme when it is formulated is to avoid liability for tax, it may have that effect or that may become one of the taxpayer’s main purposes when he subsequently carries it out, thereby rendering s 103(1) applicable if its other requirements are fulfilled”.

In an obiter dictum in the case of *R Ltd and K Ltd v COT* (1983), 45 SATC 148 the courts supported the view that “when a genuine commercial transaction is considered and there are two ways of carrying it out, one that involves paying more tax than the other, it is quite wrong to draw the inference, as a necessary

consequence, that in adopting the course which involves paying less tax, one of the main objects is to avoid tax”.

In *Meyerowitz v CIR* 1963 AD 25 SATC 287 it was held that “As a result of this series of transactions the income which the appellant would have received for his work and labour was transferred to his children, and the effect of the transaction was to avoid liability by the appellant for tax on that income The word ‘scheme’ is a wide term and I think that there can be little doubt that it is sufficiently wide to cover a series of transactions such as those mentioned above”.

In *Geustyn, Forsyth and Joubert* cases the transfer of partnership business to another entity was dealt with as follows:

“Generally speaking, there is nothing abnormal in transferring an existing partnership business to a company: indeed, such a transaction may, I think, fairly be regarded as relatively commonplace in the commercial world.....the erstwhile partners regarded as considerable the advantage to be derived from incorporation as contrasted with partnership.....”.

4.10 SALE OF INTEREST IN A BUSINESS TRUST

While many individuals use family trusts to organise their personal affairs, schemes involving the use of trading trusts for business activities is not as common. Nevertheless, as their use become more widespread, some businesses are being restructured as trading trusts to unlock the benefits which trading trust structures offer. There is often a fine line between schemes that will be given effect to and those that will be attacked by the Commissioner. One such scheme is the so-called ‘sale of a trust’ to avoid paying transfer duty.

The scheme involves the transfer of the rights of the beneficiaries in a property holding trust instead of the sale of the property itself by the trust. *Kourie and Ryder* (1997 : 244) say this is ostensibly achieved by ‘selling’ the trust itself, rather than having to transfer the property out of the trust. The ‘sale of a trust’ is usually accompanied by a change of trustees and existing beneficiaries of a particular business trust holding a specific fixed property. Change of trustees result in the new trustees acquiring the rights to obtain ownership of the trust property and the new beneficiaries acquiring a personal right in exchanged for an agreed sum of money. Although the original acquisition of the property by the trustees attracts transfer duty, the common belief is that transfer of rights by beneficiaries does not attract transfer duty. The question which is often asked is whether this technique is valid in view of the prevailing trust and corporate law and secondly whether this technique in fact does obviate the payment of transfer duty (*Van der Westhuizen*, 1997 : 72).

In the South African law of trusts, it is generally accepted that a beneficiary's right in a trust can be ceded. For example, a person who wishes to acquire property in an existing trust may do so by way of a cession by the beneficiaries of the beneficial interest in the trust and by the appointment of new trustees. However, there is a dilemma that confronts the prospective seller and purchaser of an interest in a trading trust. Is the sale of an interest in a trading trust subject to a donations tax or transfer duty or both? This confusion was caused by the issue of letters to taxpayers concerned by South African Revenue Service advising them that not only was the transfer subject to transfer duty, but that donations tax could also be imposed (PricewaterhouseCoopers Synopsis, 2000 : 8).

A test case is pending where the Commissioner is challenging that the 'sale of interest' in a trust is a 'transaction' and, accordingly, transfer duty is leviable. Secondly, that such a 'sale of interest' means that the trust was not valid from the outset because the rights of the beneficiaries are freely transferable. It is doubtful that the second contention holds water, as the trust law does not contain any clause or provision that prevents the transferability by beneficiaries of their interest. Unless the trust instrument contains a contrary provision, it is submitted that the argument is not a legitimate ground for attack. Further, it can also be argued that it was the intention of the parties to form a valid trust. The mere fact that the parties might have used another vehicle, such as a partnership or close corporation, is irrelevant, Goodricke's case. It is respectfully submitted that a taxpayer is free to so arrange his affairs that he pays the minimum tax, provided that the agreement entered into reflects the true intention of the parties, (*Erf 3183/I Ladysmith (Pty) Ltd v CIR* 1996 (3) SA 942 (A), 55 SATC 229).

4.10.1 Transfer duty implications

The South African Revenue Service has taken the view that the acquisition of the beneficial rights in a trust is a transaction as defined and is subject to transfer duty. Transfer duty is payable, in terms of Section 2(1) of the Transfer Duty Act, 40 of 1949, on the value of any property acquired by any person by way of a transaction or in any other manner. A transaction is defined as 'an agreement whereby one party thereto agrees to sell, grant, donate, cede, exchange, lease or otherwise dispose of property to another, or any act whereby any person renounces any interest or restriction in his favour upon the use or disposal of property'. The term 'property' is defined as any right in or to property, whether it is movable or immovable, corporeal or incorporeal and embraces only rights that are vested in the taxpayer and would not include contingent rights or rights in which the taxpayer does not have ownership or that may accrue upon the happening of certain events (Silke, 2003 : §23.3). Louro J (1986 : 23) and Green R (1997 : 763) are of the view that a disposal of these rights and the acquiring of same by a person falls within the definitions of 'transaction' and 'property', causing transfer duty to be levied on the acquisition of these rights.

in order to determine whether transfer duty is payable on the disposal of an interest in the trust is whether a beneficiary has acquired a right in the trust property or not. In *SIR v Estate Rhode-Knight* 1974 (1) SA 253 (A), it was held that the word 'acquired' in section 2(1) of the Transfer Duty Act does not refer to the acquisition of ownership, but rather to the right to obtain ownership. The consequence is that transfer duty is payable when a person obtains an enforceable right to acquire ownership in future and not when the ownership is obtained. As mentioned previously, the 'sale of a trust' is usually accompanied by a change of trustees. The change may result in the endorsement of the title deed to reflect the change in the identity of the trustees. Although it may be argued that this amounts to a transaction for the purposes of the Transfer Duty Act, a possible exemption may exist under section 9(4)(a) of the same Act.

The nature of a trust and the rights of the beneficiaries determine whether a person purchasing an interest in a trading trust is liable for transfer duty. For instance, in the trust in a narrow sense, the ownership and control of the trust property vests in the trustees in their capacity as trustees whereas in the trust in a wide sense (*bewind trust*), ownership vests in the beneficiaries, but control vests in the trustees.

When a person acquires the rights of a beneficiary in a trust the liability for transfer duty depends on whether the beneficiaries have a real right; a right to acquire the ownership of property; or a personal right. If it is the latter, then it appears as if no transfer duty is payable, but the possibility of donations tax does exist. When ownership vests in the trustees the beneficiaries do not have an immediate right to the trust property itself, or to acquire ownership of the property in future. They merely have a personal right against the trustee that the trust be properly managed for their benefit. The result is that when beneficiaries under a trust in a narrow sense transfer their interests in the trust, the right to obtain property is not disposed of to the purchaser. Conversely, such a transfer by beneficiaries under a *bewind trust* will constitute a disposal of property thus attracting transfer duty (PricewaterhouseCoopers Synopsis, 2000 : 8) and (Van der Westhuizen, 1997 : 75). Van der Westhuizen further submits that where a beneficiary has a real right or a personal right to acquire the ownership of property and another person acquires these rights, transfer duty will be payable.

In conclusion any sale of beneficial interest will involve amendments to the trust instrument. Whether or not transfer duty is payable depends on the interest being ceded and the right which attaches to such interest. In a conventional private business trust the rights of a beneficiary are usually of a personal nature and a cession by the beneficiary of its interest in the trust will not give rights to the imposition of transfer duty but again it is the terms of the trust instrument that will determine whether or not transfer duty is payable. The author of the quoted article is of the view that in most instances the sale of beneficial interest is valid and transfer duty is not payable. Van der Westhuizen (1997 : 76) is of the view that the disposal of interests in a trust holding fixed property and the acquiring of these interests by new beneficiaries and all its implications

remains a grey area of uncertainty. Depending on the circumstances, in some cases liability for transfer duty can occur whilst in other cases not.

4.10.2 Donations tax implications

It has been argued by Olivier (1990 : 235) that the inflow of the purchase price in the trust property takes the place of the sold property. Once the purchase price is distributed, the trust is terminated and the purchaser no longer has a viable trust. If the trust instrument is amended to substitute new trustees and beneficiaries, and the distribution is undertaken thereafter, persons who are no longer beneficiaries will receive the purchase price. This can be done only under a donation.

The South African Revenue Service's view that the disposal of the interest is subject to donations tax, is presumably based on the assumption that as beneficiaries under a trust in the narrow sense, other than a bewind trust, they have no right to the trust property itself, the only right they could dispose of is their personal right against the trustee to manage the trust property. As has been stated in the preceding section, where the beneficiary has a personal right and such a right is ceded or disposed of, the possibility of a donations tax exists. That may be so, because the price paid by the incoming beneficiary reflects the market value of the trust assets. If this value exceeds the value of the personal right against the trustee to manage the trust property, there may be a donation, subject to donations tax at 20%. Based on the decision that was reached in ITC 1545 (1992) 54 SATC 464, if the purchaser can prove that the excess price had not been paid out of sheer liberality or generosity, but was motivated by self-interest, donations tax will not be payable.

In conclusion, if the Commissioner for South African Revenue Service is successful in the test case, it is foreseen that all transactions involving the transfer of trust interest by beneficiaries in a property holding trust will be reopened and transfer duty as well as penalties levied with retrospective effect.

4.10.3 Stamp duty

The sale of an interest of beneficiary in a business trust currently attracts stamp duty which is payable on the deed of cession and amounts to far less than the duty payable on the transfer of shares. However, beneficiaries of the business trust often have their interests evidenced by transferable certificates. The transfer of these certificates may attract stamp duty in the same way as other marketable securities.

4.10.4 Interest on loan raised to acquire beneficial interest

A business trust may, if provided for in the trust instrument, assist financially a new beneficiary to acquire interest of the selling beneficiary of the business trust on the security of the trust assets. In ITC 224 (1931) 65 SATC 156 a company, on the security of its assets, borrowed money and lent it free of interest to new

shareholders for the purpose of facilitating a change of shareholding from one set of persons to another. The court held that the interest was not incurred in the production of income and was, therefore, not deductible. It is submitted that, based on the decision reached in the said case, the business trust would not be able to claim a deduction of interest incurred as indicated above. It is further submitted that if the business trust were to raise a general purpose loan and use a portion thereof to finance the acquisition of interest in the business trust by a new beneficiary, the interest would be deductible as the purpose of the loan and not its ultimate use or destination would be a decisive factor (*Standard Bank of South Africa*). However, Silke (2003 : §7.35) warns that the ultimate use of the money may in certain cases be a relevant factor. Even though the loan to the new beneficiary may bear interest, as long as the interest rate is lower than that being paid by the business trust on the same loan, the interest would not be deductible as it would not be regarded as an expenditure incurred in the production of income or expended or laid out for the purposes of trade, (*ITC 112 (1928) 4 SATC 61*).

4.11 CONCLUSION

The review of literature on business trusts has revealed that not only South Africa has raised concerns on the abuse of such trusts. The study has shown that in Australia a Board of Taxation was commissioned to investigate the possibility of aligning the tax treatment of discretionary trusts, which are widely used for carrying on business in that country, and companies but recommended for the retention of the flow-through principle.

It is submitted that there are no compelling reasons for subjecting business trusts to tax at the corporate tax rate. The Income Tax Act has all the provisions aimed at countering perceived abuse of trusts. It is thus submitted that the current flow-through tax treatment of trading trusts should be retained.

OTHER TAX STATUTES AND BUSINESS TRUSTS

5.1 INTRODUCTION

The Minister of Finance in 2001 stated that Capital Gains Tax (CGT) had been introduced to make tax more equitable, since capital gains are regarded as income and that the absence of CGT could encourage taxpayers to convert taxable income into tax-free capital gains. CGT was incorporated into the Income Tax Act to utilise the existing provisions and procedures of this Act to collect CGT (Cooper, 2001 : 15).

The introduction of CGT in October 2001 has had a profound effect on both conventional and business trusts. The Business Day, 08 December 2001, stated that CGT laws would be punitive for taxpayers who structured their tax affairs for estate planning and the tax rates on capital assets held in family trusts or trading activities conducted through a business trust would be heavy for them.

5.2 EFFECT OF CAPITAL GAINS TAX ON BUSINESS TRUSTS

Capital gains tax applies to all forms of business entity including business trusts. Capital gains tax is triggered when an affected asset is disposed of or (deemed to have been disposed of) and proceeds have been received in respect of that disposal in a particular year of assessment. A disposal with regard to trusts include the vesting of an interest in an asset of a trust to a beneficiary and the decrease in the value of a beneficiary's interest in a trust, known as the value shifting arrangement. To assess the impact of CGT in a business trust, a distinction should be made between 'vesting' and 'discretionary' business trusts. In a vesting business trust, the income and rights to the assets automatically flow through to the beneficiaries, and there is no disposal by the trustee to the beneficiaries on the distribution of assets. Therefore, any disposals for CGT purposes in a vesting business trust will be made by the beneficiaries. In the case of a discretionary business trust, a disposal occurs only when an asset is transferred by the trustee to the beneficiary. Furthermore, a business trust and the beneficiary are connected persons. Any purchase price agreed upon between the parties will be ignored and the market value at the date of the transaction substituted. Should the capital loss arise, this will be retained in the trust and will not pass to the beneficiaries. The tax laws provide for the tax burden to be shifted from a trust to beneficiaries where capital distributions are made at the discretion of trustees (Business Day : 8 December 2001). Accordingly, it is important that a trust deed should not contain any restriction on the distribution of capital gains to beneficiaries lest a capital gain would be taxed in the trust. The Business Day further suggests that when there are no restrictions on the distribution of a capital gain, a capital distribution may be made to the

beneficiaries which is conditional on the capital distribution being retained in the trust on the basis that any future growth of the capital distribution in question accrues to the trust. It is submitted that this arrangement may create financial constraints for the beneficiaries because they will not have received cash.

A trust, like any other non-natural person pays tax on 50% of any capital gain made on disposal of assets. Therefore, should a trust dispose of its asset and realise a capital gain, 50% of the capital gain will be subject to tax at the rate applicable to trusts. From 1 March 2003 trusts, excluding special trusts, are taxed at a flat rate of 40%. This yields an effective tax rate of 20% ($50\% \times 40\%$) compared to that of a company of 15% ($50\% \times 30\%$). It is apparent that holding an asset in a business trust is not tax efficient. As has been mentioned previously, the tax implications of a trust are not the only decisive factor in choosing a trust as a commercial vehicle. There are other compelling factors such as continuity, preservation and limited liability amongst others. The Capital Gains Tax Act has provisions similar to those of the Income Tax Act, namely section 7 and 25B. As the theme of this project is not on Capital Gains Tax, the detailed discussion of Capital Gains Tax Act will not be undertaken in this work. In this work only certain implications of the Capital Gains Tax Act on business trusts will be canvassed. The writer is not aware of any decided cases on capital gains tax involving business trusts. The discussion capital gains tax implications will be limited to the available literature on the subject.

5.3 CAPITAL GAINS TAX – COUNTERING AVOIDANCE USING TRUSTS

5.3.1 Capital gains retained in the trust

Paragraph 70 of the 8th Schedule has provisions similar to section 7(5) of the Income Tax Act. Paragraph 70 contemplates a situation where a capital gain, which is derived by reason of a donation, settlement or other disposition, is retained in the trust. If the beneficiary, who is a resident of South Africa, does not have a vested right in the gain and the gain is not distributed, the donor is taxed on the capital gain. However, if a beneficiary has a vested right in the property disposed of, he is liable for tax on the capital gain realised in the same year that it arises. Huxham (2002 : 628) says “this is beneficial if the resident is an individual as only 25% of the gain is taxed instead of the 50% that would be taxed if the gain was taxed in the trust’s hands. The disadvantage is that where the capital gain has not be distributed to the beneficiary who has a vested interest the beneficiary will have a liability for Capital Gains Tax without actually having received the amount of the capital gain from which to settle the capital gains tax liability. It is submitted that where a trustee has discretion to distribute the capital gain and has not done so, the capital gain is taxable in the hands of the donor if it has been derived by reason of a donation, settlement or other disposition made by the donor.

5.3.2 Capital gains distributed by the trust

Where the founder of the trust has the right to revoke the beneficiary's right to the capital distribution, the founder will be taxed on the capital gain in terms of paragraph 71 if the efficient cause of the capital gain is the donation, settlement or other disposition made by him. This is a tax avoidance provision, which deters the founder from alternating beneficiaries each year by allocating the capital gain to a beneficiary with a higher marginal tax rate to the beneficiary with a lower marginal tax rate. Paragraph 80 provides that where a capital gain made by the trust vests in the beneficiary, the beneficiary is taxed on the capital gain provided that the capital gain is distributed in the same tax year that it arises. A capital gain distributed to a minor child will be deemed to be that of the parent if it has been derived by reason of a donation, settlement or other disposition made by that parent. Interestingly, paragraph 80 provides that if an asset has been distributed to a beneficiary, the capital gain made is not taxed in the hands of the beneficiary. This provision applies equally to companies, if an asset has been distributed to a shareholder and was not subjected to the secondary tax on companies (STC), the shareholder pays capital gains tax again.

5.3.3 Value shifting arrangement

One of the attributes of a business trust proposed by the Margo Commission was the 'transferability of beneficial interest'. Invariably the beneficiaries and their families would be 'connected persons' so that any transfers of interest among them would be at market value and trigger a 'value shifting arrangement'.

In terms of paragraph 1 of the 8th Schedule, the definition of a value shifting arrangement includes a trust. Value shifting means a change in the value of interest held, in this case, in a business trust because of rights or entitlement changes which benefit a connected person. Therefore, value-shifting provides in essence for the shifting of value between connected persons in a way that would otherwise not have been a 'disposal' for capital gains tax purposes and would therefore not have triggered the payment of capital gains tax.

For an arrangement to qualify as a 'value-shifting' arrangement, it must be:

- an arrangement, by which a person retains an interest in a trust, but;
- following a change in the rights or entitlements of the interests in the trust;
- the market value of the interest of that beneficiary decreases;
- and the value of the interest of the connected person, in relation to the beneficiary, held directly or indirectly in that trust increases; or
- a connected person, in relation to the beneficiary, acquires a direct or indirect interest in the trust.

This change in value is treated as a disposal and paragraph 35(2) of the Capital Gains Tax Act, deems the proceeds from a 'disposal' to be the market value of the interest immediately prior to the disposal, less the

market value of that interest immediately after the disposal regardless of whether payment was actually made.

Though not very clear from the legislation, it would appear that the intention of the legislature was that the concept of value-shifting should apply only to persons who are also 'connected' on some other level, for example, relatives and not merely because they are, for example, beneficiaries of the same business trust.

The provisions of paragraph 35(2) are clearly a loophole stopper which prevent avoidance of a capital gains tax liability by placing assets in the business trust in which an individual retains an interest and then selling his interest in the business trust without paying capital gains tax. However, section 35(2) does not address a possible double tax charge which can arise when the underlying trust asset is disposed of.

The possible solution is, perhaps, where an interest in a business trust in which a beneficiary has an interest is disposed of for consideration, the asset to which the interest relates would have to be deemed to have been disposed of and reacquired by the trustees at its market value. Any resulting gains would be chargeable on the beneficiary under the normal provisions.

Pieterse (2002 : 4) submits that the concept of value-shifting will give rise to several pertinent problems in the context of a discretionary business trust. It is yet not clear whether or not a beneficiary of a discretionary business trust has an interest in such a trust. The answer to this problem becomes more important, for example, when one has to evaluate whether 'value-shifting' occurs when a third beneficiary is added to a business trust with two beneficiaries.

The Business Day, dated 27 December 2003, quoted Professor Williams as having said that doubt remains on the CGT implications of adding new beneficiaries to a discretionary trust. Professor Williams further stated that South African Revenue Service would look for a suitable test case in which it would ask the court to rule on whether the addition or removal of trust beneficiaries had resulted in a CGT liability on the basis that a value-shifting arrangement had taken place.

It is imperative that one should consider each and every case on its own facts. The wording of the trust instrument should be carefully considered to determine what the nature of the beneficiaries' rights is and to what extent the concept of value-shifting finds application.

A taxpayer is permitted a deduction of the cost or the interest in the business trust that has been disposed of. The portion of the base cost of the interest disposed of that can be deducted from the proceeds is determined by the following formula:

$$Y = \frac{(A - B)}{A} \times C$$

A

A = market value of the interest prior to disposal

B = market value of the interest after disposal

C = is the base cost of the interest prior to disposal

Y = is the portion of the base cost deductible from the proceeds

In a discretionary business trust, a beneficiary's interest will have a base cost of nil if no trust asset has been vested in that beneficiary. It is submitted that such a situation will apply to a private business trust created by the founder and the beneficiaries have not contributed any capital. A situation could arise where the beneficiaries of a discretionary private business trust acquire for cash interest in that trust. It is difficult to assign a 'value', Professor Williams (Business Day, 27 December 2003), to the interest of a beneficiary of a discretionary business trust or to quantify any capital gains or losses among beneficiaries that occur when a trust deed is amended to remove an existing beneficiary or add a new beneficiary.

5.4 VALUE-ADDED TAX

In terms of the Value Added Tax Act if an inter vivos trust carries on or intends to carry on an enterprise it will be regarded as a vendor. This essentially means that it has to pay over the output tax on the supply of goods and services by it and claim the input tax on goods and services supplied to it. The trustee will be the representative vendor and responsible for all the business trust's obligations in respect of value added tax.

Distributions of cash or shares or any other assets by the business trust, even if it is registered as vendor, to the beneficiaries will not be taxable. On the other hand in terms of section 18(1), value-added tax may be leviable on distributions to a beneficiary of goods normally supplied or manufactured by the business trust in the furtherance of an enterprise. On cessation of carrying on an enterprise, the business trust will be liable for the output tax in that it will be deemed to have supplied its assets forming part of the enterprise prior to the cessation. The consideration will be based on the lesser of the cost to the business trust of the goods or their open market value. This will also apply where goods are supplied to a beneficiary by reason of cessation of an enterprise.

The subsequent disposal of assets will not be subject to value added tax. Where assets of the business trust are distributed in specie to the beneficiaries, there will be no notional input tax or output tax as there will be

no consideration. Alternatively the trustees may dispose of the business trust as a going concern in which case the supply will be zero rated if the purchaser is a registered vendor.

5.5 CONCLUSION

Although the CGT exposure by business trusts is the most punitive, this burden can be alleviated by avoiding unnecessary restrictions in the trust instrument on the distribution of capital from the discretionary business trust. Korten, quoted in the Business Day, 8 December 2003, said this problem could be achieved by making a capital distribution to the beneficiaries conditional on the capital distribution being retained by the trustees on the basis that any future growth of the capital distribution in question accrues to the trust.

It has been shown above that a business trust carrying on business will be regarded as a vendor for value-added tax purposes and all the rules of the Value-added Tax Act will find application.

CONCLUSION AND RECOMMENDATION

It is amazing to see, how, after all these years, the trust is still surrounded by a great deal of uncertainty, but despite this, it has grown into an indispensable tool for protective planning where its popularity overshadows its uncertainty entirely. In recent years it also has become a popular and an important tool for the planning of privately-owned businesses and is indeed the ideal *tertium quid* between the partnership and the close corporation (Van der Westhuizen, 1991 :15).

It would appear that the *Gooricke* and *Pretorius* cases establish that the trading trust is recognized in our law. As such, our law would accord to a large extent with American law where the American Courts have taken the view that a business trust is an unincorporated business organization created by an instrument by which property is to be held and managed by trustees for the benefit of such persons as may be or become the holders of transferable certificates (interest) evidencing the beneficial interests in the trust estate.

Despite any legal problems that may exist as to the precise juristic nature of a trust, these problems have not affected their use for business purposes in practice. The study has shown that the business trust is a 'true trust' and all the rules and principles of trust law find application. Accordingly, it is not an institution *sui generis*. The trust has in practice proved to be very flexible, easy to administer and easily manageable. The ease of adaptation to panoply of uses has led to the growing tendency to use a traditional trust structure as a business vehicle. Despite all the controversies surrounding the business trusts, it is generally accepted that the business trust provides a more valuable form of business enterprise than any other business enterprise. *Wunsh* (1990 : 38) quoted the observation of *Walter Pollak QC* in the 1986 Annual Survey of South African Law: "The trust, the greatest achievement in the field of jurisprudence performed by Englishmen, has long found a welcome home in South Africa. The reasons are not far to seek. As a device for making dispositions of property, it is more flexible a tool than any of our Roman-Dutch instruments. It is not surprising that men of property and their legal advisors have seized upon this device and have put it to many uses".

This work has revealed that the major problem with a trading trust is to get a clear definition of it. Well-known academics and professionals on the subject of business trusts have attempted to suggest a definition of a trading trust but none of these are precise. The obiter by Judge Stanley in the case of *Re Stanley* (Cilliers and Benade, : 4) sums up the problem. The learned Judge concluded as follows:

"...thus we find no single criterion which could be designated as being in any sense typical of the corporate existence....If the state declares something to be a corporation, no matter how few rights it may attribute to it, this something will undoubtedly become a corporation".

The Judge continued as follows:

"Thus to give a correct definition of the corporation is an impossible task. The word stands for no single well-ascertained concept, but is, on the contrary, a mere name given to groups which in themselves have nothing in common. The more vaguely we word our definition, the more types of corporations we can bring under it, yet the more of those legal entities which are not recognised as corporations we will have to admit. The stricter our definition, the fewer of these unwanted entities shall we include, but the less will it be applicable to all our corporate formations. Corporation means anything to which the term is applied by common usage; no more adequate definition has been offered as yet for this word, and nobody will ever be able to propose one".

In USA the Courts have held that, where trustees were subject to the control of the beneficiaries either directly or indirectly, the beneficiaries were liable for the debts of the trusts on the basis that the trusts constituted partnerships or on the basis that the trustees were their agents. The question is, can a similar progression take place in South Africa? There is no doubt that there is concern about the use of business trusts as business vehicles. These concerns were clearly emphasised in a statement by the Standing Committee on Company Law, which was published in February 1985. The Committee had this to say:

"The dangers ... are clear. In effect, limited liability in a business venture is obtained without the essential protection for creditors – maintenance of capital in company law, and solvency and liquidity in close corporation law. Unwary trust 'beneficiaries' may also be seriously prejudiced by the lack of clear rules for their protection".

The Trust Property Control Act does not deal with legal issues affecting trusts. In the light of this statement and the perceived abuse of business trusts, it is submitted that the business trust should be subjected to limited statutory control. In the interest of third parties contracting with business trusts, the doctrine of disclosure should be made mandatory so as to protect such third parties. The laying of the trust instrument for inspection by interested parties and the preparation of audited financial statements will undoubtedly give credence to the business trust and enhance its reputation as an alternative business vehicle.

The South African Legislation has, generally, not been all that innovative in the past with regard to tax law and has tended, where possible, to follow tried and tested developments in other countries. As the USA gave birth to the trading trust in its original form, it is likely that developments in that country will be accorded more than passing interest.

The business trust is akin to a partnership and yet the Margo Commission failed to consider this fact when it proposed that the business trust should be taxed in the same manner as a company. The writer submits that any proposal for fundamental change to the taxation treatment of business trusts must be justified by compelling policy before it could be supported. The writer is of the view that the efficiency and equity of the tax system would not necessarily be improved by aligning the tax treatment of business trusts and companies. Structural differences would remain in the taxation of entity income, and in the taxation of income through an entity and income earned directly.

In view of the above statement, the writer submits that that there are no compelling arguments for broad based reform to more closely align the tax treatment of business trusts and companies and the legislature should retain the current 'conduit-pipe' treatment of distributions by business trusts. Further in light of the implementation of trust integrity measures over several years, concern about the abuse of business trusts for tax planning does not of itself warrant fundamental changes to the tax treatment of business trusts.

It submitted that if the South African law of business trusts develops in the same manner as in Australia, many of the advantages of the business trust would be preserved, specifically the conduit-pipe principle and income-splitting. The Australian Tax Authorities exercised good judgement by abiding by the recommendations of the Board of Taxation and abandoning the idea of aligning the tax treatment of business trusts and companies because the proposed tax treatment would not have reduced abuse of such trusts and prevented income-splitting. However, if the developments follow that of the USA the advantages will be substantially affected, and, in some cases disappear altogether. That this is so, it has been shown in the study that in the USA business trusts may either be taxed as companies or partnerships. The business trust will be classified as a partnership if the trustees are subject to control of the beneficiaries. Therefore, such possibilities must be borne in mind when making the choice as to which business vehicle to use.

With all the concerns surrounding the business trust, it appears that such trusts are far more likely to receive extensive legislative attention in the future than are other forms of business entities. Therefore, a trust as a business venture should not take precedence over any other form of business enterprise because of the current advantage to split trust income amongst beneficiaries, but should be selected for its core qualities

such as limited liability, continuity, conservation and protection of business for the benefit of the beneficiaries.

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