

**THE TAXATION OF TRUSTS:
AN ANALYSIS OF S 25B AND THE ANTI-AVOIDANCE PROVISIONS
CONTAINED IN S 7 OF THE INCOME TAX ACT NO. 58 OF 1962**

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Being a technical report submitted by

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ABSTRACT

This dissertation analyses the legislation enacted in the Income Tax Act to counter taxpayers' use of trusts as a means of minimising their exposure to normal tax.

The legal nature and classification of trusts and the evolution of their use in South Africa are examined. Thereafter, an in-depth analyses of anti-avoidance provisions contained in the Income Tax Act is undertaken.

The pertinent sections are as follows:

- Section 25B
- Sections 7(3), 7(4), 7(5), 7(6) and 7(7)

Section 25B apportions income to beneficiaries with a vested interest therein, and the balance to the trust. Section 25B is made subject to section 7, which is aimed at circumventing taxpayers' attempts to reduce their taxable income by divesting themselves of income-earning assets, while still retaining control thereof, through the use of trusts.

DECLARATION

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



ARNO GOEBEL

15 March 1999

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CHAPTER 1

INTRODUCTION

The use of trusts is widespread in South Africa and has come under the scrutiny of various commissions of inquiry, of which the Katz Commission is the most recent. Trusts are perceived as tools by which taxpayers can effectively shelter their wealth from the Commissioner for South African Revenue Services (the Commissioner). Amendments to legislation have been enacted by the legislature, upon the advice of the above-mentioned commissions, to curb this perceived usage of trusts as vehicles to avoid taxes.

This report focuses on an analysis of the legislation enacted in the Income Tax Act (the Act) to counter taxpayers' endeavours to use trusts to minimise their exposure to these taxes.

Before a detailed analysis of the effects of various taxes upon the use and effectiveness of trusts can be undertaken, the legal nature and classification of trusts need to be made clear.

The second chapter of this report looks at the development of trusts and the evolution of their use through common law and legal interpretation. As long ago as 1952, R Hahlo wrote,¹

‘when it comes to trusts in our law, even the most elementary propositions cannot be regarded as settled...’.

As will be illustrated below, the use of trusts is still surrounded by uncertainty, but South African courts have come a long way in defining the use of trusts and evolving unique trust law that is a mixture of English, Roman-Dutch and distinctively South African rules.

¹ R Hahlo, 1952 (69) SALJ at 349.

In the third chapter, an in-depth analysis of certain provisions contained in the Act which make it their purpose to curb certain abuses by taxpayers through the use of trusts is undertaken.

Section 7 of the Act contains anti-avoidance legislation aimed at circumventing methods whereby taxpayers attempt to divest themselves of income-earning assets, but still retain control thereof, an effect being the avoidance of income accruing in the taxpayer's hands. Under these circumstances, the income is taxed either in the hands of the trustees as representative taxpayers, or in the hands of the beneficiaries of the trust, who are usually in a lower tax bracket than the taxpayer, resulting in a reduction of taxes paid by the taxpayer.

The starting point for an analysis of the provisions contained in s 7 will be s 25B, which is made subject to s 7.

In essence, s 25B apportions income to beneficiaries with a vested interest therein, and the balance to the trust.

Thereafter, the chapter addresses itself in turn to each of the relevant sub-sections of s 7.

Chapter 4 concludes the dissertation.

CHAPTER 2

CLASSIFICATION AND LEGAL NATURE OF TRUSTS

The legal development of trusts in South Africa spans a period of 150 years, with the earliest reported case in 1833.² The trust was a legal institution not known to Roman or Roman-Dutch Law, and was brought to South Africa in the Nineteenth Century by the British Settlers in the Cape and Natal. These settlers were first to use the word 'trust' in their wills, their antenuptial contracts, and their transfers of land. This use of trusts went on for approximately a century before the courts were called upon to decide authoritatively on the concept of trusts, whether or not it formed part of South African law, and if so, on what basis.

The first landmark case was *Estate Kemp v McDonald's Trustee*.³ This case came before the Appellate Division of the Supreme Court (now the Supreme Court of Appeal) from the Cape Provincial Division,⁴ where Jutta JP had delivered the judgment.

What emerged from the judgment in the Appellate Division and from Jutta JP was,

- in the first place, that the English law of trusts had no place in South African jurisprudence and had not been adopted by South African courts, and
- secondly, that a Trust set up in terms of a Will should be given legal effect and accordingly accommodated in South African law.

As Solomon JA stated,⁵

‘the constitution of trusts and the appointment of Trustees are matters of common occurrence in South Africa at the present day. Thus it is recognised practice to convey property to Trustees under an antenuptial contract; trustees are appointed by deed of gift or by will to hold and administer property for charitable or ecclesiastical or other public purposes; the property of limited companies and other corporate bodies is vested in trustees

² *Twentyman v Hewitt* (1833) Menz 156.

³ 1915 AD 494.

⁴ 1914 CPD 1084.

⁵ 1915 AD 494 at 507–8.

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

The difficulty facing the court was to find a proper place for trusts in our legal system.

Both Innes CJ and Maasdorp AJ attempted to classify the trust using the concept of fideicommissum, but drew criticism from academic writers.

Honoré⁶ states that the temptation to identify trusts with fideicommissa arose from a search in South Africa to find a way to enforce the institution of trusts where no basis existed in common law or statute to accommodate the concept.

The case of *Braun v Blann & Botha*⁷ has now settled the issue in the sense that the two are not to be identified.

Chief Justice Corbett commented that the decision in *Kemp*’s case,⁸

‘constituted, in the realm of testamentary trusts, a form of jurisprudential osmosis; but osmosis on a selective basis, absorbing so much of the English Law as was considered to be desirable and appropriate, having regard to the general principles of our common law’.

Corbett CJ went on to comment on how Roman-Dutch law is capable of sustaining development in new directions and adapting to the needs of society. This is readily illustrated by the way in which South African law has created a niche for trust law, and demonstrates the advantages of a legal system based on a common law rooted in general principle, which avoids the unnecessary ‘rigidity of codification’.

⁶ *Honoré’s South African Law of Trusts* at 42.

⁷ 1984 (2) SA 850 (A).

⁸ MM Corbett CJ, 1993 (56) THRHR at 264.

The next judicial landmarks concerning the legal nature of inter vivos trusts are contained in the following three cases, namely, *CIR v Estate Crew*,⁹ *CIR v Smollan's Estate*,¹⁰ and *Crookes v Watson*.¹¹

In both *CIR v Estate Crew* and *CIR v Smollan's Estate*, the court was forced to deal with the nature of a trust and the rights of the parties to a trust deed. In both cases the court treated the trust as a contract for the benefit of a third party, namely a stipulatio alteri.

As in *Kemp's* case the court held that the English law of trusts had no part to play in South African law, and that the law of contract could govern the application of trust law in South Africa.

Corbett CJ comments that in these judgments there is a general conviction that legal policy requires the recognition of trusts inter vivos in South African law.¹²

On the issue of resorting to the law of contract to solve the problems presented by trusts, Honoré refers to the judgment in *Estate Crew*¹³ where Watermeyer CJ states,

‘there is no reason why the problems presented by trusts in our law should not be solved by the application of the principles of our law of contract,’

and suggests that Watermeyer CJ must be taken to refer to problems concerning the revocation and formation of trusts inter vivos and the rights of beneficiaries, and not to the administration of trusts and the supervisory role of the Master of the High Court and the South African Courts.

Honoré cautions that trusts inter vivos are not a species of contract, since a contract is not a public law institution.¹⁴ South African courts have consistently resisted the

⁹ 1943 AD 656, 12 SATC 344.

¹⁰ 1955 (3) SA 266 (A), 20 SATC 155.

¹¹ 1956 (1) SA 277 (A).

¹² MM Corbett CJ, 1993 (56) THRHR at 264.

¹³ 1943 AD 656, 12 SATC 344.

¹⁴ Honoré's *South African Law of Trusts* at 26.

temptation to assume the role of guardians over contracting parties, which is the case with trusts in South African law.

A contract for the benefit of a third party can, in general, be revoked or varied by agreement between the contracting parties, prior to the beneficiary accepting any benefit thereto. This would not be consistent with the English law of trusts, where the rule is that a trust which has been constituted is not revocable or may not be varied, unless a clause in the trust deed makes provision for its cancellation or variation.

It further appears that a trust may come into existence even without the communication thereof to the trustee or the beneficiary. It is therefore apparent that the English law of trusts has no bearing on or resemblance to the South African law of trusts.

In the case of *Crookes v Watson*,¹⁵ the issue of revocability or variability of a trust deed arose. The donor donated a portfolio of shares to a trust consisting of two trustees, one of which was the donor. The sole income beneficiary was the donor's daughter, who was to receive a portion of the trust income. The remaining income was to be retained in trust and capitalised. The capital was to be distributed to certain capital beneficiaries upon the death of donor's daughter. The capital beneficiaries could only be determined when the income beneficiary died. In terms of the trust deed the donor was given the power to remove a trustee from office and appoint another trustee. Twenty years after the creation of the trust, the donor wished to make a capital payment to his daughter as well as increase the income she was to receive from the trust. It was quite clear that these amendments to the trust deed would adversely affect the ultimate beneficiaries.

The matter came before the courts for a declaratory order declaring that the amendments to the trust deed were legally acceptable in South African law. A number of the major interested parties consented to the amendments and also consented on behalf of their minor children, who were also beneficiaries. There were, however, parties who could not consent, including unborn issue.

¹⁵ 1956 (1) SA 277 (A).

Centlivres CJ summarised the immediate issue in the case, which was whether, in South African law,¹⁶

‘a [donor], having executed a trust deed and having handed over the subject matter of the trust to the two trustees appointed in terms of the deed, one of whom is himself and the other of whom holds his office during the pleasure of the [donor], is entitled to amend the deed with the concurrence of his co-trustee and of the only beneficiary who has accepted any benefit under the deed, if the result of such an amendment will be to prejudice the rights of other beneficiaries who have not notified their acceptance of any benefit and who have not agreed to the amendment...’.

In considering this issue, the court was again forced to ponder the juristic nature of a trust inter vivos in South African law. In coming to a decision the court was divided, with the majority, consisting of Centlivres CJ, Van Den Heever JA, and Steyn JA, holding that a trust constituted an agreement between the donor and the trustee(s) for the benefit of a third party (*stipulatio alteri*), and that this agreement could be varied or revoked by agreement between donor and trustee(s) prior to any beneficiary notifying his acceptance of any benefit from the trust. The declaratory order was therefore granted in favour of the amendments the donor wished to make.

The minority view by Schreiner JA and Fagan JA on the other hand was not in favour of drawing a comparison between a contract for the benefit of a third party and a trust. Schreiner JA stated,¹⁷

‘our modern law of trusts should not be unduly hampered by views regarding its association with other branches of our own law which may not be historically justified and which, in any event, should not govern, though they may sometimes assist the development of the law of trusts’.

And later he stated the following:¹⁸

‘Care must be exercised not to force a legal instrument of great potential efficiency and usefulness into a mould that is not properly shaped for it.’

¹⁶ *Supra* at 284B–C.

¹⁷ *Supra* at 290D.

¹⁸ *Supra* at 291A.

The minority judgment voiced concerns over the comparison of the trust with the contract for the benefit of a third person, allowing the donor and the trustee(s) to vary or revoke the agreement prior to acceptance by the beneficiary.

These judgments are now history as it is generally accepted that a trust *inter vivos* is analogous to the *stipulatio alteri*. As mentioned above, however, Honoré makes the point that although trusts are not a species of contract, the reference to the *stipulatio alteri* and the law of contract is useful when considering the variability or revocability of the trust *inter vivos* prior to the beneficiary or beneficiaries of the trust accepting any benefit which the trust may confer upon them.

It must also be noted that a trust is a public-law institution over which the courts and the Master of the High Court have certain powers of control, which distinguish the trust from normal contracts.¹⁹

In the case of *CIR v Estate Merensky*,²⁰ the question of revocability was taken a step further. Here the court held that a donor may not unilaterally revoke a trust *inter vivos* prior to the acceptance by the beneficiaries. This case is, however, confined to the situation where the donor's donation is stated in the trust deed as being irrevocable. It therefore seems to apply only to the situation where the donation is expressly or implicitly stated to be irrevocable.²¹

Corbett CJ sounds a warning that a trustee will not always be free to agree with the donor to cancel the trust even in the absence of a clause stating that the donation is irrevocable. Honoré submits the following:²²

‘A trustee holds an office and is not merely party to a contract with the founder. In principle therefore, in the absence of an express provision in the trust instrument, he is entitled to agree to revocation or variation only if he thinks that to do so is in the interests both of the founder and of the actual or potential beneficiaries.’

¹⁹ Honoré's *South African Law of Trusts* at 25–6.

²⁰ 1959 2 SA 600 (A), 22 SATC 343.

²¹ MM Corbett CJ, 1993 (56) THRHR at 266.

²² Honoré's *South African Law of Trusts* at 417.

The above landmark cases assimilated into South African law the two main categories of trust,

- the inter vivos trust, and
- the testamentary trust.

South African courts had achieved a broad outline of the principles applying to the trust, however, many issues remained unresolved.

An example of this is the legal relationship between the trustee and the trust property committed to his administration. This issue is of particular importance in the event of the trustee becoming insolvent.

- Does the trust property fall into the trustee's insolvent estate, leaving the beneficiaries with a mere concurrent claim against that estate?
- Does the trust constitute a juristic person?
- When do the trust benefits vest in the beneficiaries?
- What are the powers of the court to vary and administer trusts?

These are some of the questions still unresolved in the South African law of trusts.

Over the years, some of these issues were dealt with in judicial decisions, but it was felt that legislation was required to resolve certain intractable problems.

The whole matter was referred to the South African Law Commission, which produced a working paper in April 1993. This working paper identified and discussed the problems and set up a draft bill for comment. As a result Parliament passed the Trust Property Control Act 57 of 1988, which largely adopted the recommendations of the South African Law Commission.

The Trust Property Control Act was the next major landmark in the development of trust law in South Africa and was generally well received. Honoré states the following:²³

‘The 1988 Act, the drafting of which deserves high praise, rightly makes no attempt to codify the South African law of trusts. Instead it contributes to its development as a distinctive body of trust law by settling certain important issues which were in dispute.’

It is to be mentioned that the Trust Property Control Act was not the first piece of legislation concerning trusts.

The earlier legislation included the Trust Money Protection Act of 1934 and Chapter III of the Administration of Estates Act of 1965. Both of these were repealed by the Trust Property Control Act.

The Trust Property Control Act is mainly devoted to creating firmer control over trustees and making them answerable to the Master of the High Court. This is done by, amongst other requirements,

- obliging the trustee to lodge the trust deed with the Master;
- the provision by the trustee of addresses for all service of documents; and
- the stipulation that the trustee may only act in his capacity as trustee once the Master has issued letters of authority.

One of the most important provisions in the Trust Property Control Act is s 12, which provides the following:

‘Trust property shall not form part of the personal estate of the trustee except in so far as he as trust beneficiary is entitled to the trust property.’

²³ *Supra* preface to the fourth edition.

Another important provision of the Trust Property Control Act is s 13, which empowers the courts to vary the provisions of a trust deed as well as order the termination of a trust.

Section 9(1) of the Act deals with the standard of care and diligence required of a trustee in the performance of his duties as a trustee. The Act defines a trustee's duties as

‘that which can reasonably be expected of a person who manages the affairs of another’.

Section 9(2) goes on to render void any provision in a trust deed which has the effect of indemnifying the trustee for any loss suffered by the trust due to a trustee's failure to exercise due care, diligence and skill.

One aspect of the trust which was not dealt with in the Trust Property Control Act was the question of the legal personality of the trust. At common law, the trust has no legal personality. Legal personality can only notionally be granted by means of statute. Thus in the Income Tax Act the definition of a ‘person’ was expanded to include any trust. This amendment was effected as a direct result of the *Phillip Frame Will Trust*.²⁴

In applying basic principles South African courts have slowly evolved a jurisprudential niche for the law of trusts. In achieving this, the courts have drawn from other legal systems, Roman-Dutch principles, and where this has proven inadequate, recourse has been had to legislation. On the whole, trust law has been left to develop relatively unfettered by legislative enactment. The introduction of the Trust Property Control Act was welcomed, in that it merely clarified certain issues which the courts had been unable to settle.

Today, the trust is still popular, and its uses multifarious. An aspect of the trust which contributes to its wide use is its adaptability to changing circumstances, and new applications for the trust are constantly being devised.

²⁴ 1991 (2) SA 340 (W), 53 SATC 166; and on appeal as 55 SATC 39..

In the following chapters, an in depth analysis of s 25B and the anti-avoidance provisions contained in s 7 of the Income Tax Act is carried out. These provisions are examples of legislation, other than the Trust Property Control Act, which have as their purpose the regulation of the use of trusts in avoiding normal tax.

It should, however, be pointed out that these are not the only pieces of legislation which regulate the use of trusts in avoiding taxes. Examples of other legislation would be

- the provisions contained in the Income Tax Act concerning the levy of donations tax, and
- s 3(2)(a) and s 3(3)(a) of the Estate Duty Act.

Donations tax and estate duty are, however, beyond the scope of this report.

CHAPTER 3

TRUSTS AND INCOME TAX

Since the legal ownership of assets in a trust vests in the trustee or trustees,²⁵ the question to be asked is, in whose hands is the income generated by these assets taxed?

Generally, it can be said that the taxation of trust income depends on three factors, namely

- the principle relating to accrual,
- the conduit pipe principle, and
- certain provisions in the Act which govern deemed income.

Depending on these factors, trust income can be taxed in the hands

- of the beneficiary, or
- the trustees in their representative capacity, or
- the person who made the donation, settlement or other disposition which created the source from which the trust income is derived.²⁶

Certain definitions in the Income Tax Act and the meaning of accrual in the context of normal tax are first considered, and thereafter the conduit pipe principle, s 25B and s 7 of the Act are considered.

Definitions

The definition of a 'person' in the Act was amended to read as follows:²⁷

²⁵ Excluding a 'Bewind' Trust.

²⁶ PA Olivier, *Trust Law and Practice* at 164–165.

²⁷ Section 1 of the Income Tax Act.

“‘person’ includes the estate of a deceased person and 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 Act also defines a ‘trustee’ as,²⁸

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

The trustee is made the ‘representative taxpayer’ in terms of the definition of a ‘representative taxpayer’ in s 1 of the Act. The definition of a ‘person’ in the Act includes a trust and a ‘trust’ is defined as,²⁹

‘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.’

Although the trustee is made the representative taxpayer in respect of the income generated by a trust, he is not necessarily the person to be assessed to tax. Assessments may be raised on the trust or the trust’s beneficiaries in certain circumstances depending on the provisions of s 25B, which is dealt with later.

Conduit Pipe Principle

When an amount passes through the hands of several taxpayers, the ordinary principle is that its character is assessed afresh in the hands of each taxpayer.

So, for example, if A is bequeathed a lump sum of R50 000 and this is used to pay B for services rendered to A, the R50 000, which is capital in the hands of A and thus

²⁸ *Supra.*

²⁹ *Supra.*

non-taxable, is fully taxable in the hands of B, as B receives it as revenue for services he has rendered to A.

In a trust, this principle is turned on its head, and income is held to retain its identity as it passes through the trust on route to the beneficiary.³⁰ Thus

- capital remains capital,
- dividends remain dividends, and
- interest remains interest.

The result is that a beneficiary can claim the exemptions attaching to income of that nature. For example, if the trust beneficiary receives dividends from companies, then the beneficiary is entitled to the dividend exemption contained in s 10(1)(k)(i).

The case of *Armstrong v CIR*³¹ was the first to establish the conduit pipe principle.

In this case the taxpayer was, in terms of the will of her late husband, entitled to receive, for her life, the whole of the net income from her late husband's estate. By family arrangement, the taxpayer's interest was vested in a trust. The court held that the dividends received by the taxpayer from the trust retained their identity. The receipt by the trustee, as representative taxpayer, of the dividends, did not cause the amount received to lose its character. The trustee was held to be a mere conduit pipe.

In the case of *SIR v Rosen*³² the court made it clear that income paid by means of an annuity or by any other means to a beneficiary retains its identity so long as it accrues to the beneficiary in the same year of assessment as it accrues to the trust. Trolip JA, who delivered the majority judgment said the following in this regard:³³

³⁰ *Armstrong v CIR* 1938 AD 343, 10 SATC 1.

³¹ *Supra*.

³² 1971 (1) SA 173 (A), 32 SATC 249.

³³ At SATC 269 – 70.

‘It suffices to say that the trust deed may itself entitle or oblige the trustee to administer the dividends in such a way that he is not a mere conduit pipe for passing them on to the beneficiary, that in his hands their source as dividends can no longer be identified or they otherwise lose their character and identity as dividends, and that the beneficiary is thus entitled to receive mere trust income in contradistinction to the benefit of the dividend rights in terms of the above crucial phrase.³⁴ Thus, a trust deed may endow the trustee with a discretion to pass on dividends to the beneficiary or to retain and accumulate them. If he decides on the latter, I think that the dividends might then lose their identity and character as dividends, so that, if they are subsequently paid out to the beneficiary, they might possibly no longer be dividends in his hands, for the conduit pipe had turned itself off at the relevant time. But if he decides on the former, i.e. to pass the dividends on to the beneficiary, the condition suspending the beneficiary’s entitlement thereto is fulfilled, and they would constitute dividends in his hands in the same way as if he had been originally entitled to them unconditionally under the trust deed.’

The decision in *Rosen*’s case has been nullified to the extent of the introduction of s 19(6) which provides that dividends distributed to a beneficiary in the form of an annuity lose their identity and accordingly do not enjoy the exemption provided in the Act.

Rosen’s case is important in that the court expressed the view that if trust income is retained and accumulated in the trust and only paid out to the beneficiaries in the following year of assessment then it may lose its character since it has already been taxed in the hands of the trustee.³⁵ This would not pose a tax problem in the hands of the beneficiary since the trustees may elect to make capital distributions to beneficiaries of income which has been capitalised in previous years of assessment. This obviously assumes that the trust deed makes provision for trustees to elect to make capital distributions to beneficiaries. In the case of *Estate Dempers v SIR*³⁶ Corbett JA said the following:

‘The fact that the trust deed speaks of such accumulated income being capitalised and added to the trust fund cannot alter its essential character, in the eye of the income tax law, of being “income”.’

³⁴ [E]ntitled to all or part of the benefit of the rights of participation in the profits or income attaching to the shares.

³⁵ *Silke on South African Income Tax* in § 12.16.

³⁶ 1977 (3) SA 410 (A), 39 SATC 95 at 110.

In this case the taxpayer had formed a number of discretionary trusts which provided, amongst other things, that it was a matter for the trustees' discretion how much of the trusts' annual income to pay to any beneficiary, that the trustees were entitled to accumulate the income and that any income not paid out in any year of assessment would be capitalised.

The dictum in this case suggests a contrary view to that expressed in *Rosen's* case, namely that if income is accumulated in trust and later paid out to beneficiaries, it will still retain its nature as income. The implication is that the conduit principle applies even where the trustees have elected to accumulate the income and thereby change its nature to capital. The court, however, did not express a view on whether the income would retain its character if distributed in a later year of assessment.

As discussed above, *Rosen's* case did express the view that the income might lose its character and be regarded as a distribution of capital in the hands of the beneficiary. This seems correct especially since the income has already been taxed in the hands of the trustees and thereafter accumulated to form part of the trust capital.

Meyerowitz is quite emphatic that it does not remain income and states that,³⁷

‘[i]ncome which accrues during a year of assessment and is taxable in the hands of the trust does not become taxable in the hands of the beneficiaries when later distributed in terms of the trust instrument. Once the income has been deemed to be that of the trust, it is deemed for all times and there is no room for a finding that subsequently it accrued to the beneficiaries as income.’

There are also further exceptions to the rule that trust income retains its identity.

Where the income derived by a trust is in the form of dividends or interest on government stocks, and the trustee pays out to the beneficiary in the form of an annuity, the Act overrides the conduit pipe principle and does not allow the annuity to retain the original character of the income derived by the trust. This provision is contained in s 10(2)(b) of the Act, which excludes the operation of the exemptions

³⁷ *Meyerowitz on Income Tax* 1998-1999 at in § 16.139.

granted under s 10(1)(h) and s 10(1)(k) in relation to dividends, and interest on government stocks, on any portion of an annuity. Hence an annuity paid to a beneficiary, who is not ordinarily resident nor carrying on business in the Republic, out of trust income consisting of dividends or interest on government stocks is not exempt from tax, under the provisions of s 10(1)(h), but it may, however, still be exempt under the provisions of s 10(1)(hA) provided the requirements of this particular exemption are met.

It is to be noted that s 10(2)(b) makes no reference to the exemptions under s 10(1)(i). It follows that, to the extent to which an annuity has been paid out of trust income, which is covered by the exemptions contained in s 10(1)(i), the application of s 10(2)(b) should not apply, and the income so covered should enjoy the exemption.³⁸

Section 25B

In *Philip Frame Will Trust*,³⁹ the court held that a trust had no legal persona either at common law or under the Act. Furthermore, the trustee was not a representative taxpayer since he did not represent a person.

This decision undermined conventional wisdom, which had accepted that income derived by a trust and not distributed by the trustees was taxed in the hands of the trustee as the representative taxpayer, subject to the provisions of s 7.

This meant that income earned by a trust, which was not subject to s 7, could not be taxed as it had not been received by or accrued to a person as defined.

Section 25B was enacted to close this loophole.

This section, which was brought into effect from the year of assessment commencing on the 1 March 1986, extended the definition of a 'person' to include a 'trust fund'. The definition of 'person' was subsequently also amended to include 'any trust'.

Section 25B(1) states that any

³⁸ *Silke on South African Income Tax* in § 12.17.

³⁹ 1991 (2) SA 340 (W); affirmed by the Appellate Division (1993) 55 SATC 39.

‘[i]ncome received by or accrued to or in favour of any person in his capacity as the trustee of a trust referred to in the definition of ‘person’ in s 1, shall, subject to the provisions of s 7, to the extent to which such income has been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, be deemed to be income which has accrued to such beneficiary, and to the extent to which such income is not so derived, be deemed to be income which has accrued to such trust’.

This section is referred to as the deemed-income rule, and made subject to the provisions of s 7.⁴⁰ It is important to note that trust income cannot accrue to a beneficiary whose right thereto is merely conditional or contingent,⁴¹ or where the beneficiary’s interest in the income is based on a spes. This principle was established in *Lategan v CIR*,⁴² which confirmed that ‘accrued’ means ‘entitled to’.⁴³

Therefore, if the beneficiary’s right is merely contingent and does not vest in him, then the income cannot be said to accrue to him. The distinction between a vested right and a contingent right was held to be as follows:⁴⁴

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

Furthermore, the fact that trust assets may grow or diminish does not make the beneficiary’s right conditional.⁴⁵ Nor does the postponement of payment to a beneficiary make the beneficiary’s right conditional or uncertain.⁴⁶

⁴⁰ *Silke on South African Income Tax* in § 12.14A.

⁴¹ The word conditional being used in its legal sense as referring to entitlement.

⁴² 1926 CPD 203, 2 SATC 16.

⁴³ This decision was later confirmed in *CIR v People’s Stores (Walvis Bay) (Pty) Ltd*, 1990 (2) SA 353 (A), 52 SATC 9.

⁴⁴ ITC 76 (1927) 3 SATC 68 at 70.

⁴⁵ *Hilda Holt Trust v CIR* 1992 (4) 661 (A), 55 SATC 1 at 8–9.

⁴⁶ RC Williams, *Income Tax in South Africa: Law & Practice* at 411.

The deemed-income rule does no more than codify the application of the principles of accrual to income flowing to and through a trust.⁴⁷ Although at times it may be difficult to establish whether the income is to be taxed in the hands of the trust or in the hands of the beneficiary, the wording of s 25B as well as the case law supports the generalisation that,⁴⁸

‘when ... the income that is the subject of a trust is received by or accrues to a trustee in his representative capacity and, at the time of the receipt or accrual, he is legally obliged to pay it over or some part of it to or to accumulate or expend the income or some part of it for the benefit of any person specified in the trust deed as the beneficiary of the income, the income, to the extent to which the trustee is so legally obliged to apply it, will be regarded as the income of that beneficiary’.

Section 25B(2) contains the discretionary-income rule, and states the following:

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

Section 25B(2) comes into play where a trustee is given a discretion to distribute income to a beneficiary in terms of the trust instrument. It deems the income to have been derived for the benefit of the beneficiary where the trustee exercises his discretion and makes a distribution to the beneficiary.

By exercising his discretion, the trustee causes the income to vest in the beneficiary and thus to be taxable in the beneficiary’s hands. Vesting may take the form of an actual distribution to the beneficiary or by crediting the beneficiary’s account in the trust and withholding actual payment till a later date. The vesting of a right must be indefeasible and must be capable of cession (if permitted to do so in terms of the trust deed) or must constitute a claim in favour of his estate upon his death.⁴⁹

⁴⁷ *Silke on South African Income Tax* in § 12.15.

⁴⁸ *Supra* at 12.15.

⁴⁹ *Meyerowitz on Income Tax* 1998/1999 at § 16.136.

A word of caution must be made at this point, concerning trustees who have been granted a discretion to use income for a specific purpose on behalf of beneficiaries. In ITC 1096,⁵⁰ the trust deed empowered the trustee to use his discretion in applying the income of the trust for the maintenance and general wellbeing of the beneficiaries. The trustee in this instance used his own funds to provide for the beneficiaries, and merely credited income to the beneficiaries in the financial accounts of the trust.

The Special Court for Hearing Income Tax Appeals held

- that the full income of the trust did not vest in the beneficiaries;
- that the trust deed did not provide that the trust was a mere conduit for trust income into the hands of the beneficiaries;
- that the trustee had a discretion and was not bound to apply the income for the intended purpose;
- that the trust deed provided that surplus income would accrue to the trust; and
- that the crediting of income in favour of the beneficiaries in the financial accounts did not constitute vesting of income in the hands of the beneficiaries.

Accordingly the trust was assessed to tax for the income so accumulated on behalf of the beneficiaries.

This case illustrates that a trustee who has discretion to distribute income for a specified purpose will not cause a vesting of income in favour of beneficiaries where he does not cause the income to be used for the specified purpose. *Silke*⁵¹ submits that s 25B does not alter this position.

Section 25B(3) contains the so-called deemed-expenditure rule. This sub-section attempts to clarify the position concerning the deduction of expenditure in

⁵⁰ (1966) 28 SATC 287.

⁵¹ *Silke on South African Income Tax* in § 12.15.

- the trust's hands,
- the beneficiary's hands, or
- both.

The section states as follows:

‘Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any income referred to in subsection (1) shall, to the extent to which such income is under the provisions of that subsection deemed to be income which has accrued to a beneficiary or to the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by such beneficiary or trust, as the case may be.’

It seems to follow logically that should income vest in a beneficiary then the expense attendant to the income should also be allowed against the income in determining the taxable portion of the income.

The problem in applying s 25B(3) is the meaning of ‘income’ in the section.

It is clear that ‘income’ in s 25B does not mean ‘taxable income’, for if it did then s 25B(3) would be unnecessary.

But does it mean

- ‘gross income’, or
- gross income less exempt income, namely, ‘income’?

If the context does not require a departure from the definition of ‘income’, then the trust itself must be looked at to determine whether or not certain income received or accrued to the trust is exempt in the hands of the beneficiaries in which the income will ultimately vest.

Thus, for example, if the trust is held to be ordinarily resident in the Republic then the exemption provided for in s 10(1)(hA) (which exempts non-residents from tax on interest income) will not be available to a beneficiary should the beneficiary be a non-resident. Since s 25B leaves intact the conduit pipe principle, it would seem that ‘income’ in this section is not used in its definition meaning, but in the sense of ‘gross income’.⁵² Accordingly, the above example would not result in the exemption being denied since the income vesting in the beneficiaries would be ‘gross income’ and the nature of income would be determined by reference to the beneficiaries and not the trust.

On the same principle, the exemption offered by s 10(1)(k)(i) on dividends will also be available to a beneficiary who has a vested interest in the trust’s income. The dividends retain their identity and the beneficiary is accordingly entitled to the exemption provided.

Where dividends are exempt from tax the expenses incurred in producing these dividends are not deductible, since the expenditure will not be incurred in relation to ‘income’ and will therefore not fulfill the requirements in s 11(a).

Section 19(1), deals with the deductibility of non-exempt dividends and expressly states that s 11(a), s 11(b), s 11(i) and s 11 (j) and s 20 are, subject to the provisions contained in s 19(2), applicable to non-exempt dividends. This is provided the beneficiary satisfies the ‘trade’ and other requirements contained in s 11.

The above expenses are not ring-fenced and if the beneficiary qualifies, then he may deduct the expenses against dividends and other income received from the trust.

A problem does, however, arise in determining how much, if any, of the expenses incurred in earning the trust income may be attributed to the income distributed to the beneficiaries and accordingly be deductible against the income to arrive at taxable income in the beneficiary’s hands. There seems to be no problem in accepting that where the trust deed provides that all income should vest in the beneficiary, s 25B(1) would apply to the trust income before deduction and s 25B(3) to expenses incurred.

⁵² (1994) *The Taxpayer* 86.

If this were not so then s 25B(3) would have no application since no portion of it would be allowed against the income vesting in the beneficiaries, but would be allowed against that portion of gross income retained in trust.⁵³

Where the trust deed grants the trustee discretion to distribute income, a real problem arises when only a portion of the income of a trust is distributed to the beneficiaries. This is best illustrated by the following example.

A trust earns a gross income of R1 000 and incurs expenditure of R400 in producing the gross income, resulting in net income of R600. The trustee exercises his discretion and distributes income of R250 to the beneficiary.

Is the beneficiary to be taxed on R250, or is he to be taxed on R250 less $R250/R1\ 000$ multiplied by R600 and the balance taxed in the trust's hands?

It is submitted that the deductions and allowances under s 25B(3) should be apportioned to the beneficiary according to the ratio that the net income of the trust vesting in the beneficiary bears to the total net income of the trust. In the above example the taxable income would accordingly be $R250/R600$ multiplied by R600, namely, R250.⁵⁴

If R100 of the gross income in the above example should consist of dividends, and the trust is allowed an allowance of R50, then the taxable income apportioned to the beneficiary and trust would be calculated as follows (again assuming that the trustee has only distributed R250 to the beneficiary and accumulated the balance in trust):

Beneficiary: $R250/R600$ multiplied by R450 ($R1\ 000 - R400 - R100 - R50$).

Trust: $R350/R600$ multiplied by R450.

The beneficiary's and trust's taxable incomes would therefore be R187,50 and R262,50 respectively.

⁵³ *Supra*.

⁵⁴ (1992) *The Taxpayer* 277.

In June 1994, Commissioner released Practice Note 23 in an attempt to clarify the confusion surrounding the application of s 25B(3). Practice Note 23 made it clear that the deductions and allowances available against income vesting in a beneficiary's hands were not restricted to that income. This effectively meant that any losses sustained by the trust could be distributed to the beneficiary of the trust.⁵⁵

In 1998, s 25B was amended by the addition of sub-sections (4), (5) and (6), which had the effect of preventing the distribution of losses to beneficiaries with effect from years of assessment commencing on or after 1 January 1999, or at any time for trusts created on or after 11 March 1998.

The new sections have the following effect:⁵⁶

‘[25B(4)] No loss whether arising from actual expenditure by the trust or because of allowances is apportionable to any beneficiary, to the extent that it exceeds the income apportioned to him.

‘[25B(5)] To the extent that the sum of expenditure and allowances in any year exceeds the income deemed to be that of the beneficiaries, it is deductible in the determination of the trust's income, if any, for that year, but also limited to the taxable income, if any, of the trust before the deduction of the excess.

‘[25B(6)] Should the loss not be fully absorbed by the income of the trust in the relevant year, the excess is carried forward into the succeeding year and may be deducted by the beneficiaries to the income to which the excess relates provided, again, that if the losses exceed the beneficiaries' income, the excess remains in the trust to be used as set out in [25B(5)] of this paragraph in the succeeding year of assessment.’

This can be illustrated by the following example. A trust earns gross income of R1 000, with deductible expenses and allowances amounting to R1 300. The trust deed provides for a vesting of 60% of the income in the beneficiaries. The beneficiaries' taxable income will be $R600 - (R600/R1\ 000 \times R1\ 300) = -R180$; the trust's taxable income will be $R400 - (R400/R1\ 000 \times R1\ 300) = -R120$.

⁵⁵ *Meyerowitz on Income Tax* 1998/1999 in § 16.140.

⁵⁶ K Huxham & P Haupt, *Notes on South African Income Tax 1999* at 583.

In the above example the full loss attributable to the beneficiary will be carried forward to the following year of assessment as there is no income retained in trust against which the loss apportioned to the beneficiary can be deducted. If there had been income remaining after the loss apportioned to the trust was deducted against the income retained in trust, then the loss apportioned to the beneficiary will be deducted against the trust income. The difference, if any, of the loss so deducted will then be carried forward to the next year of assessment for deduction against income accruing to the beneficiary.

In the above example the beneficiary would be entitled to the R180 loss as a deduction in the next year of assessment. The trust would, however, not be entitled to carry forward its loss of R120.

It must be noted that should a beneficiary have a vested right to both the income and the capital in a trust, he will be held taxable not only on income received or accrued to him, but also on any expenditure which is not deductible, for example any non-deductible donations made by the trust.⁵⁷ In these circumstances the trust is held to disburse expenditure on behalf of the beneficiary, and the taxable income is derived by him and not the trust.

It is submitted that where the beneficiary is only to receive the income from the trust and it is clear from the trust deed that he does not have a vested interest in the capital, any inadmissible expenditure will be taxed in the hands of the trust and not in the beneficiary's hands.⁵⁸

Anti-Avoidance – The Deemed Accrual Provisions Contained in s 7

While s 25B apportions income to the beneficiaries with a vested interest therein, and the balance to the trust, it is made subject to s 7.

Section 7 of the Act contains a number of deeming provisions, which have a direct impact on how income generated by property held in the name of a trust is taxed. (It

⁵⁷ ITC 636 (1947) 15 SATC 120.

⁵⁸ *Silke on South African Income Tax* in § 12.14A.

must be noted that, although the objectives of s 7 are not limited to trust income, this report will only consider its effects in the context of a trust.)

These deeming provisions are also referred to as anti-avoidance provisions, since they deem income which has accrued to a beneficiary of a trust to accrue to someone else. This is normally the person who engineered the accrual to occur out of his hands and in the hands of the other person (example a trust) with the aim of reducing the normal tax payable on the amount by having it taxed in a lower tax bracket. It is precisely this kind of behaviour which s 7 attempts to prevent, and the section is specifically directed at transactions,⁵⁹

‘in which a taxpayer seeks to achieve tax avoidance by donating, or disposing of income-producing property to or in favour of another under the ... specified conditions or circumstance, thereby diverting its income from himself without his replacing or being able to replace it’.

In an attempt to counter this avoidance behaviour, the legislature created a complex piece of legislation. A detailed study of the courts’ interpretation of the provisions contained in s 7 follows.

An important point to note is that the word ‘donor’ as used in the section does not necessarily mean the founder of a trust or person who initially settled property upon a trustee for the benefit of certain beneficiaries. After the trust has been created, a third party could, for example, make a donation to the trust, and the income generated by the donation could be deemed to be the income of the third party under one or other of the provisions of s 7, and taxed in the third party’s hands and not in the hands of the founder of the trust.

Its operation is, therefore, not limited to the founder, but to any person who falls within the ambit of s 7.

The meaning of ‘income’

Section 7 makes reference to income.

⁵⁹ *Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55 at 72.

The question to be asked is whether the definition of 'income', namely, gross income less exempt income, is intended or not.

In *CIR v Simpson*⁶⁰ Watermeyer CJ made the following comment on definitions in statutory enactments:⁶¹

'[I]t seems to me that effect should be given to the rule laid down by Halsbury, Laws of England, ...[namely]: A definition section does not necessarily apply in all the possible contexts in which a word may be found in a statute. If a defined expression is used in a context which the definition will not fit, it may be interpreted according to its ordinary meaning.'

Olivier submits that the legislature did not intend income to have the same meaning as defined in the Act and agrees with *Silke*'s view that it should mean gross income, less related deductible expenditure and losses.⁶²

Should income, within the context of s 7, be given the meaning of taxable income, as defined, then the expenses relating to the income earned will not be allowed as a deduction against the income which has vested in a beneficiary's hands. The expenses would then remain in the trust, which would not have the income against which to deduct the expenses that relate to it.⁶³

Olivier takes the view that the meaning of income in s 7 can only be speculated on, and that the intervention of legislation is needed to clarify the position. Until the section is amended, *Silke*'s view would seem correct.

The meaning of 'donation, settlement or other disposition'

The words 'donation, settlement or other disposition' are used in every sub-section of s 7 except sub-section (1), and it is submitted that their meaning is the same wherever used in the section.⁶⁴

⁶⁰ 1949 (4) SA 678 (A), 16 SATC 268.

⁶¹ *Supra* at SATC 282.

⁶² PA Olivier, *Trust Law and Practice* at 177.

⁶³ (1994) *The Taxpayer* 108–9.

⁶⁴ PA Olivier, *Trust Law and Practice* at 178.

The first two words, donation and settlement, do not seem to pose too much of a problem. The meaning of donation was held to be as follows in *Ovenstone v SIR*:⁶⁵

‘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.’

Although the word settlement does not necessarily mean a gratuitous disposal of property or a disposal at a negligible consideration,⁶⁶ it was held in *Joss v SIR*⁶⁷ that

‘settlement ... would not include a transaction made for full value in money or money’s worth’.

This view was confirmed in *Ovenstone’s* case.⁶⁸

It is, however, submitted that the word settlement must be considered with reference to the word donation and accordingly interpreted ejusdem generis.⁶⁹ In other words there must be an appreciable element of gratuity in the settlement.

In *Ovenstone’s* case, Trollip JA made the following comments on the word ‘settlement’:⁷⁰

‘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 persons, or for the benefit of persons in succession as in a fideicommissum As far as the beneficiaries are concerned a settlement is also generally made gratuitously out of liberality or generosity in the sense that no consideration usually passes from them to the settlor [or donor] for the benefits conferred on them. “Settlement” is thus usually of the same genus as “donation”. It is probably separately mentioned in the critical phrase because in form, substance, or effect it may sometimes not be regarded as a true donation.’

⁶⁵ 1980 (2) SA 721 (A), 42 SATC 55 at 73.

⁶⁶ PA Olivier, *Trust Law and Practice* at 179.

⁶⁷ 1980 (1) SA 674 (T), 41 SATC 206 at 214.

⁶⁸ 1980 (2) SA 721 (A), 42 SATC 55 at 73–4.

⁶⁹ Emslie, Davis, Hutton, *Income Tax Cases & Materials* at 1020; *Silke on South African Income Tax* in § 10.64.

⁷⁰ 1980 (2) SA 721 (A), 42 SATC 55 at 73–4.

The final words in the phrase, namely ‘any other disposition’, throw the possibilities wide open, and again reference must be made to the words ‘donation’ and ‘settlement’ for assistance in their interpretation. Trollip JA’s comments in *Ovenstone v CIR* are instructive on this point as he considers the whole phrase:⁷¹

‘[T]he words “donation, settlement or other disposition” ... each connote the disposal of property to another otherwise than for due consideration, i.e. otherwise than commercially or in the course of business. “Donation” and “settlement” have this further feature in common: the disposal of property is made gratuitously or (occasionally in the case of a “settlement”) gratuitously to an appreciable extent. Since “disposition”, the general word that rounds off the critical phrase, was not intended to have its wide, unrestricted meaning, I think that this is an appropriate situation in which to circumscribe its scope by extending that common element of gratuitousness to it too by the ejusdem generis or noscitur a sociis rule. The critical phrase should, in other words, be read as “any donation, settlement or other similar disposition”. So construed, “disposition” means any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer. It need not flow from a unilateral contract, for that is not necessarily a common element of a “donation” and “settlement”. That a “disposition” need not be wholly gratuitous and is not restricted to any particular form of disposal of property differentiates it to some extent from a “donation” and “settlement”. To the extent, however, that it does overlap either of the latter that is quite understandable and acceptable as having been done ex abundanti cautela in these anti-tax avoidance sub-sections of s 7. For “donation” and “settlement” are technical terms of the law: whether a particular disposal of property constitutes a true “donation” or “settlement” may give rise to difficulty and contention; and the legislature probably used the more general, comprehensive word “disposition” for the sake of achieving clarity and certainty and in order to eliminate any such problem.’

Trollip JA went on to sum up the position as follows:⁷²

‘To sum up: the critical phrase ... “any donation, settlement or other disposition” – excludes any disposal of property that is a wholly commercial or business one, i.e. made for due consideration, 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.’

⁷¹ *Supra*.

⁷² 1980 (2) SA 721 (A), 42 SATC 55 at 76.

Where income is received partly as a 'donation, settlement or other disposition' and partly for some other reason, the question to be asked is whether the income so derived can be apportioned.

In *Joss v SIR*⁷³ the taxpayer had donated shares in C company at par value to his minor daughter. Thereafter, he sold assets to C company, the purchase price of which remained an interest-free loan by the taxpayer to C company. The taxpayer's minor daughter received dividends as a result of her shareholding in C company. The Commissioner invoked s 7(3) to deem the dividend to be the taxpayer's. The court held that only that portion of the dividend which was attributable to the interest-free loan could be deemed to be income in the hands of the taxpayer in terms of s 7(3).

On this same issue of apportionment, Trollip JA had the following to say in *Ovenstone's* case:⁷⁴

'Now where the consideration, while not being due consideration, is nevertheless appreciable, it will mean that the income in question under s 7(3) will usually have accrued or been received "by reason of" [the meaning of this phrase is discussed in detail below] both elements of gratuitousness and consideration. I see no reason why in those circumstances the income should not then be apportioned between the two elements. The words, "by reason of", themselves suggest some apportionment in order to give proper effect to the real cause of the accrual or receipt of the income. If such apportionment is not possible, or if insufficient evidence is adduced to enable the court to effect it ..., the composite disposal will usually, because of its appreciable element of bounty, be then simply treated as a gratuitous settlement or disposition, as the case may be, that falls within the scope of the critical phrase.'

As a result of both *Ovenstone* and *Joss*, an interest-free loan falls within the ambit of s 7(3), since the court considered it to be a similar disposition to a donation or settlement. It is also authority for the view that that portion of income attributable to the interest-free loan will be deemed to be income in the donor's or settlor's hands.

⁷³ 1980 (1) SA 674 (T), 41 SATC 206.

⁷⁴ 1980 (2) SA 721 (A), 42 SATC 55 at 76–7.

The meaning of ‘by reason of’

The term ‘by reason of’ are used in s 7 to create a causal connection between the words ‘donation, settlement or other disposition’ and the income which is deemed to be that of the donor.⁷⁵ Centlivres CJ held the following in *CIR v Widan*:⁷⁶

‘When income has been received by a minor child the inquiry is whether such income has been so received “by reason of any donation, settlement or other disposition” made by the parent of the child. There must be some causal relation between the donation and the income in question. Difficult cases may conceivably arise. Where, for instance, a father donates a sum of money to a minor child and the child buys a business to which he contributes his skill and labour and from which he earns an income that income may be regarded as being attributable to two causes, viz. the donation and the skill and labour of the child. In such a case it may be impossible to say which part of his income was the result of the donation and which part the result of his skill and labour and it may be that the Commissioner would not be able to apply [the equivalent of s 7(3)].’

CIR v Widan is the leading case on the interpretation of the term ‘by reason of’, and gave it a wider meaning than that given by the court in *Kohler v CIR*.⁷⁷ The question was whether the deeming provision contained in s 9(3) (the equivalent of today’s s 7(3)) applied only to the income earned on the donation, or whether the section would reach as far as any income earned on an investment that was made from the funds of the original donation. In other words, it must be asked whether s 7(3) applies to income on income.⁷⁸

In *Widan’s* case, the taxpayer had donated certain shares to a trust created for the benefit of his minor children. Dividends derived from the shares donated were used to purchase shares in a second company. The question was whether the dividends declared by the second company were taxable in the hands of the income beneficiaries of the trust, or those of the taxpayer. In other words were the dividends earned from the second company ‘by reason of’ the initial donation of shares to the trust?

⁷⁵ PA Olivier, *Trust Law and Practice* at 180.

⁷⁶ 1955 (1) SA 226 (A), 19 SATC 341 at 351.

⁷⁷ 1949 (4) SA 1022 (T), 16 SATC 312.

⁷⁸ RC Williams, *Income Tax in South Africa: Cases and Materials* at 141.

The court in *Widan*'s case held that, on the facts before it, the deeming provision did extend to income on income.

This decision was contrary to that taken in the earlier case of *Kohler v CIR*.⁷⁹ The facts were similar to that of *Widan*'s case and the court had to decide whether the Commissioner had been correct in including in the income of a taxpayer, income earned on investments which had been made from the funds of a donation made by the taxpayer to his minor children. Murray J held that,⁸⁰

'though the original donation may have been a *causa sine qua non* it was not the *causa* by reason of which the amounts now in issue [the income upon income] came to the minors. ...[T]his causal connection between the donation and the accrual (or receipt) of this 'income upon income' was interrupted by the introduction of a *novus actus*, viz. the re-investment of the original income, and it was by reason of this re-investment that such accrual (or receipt) occurred.'

The court in *Kohler*'s case regarded the new investment as severing the causal link required by the words 'by reason of'. The Appellate Division in *Widan*'s case disagreed and effectively overruled this narrow approach adopted by the (then) Transvaal Provincial Division. The Appellate Division held that it was unlikely that legislature would have intended a narrow interpretation of the words 'by reason of' in the section. The court held that the determination of proximate cause was a matter of fact and before a decision could be made as to whether or not income was earned 'by reason of' a donation, the court would have to refer to the surrounding circumstances and makes its decision with reference to the particular facts of each case.

The Appellate Division did concede that if a parent donated money to his child and the child in turn contributed his skill and labour in utilising the donation, then the resulting income would not be earned 'by reason of' the donation. Under these circumstances the child's input in the form of skill and labour would break the causal link to the donation and the deeming section would not operate.

⁷⁹ 1949 (4) SA 1022 (T), 16 SATC 312.

⁸⁰ 1949 (4) SA 1022 (T), 16 SATC 312 at 316–8.

In applying the principle laid down in *Widan's* case, namely, that there must be a causal connection between the taxpayer's donation and the income, the court in *CIR v Berold*⁸¹ looked for what it termed the 'effective cause' of the income, and said that it would not allow the form of company law to break the effective causal connection. In this case, the court adopted the so-called substance over form approach,⁸² to effectively trace the causal chain of a dividend, back through an intervening company, and find that the effective cause of the income was the donation by the taxpayer.⁸³

Section 7(3)

Section 7(3) reads as follows:

'Income shall be deemed to have been received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child –

- (a) it has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child; or
- (b) it has been accumulated for the benefit of that child.'

The objective behind this section is to prevent income splitting between parents and their minor children.

Should a parent create a trust in favour of his minor child and donate assets to the trust, any income earned by the trust and distributed to the minor child will be taxed in the parent's hands in terms of s 7(3). It also does not matter if the income generated by the trust is expended or accumulated on behalf of the minor child; the parent will still be liable for the tax on such income.

Although s 7(3) normally applies to inter vivos trusts there is no reason why trusts created in terms of a will (testamentary trusts) could also not be affected. It is conceivable that a parent of a minor child who is the beneficiary of a testamentary trust created by the child's grandparent, could make a donation, settlement or other disposition to the will trust. The income generated by the donation, settlement or other

⁸¹ 1962 (3) SA 748 (A), 24 SATC 279.

⁸² Emslie, Davis, Hutton, *Income Tax Cases & Materials* at 1063.

⁸³ RC Williams, *Income Tax in South Africa: Cases & Materials* at 138.

disposition, and distributed, accumulated or expended for the maintenance, education or benefit of the minor child, will be taxed in the hands of the parent in terms of s 7(3).⁸⁴

It is to be noted that as a matter of practice the Commissioner does not invoke s 7(3) where a farmer donates livestock to his minor children where it is a well-established custom. Accordingly, the income from any progeny of the donated livestock which is sold, or any produce derived and sold, such as milk, will be taxed in the hands of the minor child and not the parent.⁸⁵

Although 'minor' is not defined in the Act, it can be accepted that it has its normal acceptable meaning.⁸⁶ The section does not include grandchildren or stepchildren but does include legally adopted children.⁸⁷ Consequently, if a grandparent were to donate property to his grandchild, any income generated by the property would not be taxed in the grandparent's hands in terms of s 7(3), but in the hands of the child.

In terms of s 7(3)(a), the income arising from any donation, settlement or other disposition will be deemed to be that of the parent donor where the income has been expended on behalf of the donor's minor child or the child has a vested right to the income.

Section 7(3)(b) on the other hand is not so clear cut.

Does 'accumulated for the benefit of the minor child' mean the child must have a vested right to the income?

Does it mean that the parent must have formed an intention to benefit the minor child?

In *Platt v CIR*⁸⁸ the court dealt with a similar provision to that in s 7(3). De Villiers JA commented as follows on s 9(3)(b) (similar to today's s 7(3)(b)).⁸⁹

⁸⁴ PA Olivier, *Trust Law and Practice* at 182.

⁸⁵ RC Williams, *Income Tax in South Africa: Law & Practice* at 379–380.

⁸⁶ PA Olivier, *Trust Law and Practice* at 182.

⁸⁷ *Silke on South African Income Tax* in § 10.63.

⁸⁸ 1934 AD 552, 7 SATC 75.

⁸⁹ *Supra* at SATC 79.

‘The language of 9(3)(b) implies purpose and intention. The words “for the future benefit of his minor child” may in my opinion be paraphrased: “for the purpose and with the intention that his minor child may in the future benefit”. If that is correct, that there must be purpose and intention, then there must be a person in whose mind the purpose and intention exists; and that person must be the parent who makes the donation or settlement. It cannot be anyone else. Now what the parent’s purpose is in any particular case, must be ascertained from the terms of the instrument of donation or settlement and from relevant surrounding circumstances. Cases may be conceived where the question might be doubtful, e.g. where some benefit is indeed conferred on a minor child, but of a remotely contingent nature.’

The old s 9(3)(b) contained the word ‘future’. It is submitted that the reasoning in *Platt*’s case still applies even though the word ‘future’ was omitted from the new s 7(3)(b). The word ‘future’ was possibly removed because it was superfluous, and to avoid any argument that the benefit must be immediate if s 7(3)(b) was to operate.⁹⁰

In *Platt*’s case the father donated assets to a trust for the benefit of his minor son and his son’s lawful descendants. The income was, however, to be retained and accumulated until his son reached the age of majority or married, whichever occurred first. Upon his son’s death the capital was to devolve upon his descendants. De Villiers JA went on to conclude as follows:⁹¹

‘It is true that if [the beneficiary] never attained the age of majority he would not benefit, but it is also true of all human purposes, that they may not come to fruition. The possibility that [the beneficiary] might not live long enough to benefit, does not derogate from the fact that the parent’s purpose was to benefit him....The parent obviously directed the accumulation of income till [the beneficiary’s] majority in the expectation that [the beneficiary] would live to attain majority, and in contemplation of his attaining majority, and for the purpose of benefiting him on his attaining majority. It follows, that, applying the test of the parent’s purpose, the income was accumulated for the future benefit of the minor child ...; and that conclusion suffices for the purpose of this appeal.’

It is therefore clear from *Platt*’s case that the intention of the parent in making the donation to the trust is the decisive factor. It does not matter whether or not the child

⁹⁰ (1994) The Taxpayer 111.

⁹¹ At SATC 79.

has a vested right to the income or that the child's vesting is contingent upon his attaining the age of majority.

As for the first part of the section, namely s 7(3)(a), it is clear that in order for the section to operate, the income must accrue to the minor child under defined circumstances. These circumstances are where the income has been actually received by or accrued to or in favour of the minor child or has been expended for the maintenance, education or benefit of that child.

The second part, s 7(3)(b), revolves around the purpose and intention of the donor parent. This purpose and intention is ascertained by reference to the trust instrument and the facts and surrounding circumstances of each case.

Section 7(4)

Section 7(4) reads as follows:

‘Any income received by or accrued to or in favour of any minor child of any person, by reason of any donation, settlement or other disposition made by any person, shall be deemed to be the income of the parent of such minor child, if such parent or his spouse has made a donation, settlement or other disposition or given some other consideration in favour directly or indirectly of the said other person or his family.’

While s 7(3) has as its objective the prevention of income splitting between parent and minor child, s 7(4) prevents the circumvention of s 7(3) through the use of a third party. This can be illustrated as follows:

A makes a donation, settlement or other disposition in favour of B's minor child, and B in turn makes a donation, settlement or other disposition in favour of A's minor child.

For this section to come into operation, there must be an element of reciprocity in the sense that there must be a causal connection between the act of the donor and the donation made by the third party.

In *COT v Paice*⁹² Clayden J stated the following:⁹³

‘There must be some causal connection between the disposition by the taxpayer to the other person, and the disposition by the other person which leads to income for the children.’

How small this disposition may be is illustrated in *Barnett v COT*,⁹⁴ where the taxpayer sold his assets to a company and the donor undertook to donate his shares in the company to the taxpayer’s minor child. The equivalent to s 7(4) was applied even though the donor did not receive any benefit. In other words, the reciprocal disposition need not be equal. The essential requirement is that there is a causal connection between the act by the donor and the disposition given by the parent of the minor donee.

Where a grandparent donates property to a trust whose beneficiaries are his grandchildren, and his son gives him a gift on his birthday which is unrelated to the donation to the trust, then s 7(4) would not operate to deem the income derived from the property donated to be taxable in his son’s hands because the causal connection between the donation by the grandparent and the gift given to him by the son would be absent.⁹⁵

Olivier is of the opinion that s 7(4) would continue to operate after the original donor dies.⁹⁶

For example, if A donates property to B and B in return donates property to a trust for the benefit of A’s minor children then the income from the trust would be taxed in A’s hands in terms of s 7(4). Should A die then his spouse would be taxed on the income accruing in favour of the minor child or expended for the maintenance, education or benefit of the minor children. Whether this is correct still needs to be decided by the courts.

⁹² (1962) 25 SATC 385.

⁹³ *Supra* at SATC 388.

⁹⁴ 1959 (2) SA 713 (FC), 22 SATC 326.

⁹⁵ *Meyerowitz on Income Tax* 1998/1999 in § 16.56.s

⁹⁶ PA Olivier, *Trust Law and Practice* at 183.

It is submitted that an argument could be made against the above interpretation since the section refers to 'any donation, settlement or other disposition made by *that* parent' and does not refer to any parent of the minor child.

Section 7(5)

Section 7(5) reads as follows:

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

In *Estate Dempers v SIR Corbett JA* summarised the reason for the introduction of s 9(5) of the then South West African ordinance, which is similar to s 7(5), as follows:⁹⁷

'[The section] seems to be aimed generally at preventing the avoidance of tax liability where and so long as the donor does not permit the beneficiary of the gift to enjoy immediately the income to be derived therefrom.'

Silke makes the following remark about the stipulation or condition:⁹⁸

'Section 7(5) applies whether the stipulation or condition for the withholding of the income from the beneficiaries was made or imposed directly by the person making the donation, that is, the donor or creator, or by some other person. Thus where a trust has been created by a donor who has made a withholding stipulation or condition in the trust deed, the income derived by the trustees from a further donation made by a new donor to the existing trust will be deemed to be the income of the new donor.'

⁹⁷ 1977 (3) SA 410 (A), 39 SATC at 107.

⁹⁸ *Silke on South African Income Tax* in § 12.20.

Before s 7(5) will apply, Olivier submits that the following questions must be answered in the affirmative:⁹⁹

- ‘(a) Did a donation, settlement or other disposition take place?’
- ‘(b) Is the income received by reason of the donation, settlement or other disposition?’
- ‘(c) Is the donation, settlement or other disposition subject to a stipulation or condition to the effect that the beneficiaries or some of them shall not receive the income or portion thereof until the happening of some event, whether fixed or contingent?’
- ‘(d) Is the person who made the donation, settlement or other disposition still alive?’

Questions (a) and (b) have already been dealt with above. The question posed in (c) has given rise to many difficulties and our courts still have arrived at a definitive answer to the problem, despite two decisions by the Appellate Division.¹⁰⁰ The problem concerns the definition of an ‘event’. What type of event did the legislature have in mind, and more vexing, is the exercise of a trustee’s discretion in terms of the provisions of a trust deed an event as contemplated in s 7(5)?

The ‘event’

It is quite clear that a provision in a trust deed that the beneficiaries may not receive income from the trust until the attainment of a certain age, or death, or marriage, or some other clearly defined future happening, will constitute an event and fall within the ambit of s 7(5).¹⁰¹

The courts, however, have not been consistent in their decisions about whether or not the exercise of a trustee’s discretion constitutes an event or not.

In *Hulett v CIR* Carlisle J, in holding that the exercise of a trustee’s discretion did constitute an event, said the following:¹⁰²

⁹⁹ *Supra* at 184–5.

¹⁰⁰ *Estate Dempers v SIR* 1977 (3) SA 410 (A), 39 SATC 95; and *SIR v Berold* 1962 (3) SA 748 (A), 24 SATC 729.

¹⁰¹ *Estate Dempers v SIR* 1977 (3) SA 410 (A), 39 SATC 95; and *Buchanan v CIR* 1945 CPD 173, 13 SATC 219.

¹⁰² 1944 NPD 263, 13 SATC 58 at 64.

‘As I interpret the document the beneficiaries are not entitled to claim payment of income as of right. They receive it – or such part of it as the trustees choose to give them – if the trustees in their absolute discretion decide to pay it over. Thus their rights are contingent until the happening of the event, viz. the exercise by the trustees of their discretion.’

In several other cases it was held that the exercise of a trustee’s discretion does not constitute an event, which brought s 7(5) into play, and that consequently trust income withheld would not be treated as taxable in the hands of the donor. In an unreported case (ITC 5928)¹⁰³ the presiding judge had the following to say:

‘With due deference, I can find no reasoning in the judgments which I have considered to lead me to the conclusion that the “event” required by s 9(5) [today’s s 7(5)] can be one of what I have called a fluctuating and intermittent character occurring in every tax year, and possibly a number of times in the tax year. There must, in my view, be a stipulation of such a character that the event is decisive, so that until the event occurs the income, or part thereof, shall not go to the beneficiary and be deemed to be that of the donor’s and so that after its occurrence it shall not be deemed to be the donor’s. An uncertain situation, in which the position changes yearly, or monthly, or even more frequently, depending on the decisions from time to time of trustees, does not seem to me to be either the meaning or intention of s 9(5).’

As mentioned above, the Appellate Division had two opportunities to settle the matter, but did not find it necessary to express a firm view on whether or not the exercise of a trustee’s discretion constituted an event.

In *Estate Dempers v SIR*¹⁰⁴ the taxpayer settled money upon trustees for the benefit of his grandson or his issue. The trust deed stipulated that

- one third of the income was to be paid to the grandson when he attained the age of twenty-five years,
- one half was to paid on him reaching thirty years, and

¹⁰³ 18 November 1960.

¹⁰⁴ 1977 (3) SA 410 (A), 39 SATC 95.

- the balance on reaching the age of thirty-five years.

If the grandson failed to reach the age of thirty-five years, then the grandson's issue (or failing that, other persons) would be substituted for him and receive the balance remaining in trust.

During the years of assessment 1970 to 1973, the trustees paid out small sums of income and accumulated the rest. The Commissioner included the accumulated income in the hands of the taxpayer in terms of s 9(5) of the Income Tax Ordinance of South West Africa (the then equivalent to our s 7(5)). The taxpayer argued that the 'event', as contemplated in the section, was

'a single, once-and-for-all occurrence until the happening of which the beneficiary did not receive the income and after the happening of which he did. Prior to the event the income was deemed by way of a fiction to be that of the donor. After the event the fiction ceased and it became that of the beneficiary.'

The taxpayer also argued that anomalies would arise if the exercise by the trustee of his discretion were considered to be an event. For example, all income that accrued to the trust during the year would be deemed to be taxable in the hands of the donor even if at the end of the year the trustees elected to pay all the income to the beneficiaries. Section 7(5) is only supposed to apply where the income has not been paid to the beneficiaries.

Furthermore, since the exercise of a trustee's discretion to distribute would constitute an event, then, following the same line of reasoning, a trustee's decision not to distribute would also constitute an event and the donor's liability for tax under s 7(5) would accordingly cease.

The court recognised the merit in these arguments, but found it unnecessary to decide whether they were correct or not since there was in the deed a stipulation that the grandson would not receive the income until the happening of an event, namely, the attainment of the ages stipulated therein. In other words, the stipulation of these ages constituted an event in itself, which satisfied the requirements of s 7(5) quite apart from the exercise of the trustee's discretion.

Whether the exercise of a trustee's discretion constitutes an event is therefore still an open question. The answer to this question is important in two respects:

- first, the incidence of tax in the donor's hands of income paid out by the trustees in the year it has accrued; and
- secondly, the incidence of tax in respect of income which is accumulated in the year it accrues and which the trustees have discretion to pay out in subsequent years.

With regard to the first question, it is the practice of the Commissioner not to tax income in the hands of the donor, where the trustees have exercised their discretion and paid the income out to the beneficiaries in the year that it has accrued. As long as this practice persists, regardless of whether it is right or wrong, taxpayers need not be concerned about whether or not the exercise of the trustee's discretion is an event or not.¹⁰⁵

In ITC 1033¹⁰⁶ the court held that if a trustee exercised his discretion within a reasonable time period after the year of assessment ended then this would be sufficient to determine the incidence of tax for that year. *Meyerowitz*¹⁰⁷ disagrees with this judgment and submits that the incidence of tax must be determined no later than at the end of the year of assessment and not thereafter, and goes on to caution trustees to exercise their discretion before the end of the year of assessment, if they so wish to.

The question of whether or not the exercise of a trustee's discretion is an event becomes particularly important where a trust deed grants the trustee discretion to distribute past and present income prior to the event, the happening of which directs the trustee to distribute the income. *Meyerowitz* is of the opinion that on the facts of the case before the court, the judgment in the *Estate Dempers* case does not make it clear that one must look beyond the exercise of the trustee's discretion to the event upon which the income must be paid by the trustee in resolving the issue of past income. *Meyerowitz* states as follows:

¹⁰⁵ *Meyerowitz on Income Tax*, 1998-1999 in § 16.145.

¹⁰⁶ (1959) 26 SATC 73.

¹⁰⁷ *Supra*.

‘If the court’s conclusion was based on a construction of the deed that the trustee had no discretion ... to distribute accumulated income prior to the donee attaining the stipulated ages, then the resolution of the issue whether the exercise of a trustee’s discretion is an ‘event’ as contemplated in s 7(5) is still of importance. On the other hand if the conclusion reached by the court was arrived at irrespective of whether clause 17 in its altered form permitted the trustees to distribute income ... at any time before the donee reached the stipulated ages then caedit quaestio; whether or not the exercise of the trustee’s discretion is an event is not relevant as long as there is some event stipulated before the happening of which income may be withheld. The difficulty in this view is that it involves, essentially, reading the words in s 7(5) “shall not receive” as meaning “shall not be entitled to demand”.’

If the above construction is not given to the words ‘shall not receive’, then it would result in s 7(5) applying to a trust where the trustees are instructed not to distribute income, but accumulate it until the happening of the event.

On the other hand, a trust where the trustees are given a discretion to distribute or accumulate income before the event would avoid the application of s 7(5). In the *Estate Dempers*¹⁰⁸ case this anomaly was alluded to.

Meyerowitz, however, seems to express doubts as to whether this anomalous result is enough to go beyond the literal meaning of ‘receive’.

The same inference can be drawn from the Appellate Division decision of *SIR v Sidley*.¹⁰⁹ The facts were sufficiently similar to those in the case of *Estate Dempers* for the court to adopt the same line of reasoning.¹¹⁰ The only difference in *Sidley*’s case was that the income was distributable unless the trustee exercised his discretion to withhold the income. In other words, the trust deed expressed the trustee’s discretion in the negative. In the case of *Estate Dempers* the trustees were granted discretion to distribute income. The court held that this distinction was of no relevance, and in the Special Court for Hearing Income Tax Appeals it was held that s 7(5) contemplated a suspensive condition and not a resolute one.

¹⁰⁸ *Estate Dempers v SIR* 1977 (3) SA 410 (A), 39 SATC 95 at 113.

¹⁰⁹ 1977 (4) SA 913 (A), 39 SATC 153.

¹¹⁰ (1994) The Taxpayer 112.

The Appellate Division held as follows:¹¹¹

‘This approach is, in my view, erroneous and unduly technical in stressing the form of clause 25 rather than the substance thereof. Viewed in a practical manner, clause 25 is merely an administrative provision which determines the way in which the income of the trust fund is to be dealt with. In substance it provides that the nett income shall be devoted to the maintenance, support, education and reasonable pleasures of the donee or other beneficiary but that he or they shall not receive it for the said purpose until the trustees decide in their absolute discretion not to withhold it. Seen in this way and regarding the ultimate termination of the trust as stipulated for in clause 2 as the true event upon which the beneficiaries receive the withheld income, the deed falls within the postulate contemplated by s 7(5).’

As mentioned above, the question is still an open one. Olivier in conclusion is of the opinion that the exercise of a trustee’s discretion is an event. He justifies this by stating that it is in accordance with the Commissioner’s practice as illustrated in the case of *Estate Dempers* where the beneficiaries were taxed on income distributed to them. The trustees had exercised their discretion, giving rise to the event, and accordingly s 7(5) fell away resulting in the income being taxed in the hands of the beneficiaries.

Vested right to the income

A further aspect to s 7(5) is the provision that, but for the stipulation, the income would be received by or accrued to the beneficiaries.

Does this mean that that s 7(5) will only apply where the beneficiaries have vested rights to the accumulated income, or could it apply where there are no vested rights? In the *Estate Dempers* case Corbett JA held as follows:¹¹²

‘In my view, in the application of s 9(5) [similar to s 7(5)] a vested right to the accumulated income is not a sine qua non. Naturally, if the beneficiaries have vested rights, then this would be a strong, possibly decisive, factor leading to the conclusion that, but for the stipulation withholding the income, it would have been received by them. That s 9(5) is not

¹¹¹ 1977 (4) SA 913 (A), 39 SATC 153 at 159–160.

¹¹² 1977 (3) SA 410 (A), 39 SATC 95 at 111–2.

confined in its application to instances where the beneficiary has a vested right to the income which is to be withheld, is indicated, in my view, by the use of the words ‘fixed or contingent’ in denoting the event until the happening of which he is not to receive the income. A “contingent event” (Afrikaans text: “ongewisse gebeurtenis”) is an event which may or may not happen.’

It can be argued that a beneficiary who does not have a vested right to the income, in the absence of a stipulation withholding the income, would receive the income or have the income accrue to him. Corbett JA had the following to say in response to this:¹¹³

‘In truth the application of the devolutionary portion of the sub-section involves a hypothetical, notional inquiry which cannot be directed solely to questions such as whether the beneficiary’s right to income is vested or contingent. The question which the court must ask itself is whether, in the absence of the stipulation withholding trust income, this income would have been received by or accrued to the beneficiary. In answering this question regard must be had to the terms of the instrument generally, the donor’s general benevolent intention, as evinced by the terms of the instrument, and all the relevant circumstances. In this inquiry the fact that in terms of the instrument as a whole the beneficiary has a vested right to the income would, as I have indicated, be an important factor, but would not be the sole touchstone.’

This judgment seems to suggest that one must inquire for whose benefit the income is primarily being accumulated. In other words, a vesting is not essential. The court found that the dominant objective of the trust was to benefit the grandson, despite the provision contained in the trust deed providing for the substitution of beneficiaries in the event of the grandson having predeceased the termination of the trust, as well as the discretion granted to the trustees to benefit certain charitable institutions.

Olivier submits that it is not clear in the *Estate Dempers* case why the court found it necessary to enter into a ‘hypothetical, notional inquiry’.¹¹⁴ He suggests that the inquiry was completely unnecessary to bring the facts of the case within the ambit of s 9(5) (s 7(5) in today’s Act). He argues that s 7(5) does not refer to an accumulation of income for the benefit of the beneficiaries. Instead, it is abundantly clear that, but

¹¹³ *Supra* at SATC 112.

¹¹⁴ PA Olivier, *Trust Law and Practice* at 190.

for the stipulation or condition, the income would be received by or accrued to the beneficiary.

Olivier criticizes what he calls the subjective approach adopted by the court in the *Estate Dempers* case, and states that¹¹⁵

‘the stipulation or condition must have the consequence that ‘the beneficiaries or some of them’ do not receive the income or portion thereof. The last part of the section indicates that it is required that in the absence of the stipulation or condition, the beneficiaries would have received the income or that it would have accrued to or in favour of them. The intention seems to be that the reference to beneficiaries embraces them as a group. If the income is accumulated by the trustees in consequence of a stipulation or condition, not one of the beneficiaries will receive any part of the income. Despite the accumulation of the income it must be certain that one or more of the beneficiaries would have received income if it had not been for the stipulation or condition.’

In conclusion Olivier warns that it may be theoretically possible for a taxpayer to argue that it was not the dominant objective to benefit a particular beneficiary, and submits that the application of the ‘hypothetical, notional inquiry’ could bring about a result not intended by the court in *Estate Dempers*.

From the above it would seem that where a trust deed does vest income in a beneficiary, but withholds its receipt until the happening of an event, s 7(5) would undoubtedly apply. This, however, does not always seem to be the position. In certain Special Court decisions the opposite was held to be true.

In an unreported Special Court Case, (Case 5781), Van Winsen J stated the following:

‘[Counsel for the taxpayer] submitted that the income received by or accrued to the trustees could only be received by or accrue to the beneficiary, but for the stipulation, if in terms of the deed she had a vested right to the income at the time of receipt by or accrual of such income to the trustees. If the beneficiary had no such right the income could not be received by or accrued to her whether or not there is a prohibition in the deed against the beneficiary receiving the income. Accordingly, so the argument ran, the prohibition against receipt can

¹¹⁵ *Supra*.

only have meaning and effect where the beneficiary has a vested right to the income and would have been entitled to receive it but for the fact that the stipulation prohibits her from receiving it. I cannot agree with this submission. It seems to me that if the beneficiary has a vested right to the income at the time of its receipt by the trustees the income could be treated as taxable in the hands of the beneficiary in which event it would not be taxable in the hands of the trustees or donor.’

In ITC 903¹¹⁶ the court agreed with the reasoning of Van Winsen J in Case 5781. Both these cases preceded the decision in *Estate Dempers*, and the remarks made by the judges were obiter dicta.

The decision, however, in ITC 1328,¹¹⁷ which followed the reasoning in these two cases, was made after *Estate Dempers*. In this case, the beneficiary had a vested right to the income which was payable to her only in terms of a discretion which was granted to the trustees. Upon her death, the income not paid to her had to be paid to her estate. The Commissioner taxed all income which had accrued to the trust and not been paid to the beneficiary in the hands of the donor, in terms of s 7(5). The court found in favour of the taxpayer, and held that all income not paid to the beneficiary was taxable in the hands of the beneficiary in terms of s 7(1), and that accordingly s 7(5) did not apply.

Section 7(1) reads as follows:

‘Income shall be deemed to have accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalised by him or that such income has not been actually paid over to him but remains due and payable to him or has been credited in account or reinvested or accumulated or capitalised or otherwise dealt with in his name or on his behalf, and a complete statement of all such income shall be included by any person in the returns rendered by him under this Act.’

Section 7(1) seems to be redundant and re-states the principal of accrual already contained in the definition of ‘gross income’ in s 1. Why then has the legislature in its wisdom seen the need to include this section? It seems merely to reinforce the idea

¹¹⁶ (1959) 23 SATC 516.

¹¹⁷ (1980) 43 SATC 56.

that income not received by a taxpayer in the year it accrues is still taxable in such beneficiary's hands in that year. If it were to go further than this then a conflict between s 7(1) and s 7(5) would arise. This difficulty lies with undistributed income to which a trust beneficiary has a vested right in terms of the trust, and which is not distributed to him due to the non-occurrence of the stipulated event.

In this instance, s 7(1) would make the income taxable in the hands of the beneficiary.

On the other hand, s 7(5) would deem the income to be taxable in the hands of the donor.

Does this mean that the income is taxed twice, once in the beneficiary's hands and again in the donor's? This would be the natural result if s 7(1) were no more than an affirmation that a postponement of payment does not affect accrual of such income.

Since the Commissioner did not appeal the decision in ITC 1328, it would seem that he accepted the correctness of the decision. The approach also accords with departmental practice.¹¹⁸

Certain writers¹¹⁹ agree that where a beneficiary has a vested right to income which has been accumulated by the trustee, such income is taxable in the beneficiary's hands by virtue of the provision contained in s 7(1).

Swersky¹²⁰ on the other hand disagrees. His counter-argument is based on certain views expressed in the case of *Estate Dempers* and in ITC 673.¹²¹ In his view, s 7(5) states quite clearly that if the beneficiary is not to receive the income before the happening of an event, as much of the income as would have been received by him or accrued to him, will be deemed to be that of the donor. This is based on the premise that s 7(5) ought to prevail over s 7(1) on the basis that *generalia specialibus non derogant* (a specific provision takes precedence over a general provision), and that the precise meaning of s 7(1) is obscure.

¹¹⁸ (1994) *The Taxpayer* 114.

¹¹⁹ Van Wyk, *Consulta* 3: 48; Wunsh, 1978 *De Rebus* 17.

¹²⁰ 1981 *Income Tax Reporter* 252.

¹²¹ (1948) 16 SATC 230.

Olivier suggests that Swersky's argument should not be ignored, but submits, as pointed out above, that the practice adopted by the Commissioner is to follow the reasoning in ITC 1328, and that this practice is in line with the legislature's objective.¹²² Meyerowitz's summary of the current position under s 7(5) is useful, and states as follows:¹²³

- '(1) Where a trust deed provides that the income or any portion thereof which is not paid out in the year of receipt or accrual (either because the deed prevents this or leaves it to the trustee's discretion) shall be accumulated until the happening of some fixed or contingent event, there is a stipulation which falls within the scope of s 7(5), namely that the accumulated income shall not be received by the beneficiaries until the happening of the fixed or contingent event.
- '(2) Where such a stipulation exists, s 7(5) deems the accumulated income to be the donor's if, in the absence of the stipulation, having regard to the terms of the deed generally, the donor's general benevolent intention, as evinced by the terms of the deed, and all the relevant circumstances, it can be predicated that the accumulated income would have accrued to or have been received by the beneficiaries (or some of them). If ITC 1328 be rightly decided, s 7(5) will not apply where the beneficiary has a vested right to the income in the sense that his right to the income is certain albeit that the enjoyment thereof is postponed; in such case the income is deemed to be the beneficiary's in terms of s 7(1).
- '(3) Current income which is paid out during the year of assessment by the trustee in the exercise of his discretion is not deemed to be the donor's income under s 7(5).
- '(4) Income which is deemed to be the donor's, does not constitute income in the hands of the beneficiaries when subsequently paid out to them, whether as capital or accumulated income.'

It must be noted that where the beneficiary is a minor child of the donor, s 7(3) or s 7(4) would be applicable if s 7(5) does not apply.

¹²² PA Olivier, *Trust Law and Practice* at 189.

¹²³ Meyerowitz on *Income Tax* 1998-1999 in § 16.147.

Furthermore, when the donor dies the operation of s 7(5) no longer applies and the trust will be taxed in terms of s 25B, in the hands of the beneficiary or in the hands of the trustees on behalf of the trust.

Where a donor is taxed in terms of s 7(5), he is entitled to recover the tax payable in his hands from the trustees.¹²⁴

Section 7(6)

Section 7(6) reads as follows:

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

Section 7(6) envisages the situation where a donor disposes of his income-producing assets, for example, to a trust, but retains control over the income-producing assets by retaining the power to revoke the right to income or confer it upon someone else. In this situation, s 7(6) deems the income over which the donor has retained such a right to be taxable in the hands of the donor and not the beneficiary.¹²⁵

It has been held that s 7(6) will apply where the trust deed contains an express clause that reserves the right of the donor to revoke the right to income or to confer such right upon someone else.¹²⁶

*Silke*¹²⁷ submits that where the beneficiary’s right to income is merely contingent, and the trust deed contains an express clause retaining the power to revoke the right to income or to confer it upon someone else, then s 7(6) will not apply. Section 7(6)

¹²⁴ Section 90 of the Income Tax Act.

¹²⁵ ITC 543 (1942) 13 SATC 118.

¹²⁶ ITC 673 (1948) 16 SATC 230.

¹²⁷ *Silke on South African Income Tax* in § 12.21.

contemplates a situation where the beneficiary has a vested right to income and not merely a contingent right.

Accordingly, where a trust deed confers discretionary powers upon the trustees and contains a clause conferring a power of revocation upon the donor, s 7(6) will not deem the income to be taxable in the hands of the donor, since the right to income is conditional upon the trustees exercising their discretion. Note, however, that s 7(5) may apply in these circumstances.

*Meyerowitz*¹²⁸ submits that the judgment in ITC 673 went too far in stating that the right to revoke granted to the donor must be expressly reserved. It is quite possible for a trust deed to contain such a right to revoke by implication. This could result where the trustees are given discretion to revoke a right to income and confer it upon another beneficiary, and the donor (who is also a trustee) is given the right to bind the trustees in the event of a dispute. It could be argued that the donor has retained the power to revoke under these circumstances.

Section 7(7)

Section 7(7) reads as follows:

‘If by reason of any donation, settlement or other disposition made, whether before or after the commencement of this Act, by any person (hereinafter referred to as the donor) –

- (a) the donor’s right to receive or have paid to him or for his benefit any amount by way of rent, dividend, interest, royalty or similar income in respect of any movable or immovable property (including without limiting the foregoing any lease, company share, marketable security, deposit, loan, copyright, design or trade mark) or in respect of the use of, or the granting of permission to use, such property, is ceded or otherwise made over to any other person or to a third party for that other person’s benefit in such manner that the donor remains the owner of or retains an interest in the said property or if the said property or interest is transferred, delivered or made over to the said other person or to a third party for the said other person’s benefit, in such manner that the donor is or will at a fixed or determinable time be entitled to regain ownership of or the interest in the said property; or

¹²⁸ *Meyerowitz on Income Tax* 1998/1999 in § 16.151.

(b) the donor's right to receive or have paid to him or for his benefit any income that is or may become due to him by any other person acting in a fiduciary capacity is ceded or otherwise made over to any other person or to a third party for that other person's benefit in such manner that the donor is or will at a determinable time be entitled to regain the said right,

any such rent, dividend, interest, royalty or income (including any amount which, but for this sub-section, would have been exempt from tax in the hands of the said other person) as is received by or accrues to or for the benefit of the said other person on or after 1 July 1983 and which would otherwise, but for the said donation, settlement or other disposition, have been received by or have accrued to or for the benefit of the donor, shall be deemed to have been received by or to have accrued to the donor.'

The aim of s 7(7) is to prevent tax avoidance by donors who transfer their right to receive income to another person without giving up control over the investment. An example of this type of arrangement would be where the donor cedes his right to receive income from an investment for a limited period of time, after which the right would revert back to the donor. This type of scheme was the subject of ITC 1378¹²⁹ in which the donor donated his right to receive dividends to a charity for a period of four years, with the result that the dividends accrued to the charity and not to him. Section 7(7) has the effect of ensuring that the income so forfeited is deemed to accrue to the donor.

*Meyerowitz*¹³⁰ is of the opinion that s 7(7) would only operate where it is clear that in the absence of the cession or make-over of the right, the income would have been received by the donor.

Thus where A makes over the use of his property to B and B subsequently decides not to use the property himself, but let out, any rental so derived will not necessarily be deemed to be taxable in A's hands. This is so since it cannot be said that income would have been received by A if it were not for the rights given to B, as there was no rental to speak of when A first made over the property to B.

¹²⁹ (1983) 45 SATC 230.

¹³⁰ *Meyerowitz on Income Tax* 1998/1999 in § 16.60.

It is suggested that an interest-free loan would not be affected by s 7(7) since there has been no cession of a right to receive income. It is submitted that this is correct,¹³¹ as money does not automatically generate income. Money has to be invested before it will earn an income.

The words 'fixed or determinable time' have not come under the scrutiny of the courts and their precise meaning can only be speculated upon. Olivier refers to the explanatory notes published with the Bill at the time this section was enacted, and suggests that the intention of the legislature was not to include an event over which the donor has no control as constituting the reference to which a fixed or determinable time must be calculated.

For example, should a donor cede his right to income to a research institution on condition that the right reverts back to him once the research has been completed, then s 7(7) would not deem the income ceded to be taxable in the donor's hands, since the donor has no control over the time when the research will be concluded.

According to Olivier the motivation, as evinced from the explanatory note, was to undermine schemes where the taxpayer retained control over the income or property, or where he ceded or made over his right for a period which was fixed or determinable.

¹³¹ PA Olivier, *Trust Law and Practice* at 197.

CHAPTER 4

CONCLUSION

The focus of this dissertation has been on s 25B and the anti-avoidance provisions contained in s 7, and more specifically s 7(3), s 7(4), s 7(5), s 7(6) and s 7(7).

Section 25B was enacted as a response to the decision in the *Philip Frame Will Trust*¹³² that a trust is not a legal persona whether at common law or under the Act. This section extended the definition of a 'person' to include a trust fund and in effect tax income in the hands of the trustee in his representative capacity or in the beneficiary's hands if the provisions contained in the section are satisfied.

The deeming provisions in s 25B leave intact the conduit pipe principle. The section is, however, subject to s 7.

Since trusts lend themselves to various tax avoidance schemes such as income splitting, s 7 was enacted to undermine these schemes. Section 7 also contains a number of deeming provisions which deem income which has accrued to a beneficiary of a trust to accrue to someone else, usually the donor. Although many of the obscurities surrounding s 7 have been addressed and resolved by the courts, certain grey areas still remain. These include

- the unresolved issue of the meaning of 'event' in s 7(5) and
- whether or not the exercise of a trustee's discretion constitutes an event as contemplated in the section.

Since anomalies arise in the court decisions, the only certainty is the practice adopted by the Commissioner, which is to regard the exercise of a trustee's discretion as an event.

A further unresolved issue is whether s 7(5) applies

- where the beneficiaries have a vested right to the accumulated income in a trust, or
- whether the section can apply where the beneficiaries do not have vested rights.

¹³² 1991 (2) SA 340 (W); affirmed by the Appellate Division (1993) 55 SATC 39.

Again, the courts have not afforded clarity. The Commissioner's practice, however, is to tax accumulated income which vests in the beneficiary in the hands of the beneficiary.

It is submitted that these uncertainties do not pose insurmountable problems, and it is improbable that the courts will provide further clarity in the near future, since the Commissioner's current practices generally favour the taxpayer and are thus unlikely to face a court challenge.

The trust is generally perceived as an effective vehicle through which a taxpayer may reduce his liability to tax.

Many estate planners will recommend the trust as a tool, with some form of tax savings possible, provided such planning is undertaken with the necessary skill.

A sound knowledge of the tax implications is required for the intelligent drafting of the trust deed. A lack of these skills could easily result in the taxpayer being in a worse position tax-wise than when he first started.

As mentioned in the introduction there are other taxes, namely, donations tax and estate duty, which also influence the use of trusts, and which estate planners need to be aware of when creating a trust.

Donations tax is particularly important when transferring property to a trust for no consideration or for a consideration which is below its value, as the difference between the value of the property and the consideration received therefor could be deemed to be a donation and attract donations tax in terms of s 58 of the Act. The taxpayer could therefore suffer tax on trust income deemed to be his in terms of s 7 as well as donations tax.

The Estate Duty Act¹³³ also contains provisions which must not be overlooked by the estate planner. The Estate Duty Act brings certain assets, as well as deemed assets, into a deceased taxpayer's estate for estate duty purposes. Estate planners should, for example, avoid provisions in a trust granting the taxpayer the right to dispose of property in the trust for his benefit or for the benefit of his estate.¹³⁴

¹³³ Act 45 of 1955.

¹³⁴ Section 3(3)(d) of the Estate Duty Act No. 45 of 1955.

In conclusion, it should be cautioned that tax avoidance should not be the primary consideration when creating a trust. Trusts offer other advantages which include limited liability and continuity, and allow the creator to provide for his children and other persons who are incapable of looking after their own affairs when he dies.

Strategically, it would be unwise to create a trust, or for that matter, any other form of enterprise, merely for tax benefits. The tax element should always be a secondary consideration even though some tax advantage may arise. This is especially so now that the use of trusts has been specifically targeted due to the perception that they are being abused in the pursuit of the avoidance of tax.

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