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Trusts, do they still have any significance as a tax planning and estate planning tool?

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Dedicated to

My Dad

My Inspiration, Strength and Superhero

GLOSSARY OF ACRONYMS

CGT- Capital Gains Tax

DTC – Davies Tax Committee

EDA- Estate Duty Act 45 of 1955

FISA – Fiduciary Institute of South Africa

ITA- Income Tax Act 58 of 1962

TLAA-Taxation Laws Amendment Act

TPCA – Trust Property Control Act 57 of 1988

SCA – Supreme Court of Appeal

ABSTRACT

In the estate planning domain, trusts specifically have been "in the line of fire" over a period of time. There have been punitive amendments made to existing trust legislation and new trust legislation introduced which has brought trusts under the spotlight. To compound the problem, trusts are exploited and utilsed as vehicles through which various schemes are developed and implemented to meet illicit objectives.

However, despite these drawbacks, at the very core of trusts is where the true and essential purpose of a trust is found in its purest form, which is to protect and preserve assets for the benefit of its beneficiaries. This is the primary focus of the dissertation.

The dissertation commences with the origins of trusts to establish the underlying reason why such an institute was created and accepted into South African law. There has been much development of trust law in South Africa since inception which is indicative of the need for the use of trusts. It becomes evident from the indepth analysis about the tax legislation applicable to trusts and the exploitation of trusts, how closely linked these two aspects are. The author agrees that a response to misconduct of the parties to a trust is necessary, but not necessarily through punitive tax legislation. In applying the latter, even the legitimate and well-managed trusts are prejudiced. There appears to be a need for a more stringent approach to deter the parties to a trust from engaging in misconduct from inception of the trust and not only after the problem has arisen. Relinquishing control by the founder or estate planner and complete independence and objectivity of trustees is a huge predicament.

It is worth noting though, that the benefits a trust offers has not been lost. Infact it is likely that the benefits of a trust will continue to evolve with each generation.

Government's intervention in making the appropriate resources available to oversee the operation and proper management of trusts is of crucial importance. A trust that is correctly structured, well managed and operates within the legal framework, will undoubtedly reap the benefits for its beneficiaries and contribute to the fiscus and the economy at large.

Chapter	Title	Page no.
1.1	Introduction	7
1.2	The purpose and rationale	8
1.3	The Chapter outline	9
1.4	Research questions	10
2	The origins and development of trusts and trust structures	11
2.1	Introduction	11
2.2	The development of trusts	12
2.3	Types of trusts	16
2.4	Rights of beneficiaries in relation to trusts	17
2.5	The parties involved in an *inter vivos* trust	18
2.6	Conclusion	19
3	Tax implications in relation to trusts	20
3.1	Introduction	20
3.2	A trust is a "person" for tax purposes	21
3.3	History of trust tax rates	21
3.4	Transferring assets to an *inter vivos* trust and the related tax implications	22
3.5	Tax implications on income generated by trusts	24
3.6	How has government and SARS dealt with such exploitation?	26
3.6.1	Anti-avoidance tax provisions	26
3.7	Conclusion	40
4	Exploitation of trusts	42
4.1	Introduction	42
4.2	Essentials for the formation of a valid trust	43
4.3	What is a '*sham trust'*	44
4.4	What is an '*alter ego trust'*	45
4.5	Piercing the veil of a trust	50
4.6	Conclusion	54
5	Benefits of a trust as a tax and estate planning tool	56
5.1	Introduction	56
5.2	The benefits of a trust	56
5.3	Conclusion	65
6	Discussion and Conclusion	66
6.1	Introduction	66
6.2	Reflecting on the research questions	67
6.3	Conclusion	73
	Bibliography	75

Table of Contents

Chapter 1:

1.1. Introduction

Trusts, in its pure and true sense, is an important estate-planning tool created, at the outset, to protect assets for the benefit of others (beneficiaries). The Trust Property Control Act[1] defines a trust as an "arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed –

a) To another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
b) To the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument."

Over the years this institution has evolved into a complex tool and significant developments in the law of trusts have taken place.

Many estate planners want to create trusts as part of their estate plan to meet their various estate planning objectives. It is therefore of utmost importance that there is clear understanding by estate planners about the implementation and management of trusts as an estate-planning tool in order to meet their objectives with a proper and correct approach.

There are undoubtedly many founders out there who have created trusts with deliberate intention of utilising the trust in an exploitative manner as will be seen further on in the dissertation. However, many estate planners do have valid objectives for their trusts. Unfortunately, for these estate planners, they are often caught up in the tireless "tactical game" played between tax evaders and SARS where tax evaders who are founders, trustees or

[1] TPCA 57 of 1988, s1

beneficiaries of trusts manipulate every possible loophole to transfer their wealth into trusts and evade paying taxes. This in turn results in punitive legislative change following up shortly thereafter with SARS endeavouring to close the loopholes, as will be evident in chapter 3 below.

1.2. The purpose and rationale

The purpose of this dissertation is to consider the true essential use and purpose of trusts and to analyse whether trusts still have a place in tax and estate planning in view of the legislative amendments that have occurred over the years. There is a need to unravel the reasons for these changes as well as the reasons for trusts being very much under SARS' radar. It can only be anticipated that there will be further changes into the future in view of a 'pattern' of legislative changes that has taken place.

With the development of schemes by tax evaders, the true and essential purpose of trusts is becoming unclear and somewhat lost. These challenges identified by SARS have not entirely been resolved and contributions to resolving these issues are necessary hence, my research on this topic.

In many instances, estate planners believe that by creating trusts and transferring their personal assets into trusts, this will be a means of tax savings. There is a need to correct this misconception. This dissertation will look into some of the complexities and misconceptions relating to trusts such as the taxation of trusts and the exploitation of trusts, which over time has come to the forefront, thereby making trusts unpopular to some extent, if not to a large extent. The true and essential purpose of trusts will be also be given due consideration to determine whether, or not, trusts have indeed lost its place in tax and estate planning.

What is clear is that estate planners either have limited knowledge regarding the tax implications relating to trusts, alternatively they have vast knowledge and experience, which they may use to try to manipulate the system. The ideal situation is to have the (vast) knowledge and experience but work within the legal framework.

A trust may work as part of a well-crafted estate plan in certain instances but certainly not in every instance. Of vital importance is the underlying objective of the founder or estate planner and this is what establishes the way forward in terms of the activities of a trust. One of the

purposes of this dissertation is to establish the instances when a trust maybe successfully and properly used.

1.3 The chapter outline

The dissertation consists of six chapters. Chapter one, sets out the introduction to the dissertation, the purpose and rationale for the dissertation, the research questions and the chapter outline to provide some insight as to why and how the author will go about analysing whether trusts are indeed still relevant as a tax and estate-planning tool.

Chapter two, is a discussion about the development of trusts over time and to analysing whether the true and essential purpose of trusts has carried through over time to present day or did it perhaps phase out along the way. This chapter will also set out the types and structures of trusts as well as the rights and obligations of the parties to a trust because reference is made in the various chapters of this dissertation about these structures, rights and obligations.

Chapter three, sets out the legislation relating to the taxation of trusts from transferring assets into a trust at inception, to retaining income and assets in trust and the distribution of income and assets from a trust to beneficiaries. Also discussed are some of the loopholes in the tax system that have been now been closed, but for how long, one cannot say. SARS' treatment of trusts has been harsh and as aptly said by Phia Van Der Spuy, "SARS treats trusts as the *black sheep* of the family of investments vehicles available to South African tax residents".[2]

Chapter four looks at the exploitation of trusts and the discussion of various case law to see how our courts have dealt with such cases. Case law contributes to building and strengthening our trust law, which is much needed in South Africa and without which the proper use and benefits of trusts will be completely blurred out.

Chapter five examines the benefits that a trust provides to estate planners. It will be argued that these benefits are much needed and therefore has not been lost along the way despite the shadow of doubt cast upon trusts resulting from the abuse and exploitation of trusts.

Chapter six, is an evaluation of the dissertation topic and a closing discussion of the research covered with recommendations by the author.

[2] P Van der Spuy *Demystifying Trusts in South Africa* 2 ed (2021) 2.

1.4. Research Questions:

1.4.1 What is the true and essential purpose of trusts that has followed through from inception to present day and how have trusts developed over the years?

1.4.2 How does tax implications relating to trusts, impact on the use of trusts as a tax-planning tool in a larger picture of an estate plan? Is the true and essential purpose of a trust being lost because of the harsh tax legislative changes implemented?

1.4.3 How and why have trusts been exploited by some founders and trustees or estate planners?

1.4.4. How does the government deal with curbing such exploitation?

1.4.5 Based on the research in this dissertation, can a trust be utilised as a tax and estate-planning tool?

CHAPTER 2:

THE ORIGINS AND DEVELOPMENT OF TRUSTS

2.1 Introduction

This chapter looks into the development of trusts from inception to date. It becomes evident in this chapter that as trusts became more entrenched into South African law, various legislation became applicable to trusts. Trusts were classified into different types of trusts as was the rights of beneficiaries.

A good starting point would be to consider the roots of trusts as well as how and why did this institution flow into South Africa. It is the author's opinion that there had to be sound reasons firstly, for the creation of trusts and secondly, the recognition into South African law. Furthermore, it is these reasons that would reflect the essential purpose of trusts, that is, before trusts became tainted and associated with abuse or exploitation for opportunistic purposes. Over time, the true purpose may have blurred, as will be evident further in the dissertation, but also evident further in the dissertation is that despite the latter is the fact that the true purpose of trusts is certainly not lost.

The inclusion of the consistent development of trusts and trust structures in the dissertation is suggestive of the growing need for the use of trusts. Trust law and principles are intertwined in various pieces of legislation and courts and judges contribute significantly to this aspect of law.[3]

The objectives of a trust will largely dictate how a trust ought to be structured. An example of this would be, where a trust is structured as a vesting trust for a beneficiary who is unable to control or manage his or her own assets but the intention of the founder of the trust is for an investment to be owned by the beneficiary for the beneficiary's specific benefit or the

[3] W Geach with J Yeats *Trusts Law and Practice* 1 ed (2007) 11

fulfillment of a condition. Furthermore, the structure of a trust sets the boundaries within which a trust and its role players may function. The author has therefore included a brief discussion in this chapter about the structure of trust forms, the parties to a trust and the rights and obligations of each party as well as the roles that each play.

2.2. The development of trusts

Trusts originated during the 12th and 13th century.[4] During these times, many landowners left England to fight in the *Crusades*. The landowners (true owners) entrusted the management of their lands to another person during their absence, by passing ownership to them (legal owner).[5] In line with the principle of equity, when the *Crusaders* returned the legal owner would return the land to the true owner. This set of events set the background for the development of trusts where the *Crusader* or the true owner was the beneficiary and the other person or the legal owner was the trustee.[6] It can be said that at this point, the underlying principle of asset protection within a trust like-system was born emphasizing one of the essential purposes of a trust i.e. asset protection. Since the 12th century to date, the trust as an estate-planning tool has been on a rather tumultuous course. However, the underlying principle of a legal obligation which the trust places on a trustee to look after trust property and invest it in a manner that will benefit the beneficiary, was the essence of a trust or the concept of a trust as far back as the 12th century.

Trusts became integrated into South African law after the second British occupation in 1806.[7] The concept

> "was received into our law from England. British settlers brought the trust institution with them and used terms such as 'trust" and 'trustee' in wills, deeds of transfer, ante nuptial contracts and land transfers. As a result of this usage the trust became a familiar feature of legal and commercial practice at the Cape which in due course spread through South Africa."[8]

[4] Van Der Spuy op cit note 2 at 4-5.
[5] ibid 4.
[6] ibid 5.
[7] L Smith *The Worlds of the Trusts* 1 ed (2013) 257.
[8] L Manie *The South African Law of Trusts with a view to legislative reform* (unpublished LLD thesis, University of Western Cape, 2015) 19.

However, this was not done through any legislative interventions. It became necessary for South African courts to interpret legal documents such as wills and trust deeds which had been drawn up by English practitioners.[9]

With regard to trusts and the English law of property, English law laid down a "dual system of legal and beneficial ownership.[10] In terms of this system it was possible to have two kinds of ownership in respect of the property - the trustee could be the legal owner under the common law and the beneficiary the beneficial owner in terms of the law of equity. This concept of dual ownership i.e. legal ownership and beneficial ownership is unfamiliar to Roman Dutch law. In terms of Roman Dutch law only one kind of ownership can exist in one and the same thing. By explaining trusts with reference to the Roman Dutch law, the South African courts have over the years created a unique South African trust law, which bears little resemblance to its current English law counterpart."[11]

South African trust law is a combination of elements of Roman- Dutch law and English law, which have been adapted to meet the requirements of the South African market.[12]

Legislation in South Africa was phased in gradually, initially through proclamations and ordinances as required at the time. Trusts were being utilsed for various purposes, such as building and managing churches, businesses, club property, marriage settlements and bequests through wills.[13]

The Administration of Estates Act[14] was the legislature's first attempt at regulating trusts but it only dealt with testamentary trusts. Subsequently, the Trust Moneys Protection Act[15] was enacted to deal with *inter vivos* trusts. It provided a clear definition of a *trustee* and what was required of a trustee amongst other provisions but this Act was not without criticism and was insufficient in certain respects. Later, the Administration of Estates Act[16] , more specifically chapter III had tighter control over both testamentary trusts and *inter vivos* trusts before the Trust Property Control Act[17] repealed it.

[9] M Honiball The Taxation of Trusts in South Africa 1 ed (2009) 2.
[10] ibid 2.
[11] ibid 2 .
[12] Van der Spuy op cit note 2 at 45.
[13] Manie op cit note 8 at 34
[14] Administration of Estates Act 24 of 1913
[15] Trust Monies Protection Act 34 of 1934
[16] Administration of Estates Act 66 of 1965
[17] TPCA Act 57 of 1988

In 1915, *Estate Kemp v McDonald's Trustees*[18] was one of the first judgments by a South African Appellate Division court (as it was then formerly known) on trusts. The court recognised trusts under South Africa law and made the first attempt at developing rules pertaining to trusts. Although this case did not escape criticism, one of the underlying principles that emerged from the case was the protection of assets by one party for the benefit and enjoyment of another party. It is evident from this very first case law on trusts in South Africa that protection of assets is at the core of this institution.

In addition to the case law, the following have had an impact on the use and development of trusts.

The Trust Property Control Act-

Today the Trust Property Control Act[19] regulates the use of trusts. The Act defines a trust as,

> "The arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed–
>
> (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
>
> (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument or for the achievement of the object stated in the trust instrument,
>
> But does not include the case where property of another is to be administered by any person as executor, tutor or curator in terms of the Administration of Estate Act" [20]

This definition includes trusts in which assets vest in the trustees as well as those trusts in which assets vest in beneficiaries. These types of trusts are discussed in more detail below.

Constitution Laws Act 5 of 2005

[18] *Estate Kemp v Macdonald Trustees* 1915 AD 491
[19] TPCA 57 of 1988
[20] TPCA 57 of 1988 s 1.

The Constitution of South Africa also governs South African trusts. Should any trust provisions in terms of the trust deed *offend* the Constitution it may be declared as invalid. While the principle of freedom of testation is the norm in South Africa, the law does not allow acts that are *contra bonos mores* or against good morals.[21] The Income Tax Act[22]-

In terms of the Income Tax Act, a trust was not regarded as a taxpayer before 1998.[23] This encouraged the abuse of trusts for purposes of savings on tax. However, government has since then made numerous amendments to the Income Tax Act to restrain the abuse. Government continues to make necessary amendments as and when taxpayers devise creative exploitative methods to circumvent the tax system.[24]

The Estate Duty Act [25]-

Estate duty is a death tax, which estate planners would prefer to avoid paying, as far as possible and in some cases perhaps taken too far in an attempt to escape the nets of estate duty. However, should a trust deed contain provisions that empowers a deceased person, prior to his death, to control or administer trust property for his or her own benefit disposing of property, revoking or varying provisions of any donation, settlement or other disposition made by him or her,[26] in such a case and in terms of the Estate Duty Act[27] the trust property will be included in the estate of the deceased person as deemed property.[28]

Common law-

Our courts and judges have, over a period, developed common law through their own decision-making and application of legal precedents to similar situations. This has developed into a body of law, which is extremely useful due to the limited legislation relating to trusts in South

[21] Van der Spuy op cit note 2 at 48.
[22] ITA 58 of 1962.
[23] Van der Spuy op cit note 2 at 50.
[24] ibid 50.
[25] EDA 45 of 1955.
[26] Van der Spuy op cit note 2 at 53.
[27] EDA s3(3)(d).
[28] ibid 53.

Africa.[29] Our courts are the primary contributors to a uniquely developing set of South African trust law principles.[30]

"While the English trust as an institution may have been incorporated into South African law, the English law of trust was never incorporated."[31]

2.3 Types of trusts

Trusts are categorised based on different criteria or a combination of criteria with different legal, tax and other consequences flowing from these criteria. [32]

Trusts are classified or categorised based on-[33]

- Whether the founder is alive or dead. In the case of the former, an *inter vivos* trust is created and the latter a testamentary trust.
- The rights of beneficiaries and ownership of property held in trust

These classifications are discussed below:

2.3.1 An *inter vivos* trust - the founder establishes a trust during his/her lifetime and in terms of a contract referred to as the trust deed.[34]

2.3.2 A testamentary trust - a testator or testatrix instructs the executor of the estate through a will, to register a trust after his/her death. The transfer of assets into the testamentary trust will take place on distribution of the estate. It will be for the benefit of the beneficiaries described in the will. This trust is only registered after death of the testator or testatrix.[35]

2.3.3 Discretionary trusts – these trusts are common and are also known as *ownership trusts*. The vesting of benefits are at the discretion of the trustees. Trust assets are

[29] Van der Spuy op cit note 2 at 58.
[30] Manie op cit note 8 at 41.
[31] Honiball op cit note 9 at 2.
[32] Geach op cit note 3 at 17.
[33] M Botha...et al *South African Financial Planning Handbook* 17 ed (2019) 835.
[34] Van der Spuy op cit note 2 at 21
[35] ibid 24-255

registered in the names of the trustees making them the actual *non-beneficial* owners of the trust assets. They have a discretion in terms of which beneficiaries receive distributions and when they would receive it.[36]

2.3.4 Vested trusts- The trustees are *non-beneficial* owners of the trust but unlike discretionary trusts, the trustees have no discretion in determining which beneficiaries are to receive a distribution. The latter is dictated in the trust instrumented.[37]

2.3.5 Bewind trusts – the assets are registered in the name of the beneficiaries i.e. they acquire ownership of the assets and the trustees merely control and administer the trust. The assets in this type of trust may be exposed to the claims of a beneficiary's creditors and could be at risk in the event of an insolvency or divorce of such beneficiary.[38]

In all of these trusts, there must be a fundamental separation of control of the trust assets from the founder and beneficiaries.

2.4 Rights of beneficiaries in relation to the trust:

2.4.1. Vested rights- the income and /or capital of the trust are *vested* in the beneficiaries. A *'vested right'* is "a right belonging completely and unconditionally to a person as a property interest which cannot be impaired or taken away without consent of the owner."[39] The trustees merely administer and manage the capital or income for the beneficiaries.

2.4.2. Contingent rights- Beneficiaries have a hope to receive something.[40] There is no guarantee that beneficiaries will receive a distribution of income and/or capital from the trust. In other words, there is neither certainty whether a beneficiary will ultimately benefit from the trust nor to what extent, if any. The distribution is dependent on the discretion of the trustees. This means that the trust is a discretionary trust.

2.4.3. Income rights- beneficiaries who may only receive income from the trust[41]

[36] ibid 30Van der Spuy op cite note 1 at 30
[37] Van der Spuy op cite note 2 at 32
[38] ibid 35
[39] ibid 32
[40] ibid 479
[41] ibid 471

2.4.4. Capital rights- beneficiaries who may only receive capital from the trust[42]

A beneficiary may also have a combination of the aforementioned rights, for example, a beneficiary could have a vested right to a part or to the whole of the income of a trust, while only having a discretionary right to the capital of the trust.[43]

This dissertation will focus, from here on forward, on discretionary *inter vivos* trusts only. *Special* [44]discretionary *inter vivos* trusts are excluded.

The other types and classifications of trusts were mentioned above briefly to show where discretionary *inter vivos* trusts fit into the structure and types of trusts generally and how they differ from other trusts including the different rights beneficiaries have which may be combined, or not, in a trust set up.

2.5. The parties involved in an *inter vivos* trust are:

2.5.1. Planner/ Settler/ Founder – this person establishes a trust. Any person with contractual capacity can establish a trust. The founder must take care that SARS does not see him or her as controlling the assets for his/her own benefits or else the trust assets may be deemed property in the founder's estate for estate duty purposes.[45]

2.5.2. Trustees – are authorised to administer the trust in accordance with the trust deed and the Trust Property Control Act. Although a trust must have at least one trustee, it is prudent to have more than one trustee to retain and ensure objectivity in decision-making. Ideally to resolve conflicts and/or an impasse through majority vote, at least three or more trustees one of whom is an independent trustee i.e. unrelated to the founder, other trustees and beneficiaries[46]

2.5.3. Income beneficiaries- are nominated and classified beneficiaries in terms of the trust deed. Income beneficiaries' receive income generated by the trust. In a discretionary trust, the beneficiaries receive income at the discretion of the trustees. Alternatively, in a vesting

[42] ibid 472
[43] Geach op cit note 3 at 19.
[44] *Special* trusts are trusts created for the benefit of mentally or physically disable persons or in terms of a will for minors related to the deceased person. Special trusts are taxed differently from other trusts.
[45] Botha et al op cit note33 at 840
[46] ibid 840

trust, the trustees are obliged to pay income to the beneficiaries in accordance with the terms of the trust deed. [47]

2.5.4. Capital beneficiaries- are nominated and classified beneficiaries in terms of the trust deed. Capital beneficiaries receive capital from the trust, on the date specified in the trust deed alternatively, when the trustees exercise their discretion.[48]

2.6. Conclusion

This chapter sets out the origin of trusts and its filtering through to South Africa. From this discussion it appears that the very purpose of trusts at the outset was to provide protection of assets for the benefit of third parties. The South African law of trusts today is a combination of English law, common law and South African law of contract.

There is one single statutory provision specifically dealing with Trusts i.e. The Trust Property Control Act, which in the author's opinion, does not do justice to the enormity and complexities of trusts. However, there are other pieces of legislation that apply to different aspects of trusts, for example the Income Tax Act, the Estate Duty Act, and The Constitution. Our common law and case law in South Africa plays a vital role in setting principles and guidance in our trust law as will be more evident in the ensuing chapters discussing various case law.

The discussion regarding the structure and types of trusts as well as the rights and obligations of the important role players sets out, in short, the "boundaries" within which trusts and its roles players should effectively operate. Stepping outside the boundaries of the purpose of trusts, the structures and types of trust or even the rights and obligations of the parties to a trust, completely undermines the proper use of a trust.

Having discussed the origins and set up of a trust, the ensuing chapter considers the tax implications in relation to discretionary *inter vivos* trusts to evaluate the extent to which such trusts function as a tax savings vehicle.

[47] Botha et al op cit note 33 at 846
[48] ibid 847

CHAPTER 3

TAX IMPLICATIONS IN RELATION TO TRUSTS

3.1. Introduction

The dissertation seeks to establish whether a trust is indeed a significant tax-planning and estate-planning tool. Tax planning can be defined as "the analysis of a financial situation or plan to ensure a person pays the lowest taxes possible. A plan that minimizes the amount of tax a person pays is referred to as tax –efficient." [49] It is therefore, without a doubt, necessary to discuss the tax implications relating to trusts and assess its impact on tax planning and estate planning.

In this chapter, the author will discuss briefly the history of tax rates applicable to trusts and in more detail the tax legislation in its current form as well as the possible reasons for the punitive tax treatment on trusts.

The chapter also aims to highlight the taxes applicable when assets are transferred into an *inter vivos* trust, potential tax risks associated with trusts that are not structured correctly, as well as the consequences of transacting with '*connected persons'.*

Over the years and more recently, the Income Tax Act has introduced various amendments including the introduction of section 7C and within a short period of time two further amendments to section 7C and another amendment forthcoming. These amendments, discussed in detail below, would have come about with legitimate reasons from a SARS perspective. This discussion illustrates the extent to which tax evaders would go, to have assets transferred into a trust without having to be accountable for the payment of taxes.

[49] J Kagan 'Tax Planning' (17 February 2021 available at *https://www.investopedia.com/terms/t/tax-planning.asp* (accessed on 21 November 2021).

3.2. A trust is a "person" for tax purposes

Initially a trust was not defined as a 'person' in terms of the Income Tax Act but a trust was nonetheless taxed on retained income. This practice was challenged in *CIR v Friedman*[50] due to the fact that a trust was not regarded as a taxable entity in terms of the Income Tax Act . It was held in this case that under common law, a trust is not a "person". This meant that trustees could not be regarded as representative taxpayers, which was the basis of the argument in *Friedman*.[51]

Subsequently section 1(1) of Income Tax Act was amended to incorporate a trust within the definition of 'a person' thereby bringing a trust within the nets of taxation. Section 25B was also then included into the Income Tax Act. In applying this section, the party responsible for the payment of tax on trust income is established. A similar provision[52] has been included in the Income Tax Act in respect of capital gains distributed to trust beneficiaries.[53]

3.3. History of trusts tax rates

Prior to February 1999, trusts were taxed on the same sliding tax scale as individual taxpayers but without rebates. This resulted in many estate planners investing in income-generating investments through multiple trusts to take advantage of the income tax structure through income splitting.[54] This became a very common occurrence with taxpayers using multiple trusts to lower the payment of tax.

Between 1999 and 2002, "trusts were taxed at a dual rate of tax."[55] The first R100 000 income was taxed at 35% and the income above that was taxed at the maximum marginal tax rate at the time. This did not deter taxpayers from having multiple trusts; in fact, it encouraged this

[50] *CIR v Friedman and others NNO* [1993] 1 ALL SA 306 (A) paragraph 4.
[51] Van der Spuy op cit note 2 at 623.
[52] ITA schedule 8.
[53] Van der Spuy op cit note 2 at 82.
[54] 'Income splitting' in relation to trusts refers to the income of the trust, which is received by or accrues to beneficiaries or the trust and is taxed either in the trust or in the hands of beneficiaries in accordance with section 25B of the ITA, subject to the anti-avoidance tax provisions of section 7. In other words, it is possible for trust income to flow to several beneficiaries via the trust (a conduit) and taxed in the hands of the beneficiaries. If the beneficiaries have a lower tax rate than the trust, this would in turn be a tax advantage. According to Kagan, income splitting is a tax reduction strategy. A discussion of Section 25B, Section 7 and the *conduit pipe principle* follows on further in this chapter.
[55] DTC Final Report on Estate Duty 35.

activity to continue and use "pour-over" trusts[56] so that taxpayers would pay tax at a lower rate. Each trust confined its income to R100 000 per annum only and any income over R100 000 was dispensed off to another trust beneficiary. Each beneficiary trust would follow suit.

Although working within the legislative framework, what is seen here is the devising of schemes by taxpayers as a means to pay less tax by using loopholes in the tax system. This was clearly not the intention of the legislature.

SARS began to monitor trusts circumspectly since it became evident that trusts were being utilised as a means of *structured tax avoidance*.[57] As a result, in 2003 the legislature decided to tax trusts at a flat rate[58] i.e. at the maximum marginal tax rate of individual taxpayers, which continues today. For the year ending 2022, the income tax rate is 45% with the effective capital gains tax rate being 36%.

3.4. Transferring assets to an inter vivos trust and the related tax implications

Once a trust has been set up and registered at the Office of the Master of the High Court, the trustees may wish to acquire assets. However, the trust has no accumulated wealth to purchase assets at this stage.

Transferring assets to an *inter vivos* trust may occur through-

- A sale,[59] via a loan to the trust if the trust has no funds of its own for the purchase of the assets;
- A donation[60] or
- By inheritance through a deceased person's will.[61]

Each of the aforementioned methods mentioned above, are discussed in more detail below, in order to establish the tax consequences thereof:

[56] ibid 35.
[57] Van der Spuy op cit note 2 at 621.
[58] DTC op cit note 43 at 35.
[59] Van der Spuy op cit note 2 at 268.
[60] Ibid 261.
[61] Ibid 287 & 288.

Sale:

The sale of assets is regarded as a disposal for purposes of capital gains tax (CGT).[62] Depending on the type of asset being sold to the trust, there could be a CGT liability for the seller and if immovable property the transfer of ownership will also attract transfer duty.

If assets are sold to a trust and a loan account is created, the trust must repay the loan to the lender with interest at the current official rate (currently 8%). The interest received by the lender will form part of his gross income and is taxable in his or her hands.

Previously, estate planners sold assets to a trust through an interest-free loan or low interest loan. This was a means used to "freeze" or "peg" [63] their estates while retaining the loan account at a minimal level. The loan was payable on demand and in many instances, the loans remained unsettled by the trust. Subsequently, the loan was bequeathed to the trust in the will of the lender. This afforded many estate planners an opportunity to reduce their personal estates by transferring their assets into trusts under the disguise of a loan owed to them by the trust. Although the loan account remained an asset in the estate of the lender, the growth of these assets occurred in the trust, which resulted in savings on estate duty and CGT for the lender. In other words, the value of the assets increased in the trust while the value of the loan remained unchanged or decreased in the estate of the lender by donations, up to the exemption limit, made by the lender to the trust as explained below in more detail. In fact, many of the wealthy do not own much assets in their own names, if any. They control their businesses, properties and other assets through trusts.[64]

However, section 7C of the Income Tax Act came into effect on the 1st of March 2017[65] bringing with it significant changes in respect of the treatment of interest-free or low-interest loans made to trusts. In terms of section 7C, an interest-free or low-interest loan i.e. below the current official rate of interest, will attract donations tax in the hands of the lender. The donations tax is calculated on the difference between the current official rate of interest and the actual rate of interest that is being charged on the loan. This difference is regarded as a donation

[62] ITA 58 of 1962 schedule 8 paragraph 11.
[63] Van der Spuy op cit note 2 at 143.
[64] Ibid.
[65] Taxation Laws Amendment Act 15 of 2016.

by the lender to the trust and the lender will then be liable for donations tax on any amount in excess of the R100 000 annual exclusion. [66]

A detailed discussion of section 7C follows below together with other anti-avoidance tax measures where the measures taken by government to close loopholes from which tax revenue leaks, is evident.

Donation:
The second method of transferring assets to a trust is by donation. Assets donated to a trust is regarded as a disposal and depending on the type of asset, is likely to attract CGT[67] in the hands of the donor as well as donations tax[68]. Immovable property will in addition, attract transfer duty, payable in the hands of the trust.

Inheritance:
Lastly, an inter vivos trust may be nominated as a beneficiary in a Will provided the trust deed allows for the receipt of the bequests.[69] There are no tax implications for the trust in this regard.

3.5. Tax implications on income generated by trusts

Once assets in the trust generate income and/or a capital gain it is taxed in one of three sets of hands namely, the trust, the donor, including the founder, or the beneficiaries.[70]

The income tax rules applicable to trusts are mostly contained in section 25B of the Income Tax Act, which deals with taxation of trusts and beneficiaries of trusts. However, section 25 B is subject to section 7.[71] The latter is an anti-avoidance tax provision, which shifts tax liability for trust income from the trust to a natural person. In terms of this provision, a donation by a person to a trust makes the donor liable for tax on trust income at his or her own marginal tax rate, which could even be lower than the trust. Section 7 is discussed in detail further on in this chapter.

[66] Botha et al op cit note 33 at 695.
[67] ITA 58 of 1962 schedule 8 Paragraph 11.
[68] ibid Section 54.
[69] Van der Spuy op cit note 2 at 291.
[70] Botha et al op cit note 33 at 855.
[71] P Haupt *Notes on South African Income Tax* 40 ed (2021) 804.

Section 25B(1) states that

> "any amount received or accrued in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to the trust." [72]

In other words, income or capital gains accrues to a beneficiary when the right to receive it vests in him or her. Should the income or capital gain vest in a beneficiary in the tax year it was received by the trust, the beneficiary will be liable for the payment of income tax or CGT and the trust will be absolved. However, if retained in the trust during the tax year of receipt, the trust will be liable for the tax. In both instances the proceeds will be subject to section 7 and the provisions of schedule 8. The income is not taxable in both the hands of the trust and the beneficiaries. In this way, double taxation is avoided and only one party to the trust is taxed. This in effect is the application of the *conduit pipe principle*.

Briefly, the *conduit pipe principle* applies when income received by the trust retains its nature[73] but flows to a beneficiary with a vested right to that income, within the same tax year it was received by the trust.

In short, a trust would more accurately be described as a "conduit" or "channel" through which income and gains flow to trust beneficiaries.[74] As a result of this, it is evident that one of the key benefits of trusts is the opportunity that trustees have to split income by distributing income and/or capital gain of the trust to trust beneficiaries who have lower rates of tax than trusts. The latter is however subject to the deeming provisions of section 7 of the Income Tax Act. [75] These deeming provisions curb the abuse of income splitting and is therefore necessary.

Paragraph 80 of the eighth schedule[76] follows the same principle for capital gains. It is equivalent to Section 25B, but applies in respect of capital gains.

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[72] ibid 804.
[73] Botha et al op cite note 33 at 857.
[74] ibid 852.
[75] ibid 852.
[76] ITA schedule 8 paragraph 80.

Splitting income by applying the *conduit pipe principle* has proven to be beneficial from a tax perspective for many estate planners. In fact, it was so beneficial that many estate planners applied this principle deliberately and intentionally, to avoid paying tax at higher rates. It is at this point when the tax advantage of income splitting turns into abuse. By vesting income or capital gains in beneficiaries with low tax rates, such as children, there is a saving on the amount of tax payable to SARS, which in its true sense is a deviation from conducting the trust tax affairs in a proper manner. Phia Van der Spuy says in her article,[77] "in practice often trustees disregard the purpose for which the trust was set up, as reflected in its objective in the trust instrument, and blindly allocate all income and capital gains to beneficiaries (without making any payment to them) in an attempt to avoid or save tax. Little do they realise that they are slowly undoing the purpose of the trust. The tax tail should never wag the estate plan dog." The benefit arising from the distribution will be exposed to creditors of a beneficiary should a beneficiary be in financial difficulties.[78]

However, over the years this practice, and perhaps the exploitation thereof, reduced the revenue which otherwise would have been payable to the State. Clearly, this frustrated the fiscus. The Minister of Finance in the 2013 Budget speech[79] as well as the first report of the Davis Tax Committee 'threatened' the removal of the *conduit pipe principle* and the possible repeal of Section 25B and Paragraph 80 of the Eighth Schedule due to the exploitation of the principle. There was much debate and opposition from the public. The principle eventually remained and in subsequent Budget Speeches, was not spoken of.

3.6. How has the government and SARS dealt with such exploitation?

3.6.1 Anti-avoidance tax provisions

The introduction of anti-avoidance provisions in the Income tax Act has provided some means of curbing the potential abuse entailed in the splitting of income, which demonstrates the legislature's efforts in preventing tax abuse relating to trusts. These provisions are updated

[77] Van der Spuy Trust- to-Trust: Making distribution to beneficiaries to save tax (14 July 2021) available at *https://trusteeze.co.za/article/making-distributions-to-trust-beneficiaries-to-save-tax-at-all-costs*, accessed on 20 December 2021.
[78] Van Der Spuy op cit note 2 at 1.
[79] SM Brink 'An investigation into the future of discretionary trusts in South Africa: An income tax perspective: Part 2' (2017) *South African Journal of Econo*mic *and Management Sciences 20(1) a1789* available at *https://doi.org/10.4102/sajems.v20i1.1789* , accessed on the 6 September 2021.

from time to time as loopholes and schemes that are creatively and strategically started by tax evaders become exposed. These tax avoidance provisions are discussed below.

Section 7 Income Tax Act:

Although section 7 is not restricted to trusts, this dissertation will consider section 7 within the context of trusts only.

Section 7 seeks to ensure that if an amount accrues to a trust or beneficiary as a result of some donation or gratuitous disposition, the person who receives that amount or to whom that amount accrues will not be taxed on that receipt or accrual. Rather, another person will be taxed on that amount in terms of section 7.[80] In other words, where section 7 applies, it overrides the provisions of Section 25B.[81] At times Section 7 is referred to as the *deeming provisions* or the *attribution rules* because Section 7 deems or attributes income to have been received or accrued to a person even though such income was not actually received by or accrued to this person.

The Eighth Schedule[82] contains certain attribution rules which are a replica to the deeming provisions contained in section 7 of the Income Tax Act except that it applies to a capital gain made by a person to be treated as a capital gain of another person. These rules mirror a few of the deeming provisions contained in section 7 of the Income Tax Act.[83] These corresponding rules will be mentioned below, but not discussed.

In order for the section 7 deeming provisions to apply, more specifically sections 7(2) to 7(8), it is essential that *a donation, settlement or disposition*[84] be made. In other words, without *a donation, settlement or disposition* these deeming provisions cannot apply.[85] To understand this conditional and essential requirement of section 7, the terminologies are discussed below:

A donation- is the disposal of one's property or assets for nothing in return. It is made out of the liberality or generosity of the person making the donation.[86]

[80] Geach op cit note 3 at 241.
[81] Haupt op cit note 71 at 806.
[82] ITA 58 of 1962 schedule 8.
[83] Botha *et al* op cit note 33 at 738.
[84] ITA section 7 (2) to 7(8).
[85] Haupt op cit note 71 at 808.
[86] ibid 808.

Settlement- "is a gratuitous disposal of property subject to specific terms and conditions, usually to the trustees of a trust." [87]

Other dispositions- applies to any gratuitous dispositions. The key elements in such dispositions are liberality or generosity for example, donations, interest free loans or low interest loans.[88]

Section 7 can fundamentally be classified as an anti-avoidance tax provision because it seeks to tax the donor in respect of income that arises from a donation, settlement or similar disposition made by such donor. The relevant subsections relating to distributed or retained trust income are subsections 7 (1), (2) (a), 7(3), 7(5), 7(6), 7(8), 7(9), 7(10) and to a lesser extent, 7(7). The purpose of section 7 is to tax the person who transferred income-generating assets gratuitously to a trust. The person who formed or created the trust is not of relevance in the application of section 7.[89]

Section 7(2) applies in a case were a spouse donates an income-producing asset to a trust. Income arising from the donation, which is distributed to the other spouse, renders the donor spouse liable for the tax on this income.[90] This scenario would typically occur where one spouse has a high tax rate as compared to the other spouse and the intention is to transfer the tax liability to the spouse with a low income tax rate. This section prevents a spouse from reducing his or her own tax liability.

[The corresponding provision in the Eighth Schedule is Paragraph 68.][91]

Section 7(3) applies in a case where a parent donates or makes a similar disposition to a trust. Any income arising by reason or in consequence of the donation or similar disposition that is distributed to a minor child of the parent, will be taxed in the hands of the parent. Once again, this section prevents parents from splitting income through the trust, with their minor children who are likely to have a low tax rate, if any at all.

[The corresponding provision in the Eighth Schedule is Paragraph 69].

[87] ibid 808.
[88] Botha et al op cit note 33 at 859.
[89] Haupt op cit note 71 at 806.
[90] ibid at 806.
[91] These paragraphs will be referred to below but not discussed.

In the following cases, it will be seen that Section 7(3) is not only applicable to income distributed to minor children from donated assets, but also from a gratuitous disposition.

In *Ovenstone, v SIR*[92] Mr Ovenstone loaned his children funds in order to purchase shares. He charged them interest of 8.5%, which at the time was a favorable rate. The loans were to be paid out of the dividends that the children would receive. Two of the children were minors. When they received dividends of R6 000 each on the shares, the tax authority deemed this to be Mr Ovenstone's income and taxed him in accordance with Section 7 (3) "because the minor children received the dividends 'by reason' of Mr Ovenstone's loan. The court held that the words 'other disposition' must be read *ejustdem generis* with the immediately preceding words (donation and settlement). Therefore, the word *disposition* had to be read as meaning a disposition with an element of gratuity. Even though the loans were not gratuitous dispositions, the charging of what was (at the time) a favourable rate of interest, was a disposition that was gratuitous. The court said that only the part of the dividends relating to the gratuitous disposition has to be deemed to be Mr Ovenstone's income."[93]

In *Joss v SIR*,[94] Mr Joss had sold shares via an interest free loan to a company. Mr Joss and his minor children were shareholders of the company. When the company paid dividends, the Commissioner taxed Mr Joss on those dividends. The court held that even though the sale was not a gratuitous disposition as "it was sold at a fair price" and neither was the loan, it was in fact "the non-charging of interest that was the gratuitous disposition. The non-charging of interest gave rise to a continuing donation of interest to the company which partially benefitted the minor children."[95] The application of Section7 (3) deemed the dividend income to have been received by Mr Joss.

It is evident from these cases the ease with which estate planners and taxpayers would, or could manipulate the tax system and legislation to split income had it not been for the Section 7 deeming provisions.

Section 7(5) applies where income, generated from an asset that was a donation, settlement or similar disposition to a trust, is retained in the trust. The donor will be liable for the income tax

[92] *Ovenstone v SIR* 1980 (2) SA 721.
[93] Haupt op cit note 71 at 808.
[94] *Joss v SIR* (1980 TPD, 41 SATC 206).
[95] Haupt op cit note 71 at 809.

on such income until his or her death. The trust will only be liable on such income after the death of the donor.[96] An example of the application of this section follows:

> "Mr X donates an amount of R300 000 to a trust. The trust earns interest of R28 000 on this amount. The trust has five beneficiaries and the trustees have discretion whether and to whom any income distributions should be made. The trustees decide to accumulate the income in the trust and not to make any distribution. Who will be taxed? Section 25B would, in absence of any deeming provision, cause the amount to be taxed in the hands of the trust. However, the Section 7 anti-avoidance provisions override Section 25B. A donor (Mr X) donated money to a trust. The trust has earned interest on this donation. The direct cause of the interest income was therefore a donation made by Mr X. The income is accumulated in the trust/retained in the trust and will be only distributed upon the happening of an event, namely the exercise by the trustees of their discretion. The R28 000 is deemed to be taxable in Mr X's hands in terms of Section 7(5)."[97]

Section 7(5) has the effect of preventing estate planners from disposing of their assets to reduce their estates by donating their assets to a trust. The fact that Section 7(5) allows the Commissioner to tax them (the donor) on the income retained in the trust arising from the donated assets is not attractive for the donor from a tax perspective. Despite having paid donations tax, the estate planner is not completely divested of these assets for tax purposes. If distributions are continually made to beneficiaries each tax year to enjoy the lower rate of tax in the hands of the beneficiaries, there would not be much opportunity for the creation of wealth in the trust.

Section 7(6) applies to income distributed by a trust, which income results from a donation, settlement or disposition. However, if the donor is given the power through rights in the deed of such donation, settlement or disposition to grant a beneficiary the right to receive such income but also allows the donor to revoke the right to such income from the beneficiary or grant it to another beneficiary, the income shall be deemed to be the income of the donor as a result of such power retained by donor.[98]

[96] Ibid 807.
[97] Botha et al op cit note 33 at 862.
[98] Haupt op cit note 71 at 807.

In this section the legislation attempts to curb the retention of control by imposing a tax burden upon the person who retains such control.

[The corresponding provision in the Eighth Schedule is Paragraph 71].

Section 7(7) applies where a taxpayer donates his right to income through a cession but owns the asset or retains the right to regain the ownership at a future date, any income received by another will be taxed in the donor's hands.[99] An example of the application of this section follows here below:

> "Mr X owns a rent-producing property. At the beginning of the school year, he sends his children to a prestigious private school. Instead of paying the school fees personally, he gratuitously cedes his right to receive income from the property to a trust. The trustees pay the schools fees."[100]

In this example, Mr X will be taxed on the rental income received by the trust because he ceded his right to receive the income and he received no monetary compensation in return for the cession. It was a gratuitous cession. Furthermore, Mr X may have ceded his right to the income but he has retained the underlying property. Therefore, Section 7(7) deems the rental income to be that of Mr X.

This section would curb schemes in terms of which untaxed income is ceded to charity,[101] thereby ensuring the donor is not taxed on the income. Had it not been for the cession, the donor would have made a donation out of after-tax income. "

Section 7(8) deals with amounts that are received by or accrued to a non-resident beneficiary, as a result of a "donation, settlement, or other disposition" made by a South African resident. This amount which would have constituted income to the non-resident beneficiary had he or she been a resident of South Africa, "is deemed to be that of the South African resident donor. This section will for example deem income arising from an interest-free loan made by a resident to a non-resident, to be that of the resident donor. The non-resident may be an individual, company or a trust."[102]

The following is an example to illustrate the application of this section:

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[99] Silke *South African Income Tax* 23 ed (2021) 939.
[100] Botha et al op cit note 33 at 862.
[101] Silke op cit note 99 at 939.
[102] Botha et al op cit note 33 at 863.

> "Mr X, a South African donates R2m into an offshore trust. The beneficiaries of the trust are Mr X and his four major children, two of whom live overseas. As a result of the donation, the trust earned interest income which amounted to R80 000. The trustees retained the interest in the trust."[103]

In this example, in normal circumstances the trust would have been liable to pay income tax on income retained in the trust for the tax year. However, the trust is a non-resident and due to Section 7(8), the income will be deemed to be Mr X's foreign interest income.

[The corresponding provision in the Eighth Schedule is Paragraph 72].

Section 7 (9) provides that were an asset has been disposed of for a consideration but the value of the consideration is less than the market value of such asset, the difference between the market value and the actual value for which the asset was disposed of, shall be deemed to be a donation.[104]

The government created the Davis Tax Commission (DTC) in 2014, to enquire into the role of the tax system in South Africa.[105] There were many recommendations made by the DTC in respect of estate planning including trusts. In its first interim report, a valid point made in the report[106] was that even though section 7 attributes the income to donors for income tax purposes, this does not resolve the loss of revenue for the government through estate duty. The asset is no longer an asset in the donor's estate. It is an asset in trust and the government will not receive estate duty it once could have, should the donor die. Furthermore, the Commission recommended that discretionary trusts would no longer act as flow through vehicles. In other words, section 25B and the *conduit pipe principle* would be repealed.[107] This recommendation was not acceptable to the fiduciary industry and the Fiduciary Institute of South Africa (FISA) submitted commentary to the DTC accordingly.[108] What this effectively meant is that

[103] ibid 863.
[104] ibid 863.
[105] E Roux *A critical analysis of the provisions contained in the Income Tax Act 58 of 1962 relating to the taxation of interest free loans made to trusts or companies* (unpublished LLM dissertation, University of Pretoria, 2020) 2
[106] DTC first interim report on Estate Duty, Ch 4 pg 38.
[107]ibid 39.
[108] FISA 'Summary of FISA's Commentary on the 1st Interim Report on Estate Duty by the DTC (available at https://www.fisa.net.za/wp-content/uploads/2016/05/Davis-Tax-Committee-FISA-summary.pdf), accessed on 11 November 2021.

beneficiaries would receive the income and capital gains tax-free, after being taxed in the hands of the trust at the highest tax rates .

In a subsequent discussion between the fiduciary industry and Judge Davis, he did concede that the views of the DTC had shifted and the *conduit pipe principle* would probably remain.[109]

However, one of the recommendations by DTC that was carried through by the government is the introduction of section 7C. The enactment applies in respect of any amount owed by a trust resulting from a loan, advance or credit before, on or after 1 March 2017.[110] The author is of the opinion that the retrospective application of section 7C has more than likely 'ruffled many feathers' of estate planners who had transferred high valued assets to trusts through loans pre Section 7C enactment.

Having dealt with the taxation of trust income, the taxation that could arise in the context of the transfer of assets to a trust by the founder of that trust, will now be considered in particular the impact of the relatively recent section 7C.

Pre- enactment of section 7C:

It is important to consider the reasons that led to the introduction of section 7C as this has certainly changed the landscape of the taxing of trusts in respect of interest free or low interest loans.

The transfer of wealth from an estate planner to a trust is achieved through a sale, donation or inheritance as discussed in detail in paragraph 3.3 above. Pre-section 7C, many estate planners did not charge interest on the loans advanced to trusts or if they did, it was at a low rate of interest. In some instances, the trust simply retained the loans.[111]

The non-payment of interest facilitated the process of reducing the estate planner's personal estate through transferring assets to a trust via a loan. This resulted in the avoidance of estate duty and donations tax for the estate planner. In some instances, the lender reduced or waived the loan, which was due and payable to him or her. This resulted in the lender's estate being

[109] Van Der Spuy op cit note 2 at 178.
[110] Explanatory Memorandum to the Taxation Laws Amendment Bill 2016 9.
[111] ibid 9-10.

reduced which in turn resulted in the loss of estate duty or donations tax thereby reducing the tax base.[112]

Because of the loss in these taxes, the introduction of section 7C into the Income Tax Act became effective from 1 March 2017 retrospectively.[113]

Enactment of Section 7C:

The introduction of Section 7C in the Taxation Laws Amendment Act[114] made it possible to control the tax-free transfer of assets into trusts though interest-free or low interest loans, advances or credit, or so it was thought at the time.[115] This anti-avoidance tax measure focused on schemes devised to allow the purchase price of assets sold to trusts or loans made to trusts, to remain outstanding indefinitely with no interest or low interest charged.[116]

In terms of section 7C of the Income Tax Act:[117]

"(1) This section applies in respect of any loan, advance or credit that [118]–

a) A natural person; or
b) At the instance of that person, a company in relation to which that person is a connected person in terms of paragraph (*d*) (iv) of the definition of a connected person,

directly or indirectly provides to –

(i) A trust in relation to which –

(aa) that person or company; or

(bb) any person that is a connected person in relation to the person or company referred to in item *(aa)*

is a connected person; ....."

[112] ibid 10.
[113] ibid 14.
[114] TLAA 15 of 2016.
[115] Explanatory Memorandum on the Taxation Laws Amendment Bill 2020 11.
[116] ibid 11.
[117] ITA 52 of 1962 Section 7C.
[118] ITA, section 7C – Sub-s (1) amended by s.5 (1) (a) of Act No. 17 of 2017 deemed to have come into operation on 19 July, 2017 and applicable in respect of any amount owed by a trust or a company in respect of a loan, advance or credit provided to that trust or that company before, on or after that date.

"(3) If a trust or company incurs –

a) No interest in respect of a loan, advance or credit referred to in subsection (1)....or
b) Interest at a rate lower than the official rate of interest,

An amount equal to the difference between the amount incurred by that trust or company during a year of assessment as interest in respect of that loan, advance or credit and the amount that would have been incurred by that trust or company at the official rate of interest must,.....be treated as a donation made to that trust by the person referred to in subsection 1 (a) ....on the last day of that year of assessment of that trust"

Reading into this section, it is noted that section 7C applies to transactions involving:[119]

- A loan, advance or credit;
- Made by a "natural person or by a company"
- "At the instance of a natural person who is connected to the company i.e. holds at least 20% of the equity shares or voting rights in the company;"[120]
- To a trust;
- "Which incurs no interest or interest at a rate lower than the official rate of interest."[121]

A situation may arise that triggers section 7C unknowingly for example when income although vested in beneficiaries, remains in trust. If the trustees utilse these amounts through an investment in the name of the trust and not in the name of the beneficiary, this is regarded as a loan to the trust by the beneficiary because the invested amount is vested in the beneficiary.[122] In such a case, it would be necessary for the beneficiary and trustees to sign a loan agreement. If the loan is interest free or attracts low interest section 7C will be triggered.[123]

[119] ITA s7C (1) read with s 7C (3) of the Income Tax Act and E. Roux *Acritical analysis of the provisions contained in the Income Tax Act 58 of 1962 relating to the taxation of interest free loans made to trusts or companies* (unpublished LLM dissertation, University of Pretoria,2020) 33.
[120] As per the definition of connected person in terms of s1 ITA 58 of 1962.
[121] ITA s7C (1) read with s7C (3).
[122] P Van der Spuy 'Making distributions to save tax at all costs' (2021) available at *http://trusteeze.co.za/article/making-distributions-to-trust-beneficiaires-to save-tax-at-all-costs*, accessed on 20 Dec 2021.
[123] ibid.

After the introduction of section 7C, taxpayers devised a further scheme. Interest free loans or low interest loans were advanced to companies whose shares were held by trusts.[124] In this way, section 7C was circumvented because it only applied to interest free or low interest loans, advances or credit made at the instance of a natural person (only) to trusts. [125]

In order to close this gap in the legislation, changes were made to section 7C (1)[126] in 2017 to strengthen these rules. These changes incorporated a natural person as well as a company (at the instance of a natural and connected person[127]) that loans, advances or provides credit to a trust at low interest or interest free. This makes companies, in relation to a trust, also subject to the anti-avoidance measure.[128] These changes were deemed to have come into operation on 19 July 2017.

The new section 7C (1) (ii)[129] reads as follows:

> " a company if at least 20% of-
>
> (aa) the equity shares in that company are held , directly or indirectly; or
>
> (bb) the voting rights in that company can be exercised;
>
> By a trust referred to in paragraph (i) whether alone or with a beneficiary of the trust, or the spouse of the beneficiary or any person related to that beneficiary or spouse."
>
> Taxpayers thereafter contrived a further scheme whereby "natural persons would subscribe for preference shares with no, or low, rate of return in a company owned by a trust that is connected to those individuals."[130] Yet again, the section 7C anti-avoidance rules including the 2017 changes were being circumvented as they only "applied in respect of loans, advance or credit made available to a company that is owned by a trust that is a connected person in relation to the natural person advancing that loan or credit."[131]

[124] Explanatory Memorandum to the Taxation Laws Amendment Bill 2020 11.
[125] ibid 11.
[126] ITA section 7C(1).
[127] ITA 58 of 1962 s 1 definition of "connected person".
[128] Explanatory Memorandum to the Taxation Laws Amendment Bill 2020 11.
[129] ITA s 7C(1) (ii).
[130] Explanatory Memorandum to the Taxation laws Amendment Bill 2020 12.
[131] ibid 12.

Van der Spuy summarily explains how this scheme worked,

> "estate planners typically replaced their loans to trusts, or companies held by trusts, with preference shares through the application of section 42 of the Income Tax Act (corporate rules allowing asset-for-share transactions) as part of a scheme, by moving trust assets, funded with interest-free, or low-interest loans, to a new company held by the trust. The preference shares (at a zero or low-dividend rate) were issued to the estate planner by the new company. Preference shares were used to circumvent the provisions of section 7C, as they are usually non-participating in the profits of the company and their value will therefore not increase, similar to those of ordinary shares. Whereas the increase in the value of the ordinary shares will normally be included in the estate of the estate planner, the value of the preference shares will remain at the original subscription value, which results in the saving of estate duty. Through this scheme, the growth in the value of the assets still took place in the trust (indirectly), as the shares in the new company (holding the assets) were held by the trust and the estate planner effectively "swopped" their loan to the trust (to which Section 7C applies) for preference shares. The introduction of this anti-avoidance provision therefore undid the effect of the 'section 42 transfers'."[132]

Yet again, amendments to the legislation were made in order to close this loophole discovered and implemented by taxpayers through preference shares. The Taxation Laws Amendment Bill 2020 proposed changes, which came into operation on the 1st of January 2021,[133] through the enactment of section 7C (1B). This new section regards the subscription price of preference share as a loan advanced. Dividends or foreign dividends in respect of the preference shares are deemed to be interest in respect of the deemed loan.[134]

Section 7C (1B) applies if –

"(a) a natural person; or

[132] P Van der Spuy 'Preference share and trust structure loophole closed by SARS' 8 September 2021 available at *https://www.iol.co.za/business-report/opinion/trust-to-trust-preference-share-and-trust-structure-loophole-closed-by-sars-06903045-d541-429b-80ae-bb682e87b955*, accessed on 13 September 2021.
[133] Explanatory Memorandum to the Taxation laws Amendment Bill 2020 12.
[134] ibid 12.

(b) at the instance of a natural person, a company that is connected in relation to that natural person in terms of paragraph (d) (iv) of the definition of connected person

subscribes for a preference share in a company in which 20 percent or more of the equity shares are held (whether directly or indirectly) or the voting rights can be exercised by a trust that is a connected person in relation to that natural person or to that company , whether alone or together with any person who is a beneficiary." [135]

Since the aforementioned amendments to section 7C, a further scheme was devised in an attempt to fall outside the ambit of section 7C.

According to the Explanatory Memorandum of the Taxation Laws Amendment Bill 2021, the features of this scheme are:

> "Step1: Shares in a foreign company held by a family trust (which is established in South Africa) are bought back on loan account.[136]
>
> It has come to light that the share capital of the foreign company would be minimal but it would have significant amounts of undistributed reserves. Under some foreign legislation, e.g. the Cayman Islands Company Law, the buy-back is not treated as a dividend or a distribution by the company. Therefore, there is no foreign dividend or foreign return of capital.[137]
>
> Step 2: Through journal entries and principle of set-off, the buy-back amount is used to capitalize new foreign companies held by a trust. [138]
>
> Under step 2 there are no cash flows nor any money inflow into South Africa. The scheme enables taxpayers to rebase the cost of foreign capital assets for the family through the capitalization of new foreign companies.[139]
>
> Step 3: As a final step, the loan claim (reflecting the amount owed by the original foreign company is to the trust in respect of the share buy-back) is disposed of to another

[135] ITA 58 of 1962 s7C(1B).
[136] Explanatory Memorandum to the Taxation Laws Amendment Bill 2021 9.
[137] ibid 10.
[138] ibid 10.
[139] ibid 10.

trust in which the relatives of the founder of the first trust are beneficiaries or the founder. This disposal is effected in terms of an interest free loan account."[140]

Further changes to the wording of section 7C has been proposed in terms of the draft Taxation Laws Amendment Bill of 2021. The proposal is to extend the anti-avoidance tax provision to any loan, advance or credit made by one trust to another trust, involving connected persons such as the parties of one trust also being parties in the other trust.[141]

Some are of the view that this proposed amendment incorrectly brings commercially viable loans between trusts into the ambit of section 7C.[142] The Bill still needs to go through the public comment process, at which point this issue will be further discussed.

Looking at section 7C and the amendments that brought in sections 7C (1) (ii) and 7C(1B) rather shortly after each other, with another amendment in the pipeline, depicts the tireless tactical "game", mentioned by the author in chapter one, which is played between the tax evaders and SARS. Each new scheme devised, appears to be more complex than the previous. Each amendment appears to create a more punitive set of anti-avoidance tax provisions. At times, punitive tax measures are referred to as an "attack" on trusts by the Government.[143] However, is it really an attack on all trusts or is it a means of managing and bringing under control exploitative schemes that threaten the tax base? In the author's opinion it is but a means implemented by SARS in an effort to eliminate these devised schemes. By implementing such schemes, the trustees deviate from the focus of the core function of trusts that is preserving and protecting assets. Ultimately, the beneficiaries of the trust will suffer. Those trusts that that do not implement exploitative schemes and are tax compliant, remain unaffected. They continue to focus on their core function of preserving assets.

[140] ibid 10.
[141] Ibid 10.
[142] KPMG Private Enterprise, Family Office and Private Client South Africa: 2021 Taxation Laws Amendment Bill, August 2021 Report available at https://assets.kpmg/content/dam/kpmg/us/pdf/2021/08/tnf-sa-aug6-2021.pdf, accessed on 18 December 2021.

[143] Van der Spuy op cit note 2 at 170.

3.7. Conclusion

Tax evasion is not unique to trusts only. There will always be those taxpayers who want more tax relief than is provided by the legislature resulting in schemes being devised, some of which have been discussed in this chapter.

Retained income and capital gains in a trust will result in income being taxed at 45% and capital gains being taxed at the effective tax rate of 36%.[144] Both are at the highest rate. It has been established in this chapter, if these rates are lower, as was the case previously, the problem arises that founders and estate planners would register multiple trusts in an attempt to split assets across multiple trusts, particularly income producing asset in order to pay tax at a lower rate. In an attempt to move away from this problem, government and SARS decided to apply the highest rate of tax so that an estate planner having multiple trusts would not threaten the tax base due to a flat tax rate applying to trusts. From a taxpayer's perspective, paying high taxes is far from the ideal situation but from Government and SARS perspective, the conduct by estate planners who creating multiple trusts was not conduct that could be ignored and because of these circumstances, trusts have the highest tax rates.

The high tax rates that trusts attract does not however diminish the value of the core function of a trust that is preservation and protection of assets. Estate planners do however need to plan strategically for example, assets transferred to a trust should be intended to be retained in trust and not disposed of easily due to the high CGT rate; income splitting can also be implemented in a beneficial rather than not an abusive way. Income splitting can be analogized to a double-edged sword. It has both favorable consequences and unfavorable consequences some of which have been discussed in this chapter and other consequences will be discussed in ensuing chapters.

The setting up of the DTC and its predecessor tax committees[145] show that the government will resort to such interventions when the fiscus is frustrated. This should communicate strongly to estate planners not to deviate from the very essential purpose of trusts and to remain within the legislative boundaries, rules and principle.

The next chapter is a discussion about trusts that are administered outside the legislative boundaries, rules and principles and how our judiciary deals with such cases that come before

[144] *Budget Stop Press: Budget Speech 2021* (unpublished notes Old Mutual) 5
[145] Roux op cit note 128 at 2.

the courts. Are there sufficient steps taken to prevent the true purpose of trusts fading away into the background?

Chapter 4

EXPLOITATION OF TRUSTS

4.1 Introduction

It is no hidden fact that trusts have been, and still are, exploited and abused. This chapter is a discussion about the exploitation and abuse of trusts through sham trusts and alter ego trusts. A profound landmark decision was made in *Land and Agricultural bank of South Africa v Parker*[146]. This case is an example of the abuse of trusts. *Parkers case* will be discussed in detail in this chapter

These abuses blur out the true and essential purpose that trusts serve and casts doubt over the benefits of trusts. Furthermore, they contribute to bringing all trusts under "attack" by SARS.

In order to determine what a sham trust or alter ego trust is, it would be more befitting to firstly discuss the elements for a valid trust and then evaluate how sham trusts and alter ego trusts deviate from such. Of equal importance is to examine the views of our courts to understand how sham trusts and alter ego trusts are dealt with. There are instances when the courts 'pierce the veil of a trust' in order to expose the real person behind the so-called veil as a means to remedy the situation. This is similar to the well-established principle of 'piercing the corporate veil'[147] where directors of a company are held to be the 'real' owners of the property, actually owned by the company and /or the directors are held personally liable for its debts and liabilities. A discussion about the conduct of the parties to a trust will be looked at to establish what leads the courts to 'pierce the veil' of a trust.[148]

In as much as there is an emphasis on protection of assets held in trust, it is important that assets not be "protected" for the wrong reasons. Examples of such situations would be in the event of a divorce or sequestration where assets are transferred to a trust with the intention to be kept away from a spouse or creditors laying claim to it, or a portion thereof as the case may be.

It is evident from the previous chapter that taxation relating to trusts can be harsh, depending on how a trust is structured. This chapter now highlights the misuse and abuse of trusts. These aspects can easily overshadow the benefits of a trust but it is important to bring this into the

[146] *Land and Agricultural Bank of South Africa v Parker* 2004 AII SA 261(SCA).
[147] Van der Spuy op cit note 2 at 554.
[148] ibid 554.

discussion to understand how our legislation and courts handle these situations in order to keep the core purpose of trusts alive.

4.2 Essentials for the formation of a valid trust

i. "There must be a clear and unambiguous intention on the part of the founder to create a trust and create an obligation."[149] The *intention* of the founder or estate planner is crucial in establishing whether or not the trust will be utilised for legitimate purposes or for his or her personal affairs. [150]

ii. "The objective of the trust must be lawful."[151]

iii. Beneficiaries of the trust are to be clearly identifiable or described failing which the trust is at risk of not existing in terms of the law.[152]

iv. "The initial trust property must be defined with certainty."[153]

v. Trust property must be transferred or bequeathed to trustees with a corresponding and binding obligation on the part of the trustees to administer trust assets on behalf of beneficiaries.[154]

vi. "The trust object must be sufficiently certain: the beneficiaries must be ascertained or ascertainable, or the impersonal object (e.g. in the case of a charitable trust) must be clearly defined."[155]

A significant consequence that flows from the creation of a valid trust is that the founder or estate planner must relinquish the "control and ownership" element of trust assets to the trustees. "There must be a clear *separation* of *control* from the *enjoyment* of trust assets."[156] In

[149] ibid 198.
[150] ibid 198.
[151] Botha et al op cit note 33 at 838.
[152] ibid 838.
[153] ibid 838.
[154] ibid 838.
[155] ibid 838.
[156] Van der Spuy op cit note 2 at 549.

practice, this is an element that many founders or estate planners find challenging, which will be evident from the case law under discussion in this chapter. The founder or the estate planner and the beneficiaries do not control the trust assets. The trustees have a duty to act with care, diligence and skill[157] and act independently ensuring that proper systems of control are in place.[158]

4.3 What is a '*sham trust'?*

A 'sham trust' is a trust created when a founder or planner does not have the *intention* to create a '*genuine'* trust.[159] A 'sham trust' exists when there is a clear intention to form something other than a trust or when there is an intentional or unintentional omission of one or more of the essential elements required for the formation of a valid trust.[160]

In *Khabola v Ralitabo*[161] "a 'trust' was formed to acquire agricultural land to conduct farming activities. The trust was registered with the Master of the High Court and had a reference (IT) number. However, there were *no beneficiaries* appointed. The Court held that no trust was formed (even if it was registered with the Master), as it is a legal requirement to appoint beneficiaries for a trust to exist. The court found that it was rather a partnership or some other association that was formed and *not* a trust."[162]

Perhaps one of the possible reasons why the partners or members of this so-called partnership or 'other association' in *Khabola* disguised the entity as a trust, a need to divest themselves of ownership of the assets in their personal capacity. In this way, the assets would be kept out of their personal estates, which would lead to a savings on tax such as estate duty and capital gains tax.

Transacting with a sham trust leads to those transactions being *void* as the trust does not exist.[163] There is a deliberate intention to mislead others. Our courts recently ruled in *Van Zyl NO &*

[157] TPCA s9.
[158] Van der Spuy op cite note 2 at 449.
[159] ibid 549.
[160] Van der Spuy Phia, Demystifying trusts in SA, ch 20 pg 551.
[161] *Khabola v Ralitabo NO* (5512/2010)[2011] ZAFSHC 62 (24 March 2011).
[162] Van der Spuy op cit note 2 at 551.
[163] ibid 552.

Another v Kaye NO[164] that when a trust is a sham trust, it is void from inception and it does not exist.[165]

4.4 What is an *alter ego trust?*

If a founder or planner has the *intention* to create a trust but deals with the trust assets as if it was his or her own personal assets, this type of trust is referred to as an 'alter ego trust' indicative of the trust being an extension of oneself.[166]

The Trust Property Control Act states,[167] "Trust property shall not form part of the personal estate of the trustee except in so far as he as the trust beneficiary is entitled to the trust property." There have however, been far too many instances in which founders and/or trustees of a trust conduct the affairs of the trust as if it is their own personal estates. This blatant disregard of separation between ownership or control and enjoyment leads to the abuse of trusts. The following cases highlight this point.

The facts of the case:

Parker created a family trust in 1992 appointing himself, his spouse J Parker and their attorney Senekal as the first set of trustees of the trust. The beneficiaries of the trust were Parker, his spouse and their descendants. [168]

In 1996, Senekal resigned as trustee.[169] The trust deed required that there always be a minimum of three trustees in office.[170] If the number of trustees fell below three, a third trustee was to be appointed by the remaining two trustees. The remaining trustees failed to do so and only appointed a third trustee some two years later in 1998.[171]

During the time whilst the Parkers were the only two trustees, they concluded a series of business loans and bound the trust as surety and co-principal debtor.[172] The last of these loans

[164] *Van Zyl NO & Another v Kaye NO* 2014 (4) SA 452 WCC.
[165] Van der Spuy op cite note 2 at 552.
[166] ibid 549.
[167] TPCA s 12.
[168] *Parker NO & others v Land and Agricultural Bank of SA* [2003] JOL 10468 (T) 3.
[169] ibid 4 .
[170] ibid 4.
[171] ibid 5.
[172] ibid 6 and 7.

was concluded after their son DG Parker ('the son') was appointed as the third trustee.[173] However, as a trustee he was not consulted about the last loan agreement of R30 million from the bank and testified that he had no knowledge of the last loan.[174]

The loans were not repaid and in October 2000 the bank obtained a sequestration order against Parker and the trust.[175] Parker was sequestrated. The trust successfully appealed to have the order to sequestrate the trust set aside.[176]

With special leave granted, the bank appealed against that decision.[177]

The judgment of Cameron JA is summarized below:

1. He emphasized the importance of ensuring that the specified minimum number of trustees are always in office to act on behalf of a trust. The trust deed lays down these pre-conditions, which must be met in order to bind a trust. He refers to it as a "capacity-defining condition."[178] "When fewer trustees than the number specified are in office, the trust suffers from an incapacity that precludes action on its behalf."[179]
2. Trustees must act jointly at all times. Parker and Mrs Parker failed in doing so which was evident from their conduct when they proceeded to bind the trust without any consultation with their son who had been appointed as the third trustee. This was a complete disregard of their trustee obligations under the trust deed, which constituted a breach.[180]
3. The fact that the trust was controlled by the beneficiaries who were also the trustees completely removed the division between control and enjoyment resulting in abuse due to the lack of independence on the part of the trustees. This is likely to occur when the control of the trust resides entirely with trustees-cum-beneficiaries.[181]
4. As part of the Masters statutory functions the Master should ensure that there is proper separation between control and enjoyment in the administration of trusts. This can avoid the violation of the use of trusts as is evident from *Parker* and other cases. The Master

[173] ibid 7.
[174] ibid 8.
[175] ibid 1.
[176] ibid 13.
[177] *Land and Agricultural Bank of South Africa 2004 AII SA 261(SCA)*, judgement para 5.
[178] ibid para 11.
[179] ibid para 11.
[180] ibid para 15.
[181] ibid para 29.

should insist on the appointment of an independent outsider trustee to every trust in which (a) the trustees are all beneficiaries and (b) the beneficiaries are all related to one another.[182]

5. In terms of the trust deed, upon insolvency trusteeship automatically terminates. In other words, upon Parker's sequestration in October 2000, his trusteeship immediately ended.[183] However, Parker disregarded this provision of the deed and continued to act as though he was a trustee. He signed the trust's petition for leave to appeal to this Court and the leave to appeal to the full court was instituted in the names of Parker, Mrs Parker and the son as trustees.[184] Due to Parker no longer qualifying as a trustee to act on behalf of the trust, Mrs Parker and the son were the only two trustees. The trust deed required a minimum of three trustees to act on behalf of the trust. Being short of a third trustee, it was decided that the trust did not validly petition the SCA to appeal against the judgment of Roux J.[185] As a result, the full court concluded that the trust had in fact not appeared before it, and struck the appeal from its roll on that ground.
6. The bank was successful in its appeal. The sequestration order of the trust was re-instated.[186]

What can be extrapolated from *Parker*?

Not having an independent trustee creates many problems relating to the proper conduct of trust affairs particularly when beneficiaries are also trustees.

"The core idea of a trust is the separation of ownership (or control) from enjoyment."[187] It is evident from *Parker* that relinquishing personal control of assets and decision-making is a challenging concept.

Mr and Mrs Parker made decisions without including the son in the decision-making regarding the last loan agreement. This was a complete disregard of the provisions of the trust deed, which

[182] ibid para 35.
[183] ibid para 39.
[184] ibid para 40.
[185] Ibid para 41 .
[186] ibid para 5 - Roux J confirmed the orders of sequestration against Parker and the trust on the 10 October 2000 and refused leave to appeal. Parker petitioned the court for leave to appeal. He failed. However, the trust successfully obtained leave to appeal to the full court which then set the order aside. The bank appealed against that decision.
[187] ibid para 19.

was clearly indicative of treating the trust as one's personal estate. In other words, the trust was an alter ego trust.

A trust deed provides guidance to the trustees about administering and controlling the trust and trust assets. If trustees remain within these boundaries set out in the trust deed, deviation outside the legal and compliance framework is avoided, hence there is no abuse of the trust.

Apart from the aforementioned separation issue raised in the judgment, a critical issue raised was the sub-minimum of trustees transacting on behalf of the trust. The tardiness in appointing a third trustee after the attorney, Senekal, resigned as a trustee, was worth noting despite the fact that the deed provided for three trustees to represent the trust.[188]

It is evident that even though the Parkers may have acted jointly in signing the loan agreements, it did not remove the trust's incapacity to transact while a subminimum of trustees held office. The Parkers, rather paradoxically, used this very same argument of the 'trust's incapacity' as their defense, that the trust could not be bound by the loan agreements as a result thereof.[189]

Parker was sequestrated in October 2000, thereby ending his trusteeship.[190] This meant that only two trustees i.e. Mrs Parker and the son petitioned the full court to appeal against the order to sequestrate the trust. Yet again, there were only two trustees acting on behalf of the trust. The trust accordingly did not validly petition to the full court and on these grounds the appeal ought to have been struck from the court roll.[191] Clearly, the proceedings instituted on behalf of the trust were not proper.

Cameron JA emphasized in this judgment the need for all trustees to act together, failing which, there are consequences that flow from this. This case also cautions those parties who transact with trusts to examine the trust deed and to make certain of the number of trustees that ought to hold office.

Ever since *Parker*, it is has become somewhat necessary that where trustees are beneficiaries of the same trust, an independent outsider trustee is recommended.

According to Cameron JA an independent outsider trustee need not be a professional person but someone who has proper knowledge about the responsibilities of trusteeship, is able to

[188] ibid para 11.
[189] ibid para 39.
[190] ibid para 39.
[191] ibid para 46.

ensure that the trust functions properly, and that the provisions of the trust deed are adhered to. Failing these duties will amount to a breach of trust.[192]

Parker was a profound example of an alter ego trust.

To reinforce the importance of an independent trustee, the Master of the High Court issued a directive in 2017[193] implementing the decision in *Parker* regarding independent trustees. The directive calls on all Masters to consider appointing an independent outsider trustee for a '*family business trust'*.[194]

The directive sets out the characteristics of a *family business trust* with the following combined characteristics mentioned below:[195]

- "The trustees have the power to contract with independent third parties, thereby creating trust creditors; and
- The trustees are all beneficiaries; and
- The beneficiaries are all related to one another."

According to the directive, the qualities that an independent trustee should possess are mentioned here below:[196]

- "An independent outsider with the realization of the responsibilities of trusteeship, ensures the trust functions properly and the provisions of the Deed are observed, need not be a professional person such as an accountant or attorney;
- May be a professional accountant, admitted attorney, an advocate affiliated to relevant professional bodies, trust companies or fiduciary practitioners;
- Has no family relation or connection, blood or other, to any of the trustees, beneficiaries or founder of the trust;
- Must be competent to scrutinise and check the conduct of other trustees who lack sufficient independence;
- Be sufficiently knowledgeable to not conclude or approve transactions that may prove to be invalid;
- Would not have any interest in the trust property as a beneficiary;

[192] ibid para 36.
[193] Chief Masters Directive 2 of 2017 'Trusts, dealing with various trust matters'.
[194] ibid 13.
[195] ibid 13.
[196] ibid 13 and 14.

- Have sufficient knowledge and experience of the business in which the trust operates
- Would not accept office without understanding that failure to observe the duties of the independent trustee may risk action for breach of trust."

It is evident that the outcome in *Parker* had far-reaching consequences, one of which resulted in the Master of the High Court issuing a directive incorporating the recommendations highlighted in the judgment.

4.5. Piercing the veil of a trust

Piercing the veil of a trust is similar to where courts disregard the separate corporate identity of a company in instances of non-compliance with statutory provisions.

With an alter ego trust, the trust exists but the court will *look through* the trust by disregarding the trust *('pierce the veil'* or veneer, of the trust) resulting in the value of the trust being included in the estate of such person. [197]

The veil may be pierced when the persons who control the trust do so with a deliberate intention to gain an unfair advantage. [198]

In *Van der Merwe NO and Others v Hydraberg Hydraulics CC and Others*[199] the court held that

> "the abuse of the trust form is something that should not lightly be countenanced by the courts in cases in which the veneer of a trust is used to protect the trustees against fraud and dishonesty and to raise unscrupulous defences against bona fide third parties seeking to enforce the performance of contractual obligations purportedly entered into by such trustees ostensibly in that capacity. Held further, a decision to disregard the veneer would, like one to pierce the corporate veil, be a decision to afford an equitable remedy."[200]

Piercing the veil or veneer of a trust plays an extremely significant and exemplary role in our trust law making people accountable for conducting trust affairs outside the legislative

[197] Van der Spuy op cit note 2 at 553.
[198] ibid 554.
[199] *Van der Merwe NO and Other v Hydraberg Hydraulics CC and Others* 2010 (5) SA 555 (WCC).
[200] Van Der Spuy op cit note 2 at 555.

framework, trust laws and principles. Two common situations that may lead to piercing the veil or veneer of a trust is a divorce or insolvency, each of which will be discussed below.

Divorce matters

One of the benefits of having assets held in a trust is the protection of these assets from disastrous divorce consequences of a beneficiary. However, on the contrary, a trust is often used or rather, misused, by a party to a trust, to 'hide' assets that would otherwise form part of the community of property or the accrual portion of the marital agreement.[201] Estate planners in failed marriages or perhaps in the process of a divorce may take advantage of transferring assets from their estate or the joint estate into a trust under the mistaken belief that the assets would be safe from the soon-to-be-ex-spouse laying claim on a portion of it.

In other situations, an aggrieved spouse may be well aware that a trust in which the other spouse is a party to, is in fact managed or controlled as if the trust is the other spouse's own personal estate. The aggrieved spouse may use this knowledge to his or her advantage by trying to persuade the court that the trust is an alter ego of the other spouse therefore the trust assets should be subject to the divorce proceedings.[202] However, it will be evident from *Mills*, discussed below, that it is easier to allege this than to prove the allegation to be true.

This was seen in *Jordaan v Jordaan*[203]and *Badenhorst v Badenhorst* .[204] In both of these cases, it appeared to the courts that although assets were held in trust, the manner in which the trust assets were controlled and managed in each separate case by Mr Jordaan and Mr Badenhorst respectively, was as if the trust assets were their own. The courts held that all assets were deemed to be owned by these respective parties and included in the calculation for divorce purposes.[205]

The judgment in *REM v VM*,[206] confirmed that in the case of an alter ego trust the value of the trust assets be included in the accrual calculation in marriages subject to the accrual.[207] The

[201] ibid 599.
[202] ibid 598.
[203] *Jordaan v Jordaan* 2001(3) SA 288 (C).
[204] *Badenhorst v Badenhorst* (2) SA 255 (SCA).
[205] Van der Spuy op cit note 2 at 600.
[206] *REM v VM* 2017 (3)SA 371(SCA).
[207] Van der Spuy op cit note 2 at 609.

judgment set out the following "test" to be applied by the aggrieved spouse to make a successful claim,

> "The respondent had to prove that the appellant transferred personal assets to these trusts and dealt with them as if they were assets of these trusts with the fraudulent or dishonest purpose of avoiding his obligation to properly account to the respondent for the accrual of his estate and thereby evade payment of what was due to the respondent, in accordance with her accrual claim. If established a declaration could be made that the trust assets in question are to be used to calculate the accrual of the appellants estate, as well as satisfy any personal liability of the appellant to make payment to the respondent."[208]

However, our courts are circumspect when it deals with including trust assets as part of the personal estate of a party to a divorce as was the situation in *Mills.*[209] In this case the SCA held that if it can be proven by a spouse that the personal assets from the other spouse's estate was transferred to a trust with the *fraudulent and dishonest purpose* of attempting to escape from his responsibility to account for the accrual of his estate and to avoid payment of what was due to his wife, then the trust assets can be included for the purposes of the accrualcalculation. The wife in this case failed to prove the aforementioned.[210] This court made it clear that the spouse who alleges, must prove there is "fraudulent and dishonest purpose" to avoid an obligation to account for the accrual calculation. The outcome of this case conveys a strong message to aggrieved spouses who want to advance baseless allegations.

Courts do not hesitate to follow the view taken in *Jordaan* and *Badenhorst,* if proven that a spouse transferred assets into a trust for the sole purpose of reducing their estates to avoid their soon-to-be ex-spouse from benefiting at divorce or deals with trust assets as if it his or her own personal estate. The fact that our courts ensure that the wrongdoer is made accountable for his or her actions is commendable on the part of the judiciary because the misuse or abuse of a trust is clearly not tolerated.

[208] *M V M* (332 of 2015) [2017] ZASCA 5 judgement paragraph 20.
[209] *Mills v Mills* [2017] 2 ALL SA 364 (SCA).
[210] ibid 608.

Professor van Wyk[211] specifically mentioned in an article about "alienations of property to a discretionary trust as a manner to engage in 'preventative estate planning prior to divorce.' The spate of High Court judgments over the past decade that have dealt with the question as to whether the (value of) assets of a trust may be taken into account for the purposes of assessing the accrual of a spouse's estate, testifies to the prescience of this statement."

Insolvency

The transfer of assets into a trust preceding a sequestration or liquidation as a means to avoid creditors laying claim to such assets can lead to the piercing of the trust veil should frustrated creditors succeed in proving the latter.

Furthermore, when the courts have sufficient evidence before it that the founder and/or trustees conduct their personal business and affairs through the trust and the trust is merely a cover, the court may order that the trust assets be used to satisfy debts of the said founder or trustee. This situation arose in *Nedbank v Thorpe*.[212] In this case, Thorpe had transferred bulk of his growth assets into various trusts over an extended period preceding the application for sequestration brought against him by Nedbank. Nedbank contended[213] that

- Thorpe had carried out his various business affairs through corporate entities or trusts he created;[214]
- He protected his wealth by holding it in the various family trusts. In this way his personal creditors could not lay claim to the assets held in trust which frustrated his creditors;[215]
- His creditors had reason to believe that Thorpe did in fact own considerable assets which a trustee of his insolvent estate would be able to uncover. This will be to the advantage to all his creditors;[216]

[211] Smith B "Trust assets and accrual claims at divorce, the SCA opens the door" (2017) *De Rebus* available at https://www.derebus.org.za/trust-assets-accrual-claims-divorce-sca-opens-door/ , accessed on 3 December 2021
[212] *Nedbank v Thorpe* [2008] JOL 22675(N).
[213] SAICA, 1711. Trusts held to be a sham, March 2009 Issue 115,https://www.saica.co.za/integritax/2009/1711_Trusts_held_to_be_a_sham.htm.
[214] *Nedbank v Thorpe* op cit note 191 at 21.
[215] ibid 1.
[216] ibid 11.

- Thorpe's use of his trust as a vehicle for his personal business activities constituted an abuse of the institution of a trust and was a means to protect his personal assets from creditors.[217]

The court had to decide whether there was indeed sufficient reason to believe that Mr Thorpe's sequestration would be advantageous to his creditors. On the evidence placed before it, the court accepted Nedbank's argument.[218] The dictum was based on the premise expressed in *Parker* that in certain circumstances " the assets allegedly vesting in trustees in fact belong to one or more of the trustees and that the trust form is a veneer that in justice should be pierced in the interests of creditors".[219]

4.6. Conclusion

One of the key issues that comes through very clearly in this chapter is the difficulty or challenge a founder or an estate planner experiences in relinquishing control of the assets transferred to the trust and granting all trustees the right to manage the assets strictly in a fiduciary capacity. This is evident from the cases discussed where founders and estate planners manage the trust affairs as if the trust is none other than their very own estate.

It is also evident that South African courts do not hesitate to look behind the veneer of the trust, whenever it becomes necessary to do so in order to restore justice. This is remarkable on the part of our South African courts, that in as much as the trust provides limited liability to the trustees, the courts will also hold them to account for fraudulent and negligent misconduct in their fiduciary capacity and / or hold the founder accountable

The Trust Property Control Act[220] provides for trustees to perform their duties with "care, diligence and skill, reasonably expected of a person managing the affairs of another." It is an onerous legal duty. Acting outside these boundaries does not warrant protection behind a veil or veneer and piercing the veil or veneer acts as a deterrent to trustees generally, from engaging in such exploitative activities.

[217] ibid 11.
[218] ibid 27.
[219] ibid 24.
[220] TPCA 57 of 1988 s 9.

There is an important legal principle "ignorance of the law is no excuse". Trustees who claim to have been excluded from trust affairs may not use *ignorance* as a defense, even if they have acted *bona fide*. The court confirmed in *Slip Knot Investments 777 (Pty) Ltd v du Toit*[221] that a silent, sleeping, absent or puppet trustee cannot claim ignorance and will be joined with the wrongdoing trustees, and rightfully so. When a trustee accepts a trusteeship there is a duty upon him or her to have knowledge of all the goings-on in the trust affairs.[222]

Cameron JA, in *Parker* stated in his judgment "The courts will themselves in appropriate cases ensure that the trusts form is not abused. The courts have the power and the duty to evolve the law of trusts by adapting the trust idea to the principles of our law. The power may have to be invoked to ensure that trusts function in accordance with principle of efficacy, sound commercial accountability and the reasonable expectations of outsiders who deal with them. This could be achieved through methods appropriate to each case." [223]

This chapter confirms through analyses of the various authorities that despite the exploitation of trusts that occurs and the shadow of doubt that can easily be cast over the significance of trusts, our courts take a strong stance against the misuse or abuse of trusts. It is re-assuring that the essential purpose of trusts, discussed in the next chapter, is not lost.

[221] *Slip Knot Investments 777 (Pty) Ltd v Du Toit* 2011 (4) SA 72 (SCA) .
[222] Van der Spuy op cit note 2 at 587.
[223] *Parker* op cit note 146 at para 37.

Chapter 5

BENEFITS OF A TRUST AS A TAX AND ESTATE-PLANNING TOOL

5.1. Introduction

Whilst the previous two chapters may have created a 'dim' view about trusts as a tax and estate-planning tool this chapter focuses on the benefits of trusts in its purest form. These benefits are far too often lost amidst the publicity given to the negativity created by the abuse of trusts, the use of loopholes in the system for the benefit of an unfair advantage and legislative amendments relating to trusts, particularly tax legislation. Despite the latter, it will be evident in this chapter that trusts in its purest form, are still able to perform their core function. In fact, the use of trusts, has continued to evolve since its inception. Trusts are still relevant today and are the only vehicle with the benefits as discussed below. [224]

At the outset of the creation of a trust, these benefits play a very important role as this is what will set the objectives of the trust and provide direction and guidance to the trustees in respect of managing the trust. The benefits discussed below are however by no means exhaustive. Estate planners who have trusts and those contemplating the creation of trusts must take cognisance of the fact that the misuse or mismanagement of trusts creates the risk of these trusts being investigated by SARS. Therefore, it is important that trusts, from the outset, are correctly structured and administered in accordance with the trust instrument and within the legal framework. This will give SARS no reason to investigate the affairs of the trust.[225]

5.2. The benefits of trusts:

5.2.1. Asset protection

Asset protection[226] is the number one benefit a trust can provide, and this has been the case since the inception of trusts.

[224] Van der Spuy op cit note 2 at 78.
[225] ibid 77.
[226] Botha et al op cit note 33 at 850.

One of the most important reasons to consider a trust as an asset protection vehicle is because it will assist in keeping one's assets separately, such as property investments, debt from business, interest and/or other financial needs.[227]

The structure of the trust, discussed in chapter 2 plays a very significant role when it comes to asset protection. It is from this structure that the rights and obligations of the parties to a trust flow. The structure is determinable from the trust deed. The lawful objectives of the trust provides guidance to the founder or estate planner in choosing a structure for the trust.

In a discretionary trust, the trustees own the trust assets and not the beneficiaries.[228] Therefore, exposure of these assets to risks that a beneficiary is open to, such as sequestration, is limited. Unless an asset has vested in a beneficiary, these assets are protected from creditors of the beneficiary, which could otherwise be attached. [229]

If a trust is a *bewind* trust, as discussed in chapter 2 (paragraph 2.2.5), the assets, although managed and controlled by the trustees, are registered and owned by the beneficiaries. These assets will form part of the sequestrated estate of a beneficiary, which creditors may attach.[230]

It is important to note though, that the intention of the founder or estate planner must be honourable. Creating a trust to transfer assets amidst a forthcoming sequestration of a founder or estate planner can result in the trustee of the sequestrated estate retrieving these assets back into the sequestrated estate.[231] The Insolvency Act[232]makes provision for creditors to ascertain whether they have a claim or not.[233] In *Nedbank LTD v Thorpe*[234] Levinsohn DJP in his dictum stated that where evidence is provided that the trust form is veneer then in light of justice and in the interest of creditors, that veneer

[227] Van der Spuy op cit note 2 at 78.
[228] Botha et al op cit note 33 at 835.
[229] ibid 850.
[230] Van der Spuy op cit note 2 at 78.
[231] ibid 79.
[232] Act 24 of 1936 s 24-31.
[233] C Weyer *The viability of the trust as an estate planning tool* (unpublished LLM dissertation 2017) 12.
[234] *Nedbank Ltd v Thorpe* [2008] JOL 22675 (N)

should be pierced. A trust provides protection of trust assets from beneficiaries who lack business and investment acumen. Prodigality, bad or financially immature decisions made by such beneficiaries could have devastating consequences if the assets are in the personal name of such beneficiaries.[235] Even in vested or bewind trusts, the assets will be protected, being managed and controlled by trustees.

Trust assets are also not subject to the marital regime of beneficiaries. In a marriage in community of property, these assets will not form part of the joint estate nor will the value of the assets be included in the accrual calculation in a marriage subject to the accrual regime.[236] In this way, trust assets are not hauled into the divorce arena, in the event of a beneficiary's divorce. It remains the asset of the trust or if vested or distributed to a beneficiary, a clear stipulation in the trust deed that such property is to remain the beneficiary's only and not form part of a joint estate or accrual calculation will keep the assets protected.[237] However, once again, parties in a divorce proceeding who intentionally and deliberately creates a trust to transfer assets into the trust thereby reducing their own personal estate will receive no protection from the trust as the objective can be proven to be unlawful by the aggrieved spouse. In such a case, the court has the power to distribute the assets as though the trust never existed.

Business owners are able to keep their personal assets separate from their business with trusts and in so doing confine their business risks to the business only and not their personal estates. Business owners experience potential claims for financial damages from creditors, employees, tenants, customers and even competitors.[238]

5.2.2. Flexibility to cater for varying circumstances and events

A discretionary trust is extremely flexible and caters for various uncertainties such as an increase in family size and fortune, divorce, re-marriage for a second or third time with children from previous marriages.[239] An example of the latter situation, which is

[235] Van der Spuy op cit note 2 at 91.
[236] *Trust Law* (unpublished lecture notes, Milpark,2018) 225.
[237] ibid 225.
[238] Van der Spuy op cit note 2 at 79.
[239] ibid 91.

rather common nowadays is a situation where a founder or planner has entered a second marriage but has children from his or her previous marriage. Should the founder or planner bequeath his or her estate to the new spouse, there is a possibility that the new spouse may disinherit the founder's or estate planner's children from the previous marriage. A solution would be to create a trust to resolve this concern where the spouse and the children may be income and/or capital beneficiaries of the trust. The trustees will manage and control the trust assets thereby avoiding prejudice to any beneficiary.[240]

A trust can also be utilsed in a divorce settlement whereby a divorce settlement can be transferred into a trust and be applied for the benefit of minor children and a spouse.[241] If a person is obliged to transfer assets into a trust in terms of a Court Order, it is unlikely that donations tax would be leviable[242] as was the situation in *Estate Welch V Commissioner for SARS* [243]

5.2.3 Indivisible assets

A trust can also provide for *joint ownership of indivisible assets,* such as holiday homes and farms. It is very difficult to sub-divide farms, as there are laws that prevent the subdivision of agricultural land. A trust, however, can be used to provide for a number of beneficiaries who could have different rights of use and enjoyment over various parts of the farm.[244]

A very simple, yet realistic situation that occurs often is a farmer who owns a farm and has for example two sons who are equally involved in the farming activities. Unfortunately, the farmer finds himself in a conundrum, as he will not be able to bequeath the farm to both his sons in equal shares through his Will. A trust would be his solution. He may transfer the farm to a trust created during his lifetime or even upon his death. In this way, his sons may continue with the farming activities and enjoy the benefits without concerns about ownership rights.

[240] ibid 91.
[241] ibid 291.
[242] ibid 291.
[243] *Estate Welch v Commissioner* for SARS [2004] 2All SA 586 (SCA).
[244] *Trust law* op cit note 236 at 227.

5.2.4. Perpetual succession and preservation of wealth for future generations -

This is probably another one of the more common reasons that discretionary trusts are so widely used. Planners very often want to ensure that the wealth accumulated over their lifetime, through inheritance or through one's own personal successes, continues far beyond the next generation and in fact enjoys 'perpetual succession'.[245]

Furthermore, this is also effective estate planning for future generations. Rather than receiving an inheritance directly into their own personal name and estate,[246] which ultimately results in increasing the beneficiaries' estates thereby attracting taxes such as estate duty, CGT and/or income tax, beneficiaries receive rights through a discretionary trust for the use and enjoyment of the trust assets without actually owning the assets and without certain tax burdens.

5.2.5. Efficient succession

An estate is frozen upon death of an individual. It could take a long time before the estate is wound up. Any delay in receiving their inheritance could lead to financial hardship for the heirs of the estate particularly in the case of a death of the breadwinner or where couples are married in community of property and their joint accounts are frozen. In contrast to this, death does not interrupt the operation of a trust.[247] There is no interruption of the enjoyment of assets upon the death of any parties to a trust.

Furthermore, the process of winding up a deceased person's estate incurs estate expenses, settlement of liabilities of the deceased person as well as taxes both for the deceased and the estate. The more assets a planner has in his estate, the higher the payments of these estate expenses, liabilities and taxes are likely to be. This results in the need for a liquid estate. The executor will require cash to settle these payments. If the estate lacks liquidity and the beneficiaries do not provide the required amount of cash, which they are not obliged to do, the executor will have no choice but to realise

[245] Botha et al op cit note 33 at 851.
[246] Van der Spuy op cit note 2 at 81.
[247] ibid 101.

assets in the estate to create such liquidity, thereby denying the beneficiaries of the estate their full inheritance.

However, if over the years, the founder or estate planner transferred assets into the trust strategically and ensured the trust reduced the loan account with consistent repayments inclusive of interest, this would result in less estate expenses, liabilities and taxes due by the estate.[248]

5.2.6. Estate 'freezing' or pegging

Estate freezing or 'pegging' of the estate is a benefit that brings some tax relief. This entails the sale or donation of growth assets to the trust at market value. Any increase in the value of these assets from the date of transfer will then take place in the trust and not in the client's estate. In this way estate duty is reduced on the growth portion of the asset. The only amount that will appear in the client's dutiable estate will be the amount that the assets were sold to the trust for plus interest and NOT the growth that took place after transfer to the trust, hence ' freezing' or 'pegging' the estate at this lower value.[249]

A misconception that requires clarity with many planners is that the estate duty relief is not an immediate relief if a loan account owed by the trust to the planner remains outstanding. The loan account remains an asset in the estate of the planner and included in his or her estate on death for purposes of estate duty as long as it remains outstanding. It is therefore important for the trust to reduce the loan that it owes to the planner. A diminishing loan account over the years increases the estate duty relief in the planner's estate. This benefit is a long-term benefit rather than an immediate benefit.

5.2.7. Taxation of trusts

In Chapter 3, the tax implications relating to trusts was considered. It may appear that the tax implications are harsh and indeed, it may be so but in certain instances, trusts offer significant tax advantages.

[248] Van der Spuy op cit note 2 at 102.
[249] *Trust law* op cit note 236 at 214-215.

Income splitting by utilising the *conduit pipe principle* may result in tax advantages and *Trustees of the Hull Trust Fund v CIR*[250] explained this principle well,

> "The court held that where income received by the trust was paid out to beneficiaries within the same tax year, it was treated, for tax purposes, as if it had never been received by the trust, but rather directly by the beneficiaries. This is referred to as the *'conduit pipe principle'*. Under this principle, the income retains its nature i.e. if the trust received interest income, the beneficiary receives the distribution as 'trust income'. Therefore, if the trust receives a South African dividend income and distributes it to a beneficiary in the year of receipt, it retains its nature as a dividend, and is exempt from tax in the beneficiary's hands."[251]

However, it is very important to note that this principle, incorporated into the Income Tax Act as section 25B, is subject to section 7[252] (discussed above in chapter 3). In other words, if the income or capital gain is not derived from a donation, settlement, other disposition, or perhaps the person who made the donation, settlement or other disposition is no longer alive, effective income splitting is possible.[253]

The benefit applies if the beneficiaries have a lower tax rate than the trust. This would indeed result in a tax saving overall because trusts are taxed at the highest income tax rate and inclusion rate for CGT purposes.

However, this principle has been exploited over the decades and continues even today. This was not the intention of the courts nor the legislature. In fact, it was a means implemented to avoid double taxation i.e. income or capital gains being taxed in the hands of the trust and the beneficiaries if received or accrued to the trust and the distributed to the beneficiaries during the same tax year.

In instances where the trustees want to retain income in the trust for capital growth in order to achieve its objective/s, rather than having the punitive tax rate of the trust apply

[250] *Trustees of the Hull Trust v CIR* (1931 WLD).
[251] Haupt op cit note 71 at 813.
[252] ITA 58 of 1962.
[253] Botha et al op cit note 33 at 851.

on the growth of the trust capital, trustees have options when investing. They may invest the trust capital in *endowments, equities* and *preference shares*, which pay after tax or tax-free dividends so as to make the receipts in the trust *non-taxable – the return is received as an after-tax amount.* [254]

5.2.8. Trading trusts

The use of trusts for business purposes has provided estate planners with wider options and has increased substantially. Trust rules have adapted to function within a business environment where the specific objective of a trust is to use the trust assets to conduct a business and to make a profit. A trading trust can be distinguished from other trusts in that the aim of the other trusts is to protect and conserve the trust assets whereas the aim of a trading trust is to use the trust assets to generate a profit.[255]

Taxes paid by trusts are higher than any other tax payer. However, estate planners are advised to structure their affairs utilising a trust to avoid or minimise paying taxes. Income generating assets are then moved into a trust, and the estate planner uses income splitting and the *conduit pipe principle* to pay less tax.[256]

Trading trusts are useful to keep business and personal estates separate thereby providing a mechanism of managing risks associated with the business.

5.2.9. Use of trust to receive retirement lump sums from retirement funds and the purchase of compulsory annuities-

It often happens that estate planners' retirement benefits is one of their largest investments. However, in many cases the concern of having this large amount paid directly to their dependants and beneficiaries upon their death is very real particularly if the dependants and beneficiaries do not have the necessary acumen to handle large amounts of funds. In such instances, the board of trustees of a retirement fund can choose to pay the retirement benefits of a deceased member into a trust so that the

[254] Van der Spuy op cit note 2 at 83.
[255] P Van der Spuy Demystifying Trusts in South Africa 1 ed (2017) 304 & 305.
[256] Van der Spuy op cit note 2 at 300 &301.

trustees of the trust will be able to manage and control the use of the benefits in the best interest of the dependants and beneficiaries. Members may nominate a trust as the beneficiary to their retirement benefits. Trustees of the trust will be able to manage and control the use of the benefits in the best interest of the beneficiaries.[257]

5.2.10. Different trusts for different purposes

Trusts are versatile and used for different purposes. Some examples of the various types of trusts which are classified according to its purpose (and without going onto detail about each of trusts) are investment trusts, property-holding trusts, trusts for agricultural purposes, voting trusts, trusts to hold mineral rights, employee share scheme trusts, black economic empowerment trusts, trusts for schools and universities, charitable trusts, trading trusts and of course estate planning trusts[258] the latter being the focus in this dissertation.

One of the characteristics of trusts is that they are extremely flexible because the trust rules can be adapted to suit specific needs and functions,[259] although the latter cannot be against public morality.

5.2.11. Mental health of planners, beneficiaries and protection of minors

Medical health issues often accompany aging. A trust plays an important role for planners who become affected by a mental health issue such as Alzheimer's disease or Dementia. His or her financial affairs would continue as before, with the trustees being entrusted to manage the trust assets in the interest of the affected beneficiary.[260]

Estate planners may have concerns over loved ones who are minors likely to receive a large inheritance upon death of the estate planner.[261]Such inheritance may be bequeathed to a trust for the benefit of the minor because trusts offer the solution of protection required.

[257] Botha et al op cit note 33 at 851.
[258] Honiball op cit note 9 at 305 – 308.
[259] ibid 304.
[260] Van der Spuy op cit note 2 at 93.
[261] ibid 101.

5.2.12. Life insurance owned by a trust

Any life policy owned by a trust on the life of a deceased person will be included in deemed property in the estate of the deceased. The amount included will however be reduced by the premiums paid by the trust plus 6% compound interest in terms of the Estate Duty Act.[262] This is one method used to increase capital in the trust without having the concern of a loan repayment by the trust nor donations tax payable (estate duty would be applicable). The proceeds can still be utilsed for the benefit of the trust beneficiaries.

5.3 Conclusion:

The benefits considered in this chapter are far reaching, but are not exhaustive because the benefits of trusts are continuously evolving. These benefits cannot simply be disregarded or ignored in view of the negativity created by the exploitation and the abuse of trusts by some founders and estate planners.

It is worth noting that even though trusts have the highest tax rate, there are tax benefits which trusts can still provide such as the application of the *conduit pipe principle* as well as a reduction of estate duty and CGT in the personal estate of the founder and beneficiaries.

Trusts is a very significant tax planning and estate planning tool which, as discussed above, promotes the furtherance of the objectives and purpose of the trust as long as the trust remains compliant in respect of all its affairs. Asset protection is the focal point of each of the benefits, which is what every estate planner seeks. The abuse of trusts and the resulting control measures have not limited the trust to the extent that it is useless - it is still able to perform its core functions.

[262] EDA 45 of 1955 s 3 (3) (a).

Chapter 6:

DISCUSSION AND CONCLUSION

6.1. Introduction:

The aim of this dissertation was to establish whether trusts are still a significant tax planning and estate planning tool. To arrive at a conclusion, the research questions were addressed through case law, legislation, articles, and textbooks. In doing so, the challenges and the benefits of trusts were both considered through the research questions.

In the preceding chapters a case has been made that trusts still have a significant role to play to a large extent in estate planning and to a lesser extent as a tax savings tool. In fact, a trust should not be created with the intention of saving taxes. If there are tax benefits, it should be purely incidental to the main objectives of the trust.

The trust vehicle is prone to abuse, as are other entities such as corporates. However, it is a legitimate vehicle with a legitimate purpose. It cannot be done away with to resolve the problem of abuse. The latter is not the solution to the problem of abuse. In fact, the legislature together with SARS have been addressing the abusive schemes very pro-actively as discussed in chapter 3.

As a pre-cursor to the discussion below, one of the first findings that appears from the research is that much depends on the objectives and intention of the founder or estate planner. The true objective/s and intention of the founder in creating a trust is what sets the tone and trajectory of success, or failure, of the trust as a tax and estate-planning tool.

Creating a trust, for example, with an objective and intention of saving taxes is not the true purpose served by a trust. It was never the intention, when trusts came about, to have this institution created for the purpose of saving (or avoiding) taxes. If there is a tax saving, it should be incidental to the affairs and workings of the trust in achieving its objectives. It should not be the primary objective.

The founder or estate planner must set the objectives of the trust prudently, undertaking necessary research to consider the likelihood of a trust being the correct estate planning tool to be utilsed in achieving the objectives. Far too often, trusts are created without much thought

put into whether it is an appropriate tool or not and as a result end up as dormant trusts or trusts that go 'astray' from lack of proper management. Trusts are significant tax and estate planning tools if there are genuine objectives laid down in the trust deed and sound strategies developed to achieve the objectives with proper management.

The objectives of the trust must be clear and lawful. The intention of the founder and trustees in creating the trust and managing the affairs of the trust must always be honourable.

It is also vitally important that all parties to a trust have, at the very least, basic knowledge about how a trust works and the tax implications relating to a trust so that they are not astounded with regret by the unknown complexities that may arise after the trust is created. An example of a common misconception by founders or estate planners is that on transfer of assets from their personal estate into a trust, there would be a tremendous savings on tax. This could not be further from the truth. The tax savings is likely to be a long-term benefit rather than an immediate benefit.

6.2. Reflecting on the research questions

The research questions set out in chapter 1 are discussed below and the outcome of the research in respect of each considered:

- What is the true and essential purpose of trusts that has followed through from inception to present day, and how have trusts developed over the years?

Chapter 2 looked into the origins of trusts, the need for the creation of this institution at the outset was pure i.e. protection of assets for the benefit of another. Of course, trusts have developed tremendously over time in terms of regulating trusts as well as the purpose and uses of trusts. Trusts became tainted in certain respects as trusts developed with time. In this regard, chapter 4 looked into the so-called sham trusts and alter ego trusts making an entrance into the estate-planning arena. Founders and estate planners started to utilse trusts in an improper manner that was unfairly advantageous to them. Despite the happenings of the latter, the true and essential purpose of trusts have certainly not been lost if the content and discussion under chapter 5 are considered. Chapter 5 highlights all the benefits of having a trust as part of an estate-planning tool. Infact, since inception, the usefulness of trusts has increased tremendously as trusts continue to evolve.

It is important to note that not all founders or estate planners abuse or exploit the use of trusts. If a trust is utilsed for legitimate and honourable reasons, a trust is very effective as a tax and estate-planning tool.

Parties to a trust have rights and obligations, which have become strengthened through legislation such as the Trust Property Control Act, the Income Tax Act and through judicial decisions through the South African Courts. Conducting trust affairs within the boundaries of this regulatory framework will go a long way in the successful use of trusts as an effective tax and estate-planning tool. In order to do this, it is essential for founders and trustees to have a sound knowledge of:

- How the trust instrument works,
- The rights and obligations of the parties to a trust,
- The type or structure of trusts that best suits the needs of the founder or estate planner to meet the objectives of the trust,
- By keeping updated with the developments of trusts. This area in estate planning is constantly developing with legislative amendments being introduced annually in recent times as well as court cases setting precedents worth following,
- The implications of deviating from the regulatory framework.

Creating a trust, without the aforementioned knowledge and not keeping abreast with the goings-on about the trust environment sets a founder and trustees up for a possible disaster of non-compliance and the possibility of losing out by not using the trust to its full potential.

- How do tax implications relating to trusts impact the use of trusts as a tax-planning tool and estate planning tool?

The founder or estate planner first encounters taxes on transfer of assets from his or her personal capacity into a trust. Chapter 3 examines the taxes. These are normal taxes encountered whenever there is a change of ownership even among natural persons i.e. capital gain tax, donations tax, transfer duty

As with the creation of any new establishment, organization, practice, entity or institute a weak link, once identified by interested parties, can be utilsed deliberately and unfairly to such parties' advantage. A trust has been no different. To reduce their own personal estates or avoid

paying taxes, some taxpayers devise schemes to meet these objectives resulting in the reduction of the tax base of the government. Undoubtedly, government does not take kindly to such schemes and returns vigorously in the form of punitive legislative changes. The latter is evident in chapter 3 under the discussion of the pre-enactment of section 7C, the enactment of section 7C which was subsequently extended into section 7C(1) (ii) and section 7C (1B) with further amendments in the pipeline in order to curb the schemes developed by tax payers dealing with loans made to trusts. Unfortunately, for those taxpayers who do not involve themselves in these manipulative schemes, these punitive legislations, also apply to them.

As harsh as the response from government may appear, had there been no response to these manipulative schemes, it would encourage more schemes to run rampant.

With regard to the anti-avoidance tax provisions, which deems income to be that of the donor, this is a means of bringing income splitting under control. If government did not take these steps, widespread abuse would be seen, far more than that which currently occurs. Chapter 3 examines the deeming provisions together with relevant case law or examples of how a section is applied.

Do trusts actually serve the purpose of saving taxes? The answer to this is yes, to some extent, there is a saving on tax. By transferring assets into a trust, the personal estate of the founder or estate planner is reduced. The growth on the assets transferred into trust, takes place in the trust. Hence, there will be no estate duty or CGT on the growth portion of the assets in the hands of the founder or estate planner. However, as long as a loan account is in existence, the loan will remain an asset in the personal estate of the lender. In this respect, the tax benefit can be protracted and seen as a long-term benefit. Where there is no loan account, upon the death of the founder or estate planner, there will certainly be savings on estate duty and capital gains tax. If the asset transferred into the trust is an income-producing asset, the income received by the trust will not necessarily be taxed in the hands of the founder or estate planner and if this is the case, it would be a savings in respect of income tax for the founder or estate planner. However, the latter is dependent on whether the income is retained in the trust or distributed to a beneficiary but subject to section 7.

When income is split and section 7 anti-avoidance tax measures are applied, it does create the impression that income splitting is abuse or exploitative. To an extent, it is true but in reality income splitting can be regarded as a double-edged sword. It has two sides to it. It can be viewed from another perspective, that is, as a benefit provided by trusts which has been

discussed in chapter 5. However, the difference between the two types of income splitting is that in one case it is with the deliberate intention to undermine the tax system whereas in the other case, income splitting occurs as a matter of course.

- How and why have trusts been exploited by some founders, trustees or estate planners?

Some founders, trustees or estate planners thrive on identifying loopholes in the system and unfairly utilse these loopholes to their advantage by devising manipulative schemes to achieve their objectives. An example of this is when section 7C was introduced, it only applied to natural persons, a scheme was then devised to make interest free loans to companies whose shares were owned by a trust. As soon as this loophole closed, yet again taxpayers devised another scheme where taxpayers subscribed to preference shares with no, or a low rate of return, in companies whose shares are owned by trusts. The latter has been discussed in detail in chapter 3.

Pivotal to all of the exploitations and abuse that occurs with trusts, are one of two elements, if not both, that are present in the administration and management of the trust. These two elements are-

i. Founders not relinquishing control of the trust assets and treating them as separate assets from their own
ii. The lack of independence or objectivity of trustees

With regard to (i) above, as seen in chapter 4, if there appears to be any indication that a founder retains control over the trust assets there is a risk that the trust is labelled a *sham trust* or an *alter ego trust* . As a result, a court can conclude that the trust assets therefore belong to the personal estate of the founder resulting in estate duty consequences that flow upon his or her death, alternatively resulting in the attachment of trust assets to settle debts of the founder or estate planner. Despite this, it is evidently seen from the various cases that this conduct by the founder or estate planner continues with many trusts nonetheless. *Parker* is a landmark case in this regard and the decision taken serves as a guide for subsequent decisions.

With regard to (ii) above, also discussed at length in chapter 4, it is well established that trustees have a duty to act independently.

Cameron JA in *Parker* referred to the importance of appointing an independent outsider trustee in family business trusts. This should in fact be extended to all trusts irrespective of whether it is a family business trust or not.

Walter Geach,[263] succinctly submits that

> "As the King Code on Corporate Governance suggests there should ideally be a majority of independent non-executive directors on the board of directors of a company in order to ensure good corporate governance", so to should be the case of trusts i.e. "there should be a majority of independent trustees who are not connected persons, in relation to the planner, the founder or any of the beneficiaries. No one person should dominate meetings or decisions of trustees or exercise too much personal influence over the affairs of the trust. A majority of independence trustees will not only ensure good corporate governance, but will ensure that there is a separation of control of the trust from the enjoyment of benefits. Such separation is arguably essential for a valid trust to be created. A trust is likely to fail if the so-called trust form is really the planner, founder or beneficiary in another guise".

Visser states,

> "The fiduciary duties of the independent trustee include checking the conduct of the other trustees, ensuring that the trust functions properly and ensuring that the provisions of the trust deed are adhered to. The independent trustee must ensure that decisions are made together, that nobody acts unilaterally and that the decisions are beneficial to all the trustees. "If the independent trustee is found to be in breach of their fiduciary duties they can be held personally liable."[264]

Without absolving other trustees from their duties, an independent trustee clearly has a large role to fill in terms of his duty as a trustee to maintain the stability of the trust by not allowing the control and objectivity of trustees to be lost.

[263] W Geach op cit note 3 at 84-85.
[264] A Visser 'The important role of independent trustees in a family business trust' (1 September 2021) available at *https://www.moneyweb.co.za/in-depth/fisa/the-important-role-of-independent-trustees-in-a-family-business-trust/*, accessed on 12 December 2021.

- How does the legislation and SARS as well as the South African courts deal with curbing such exploitations

Chapter 3 and 4 addresses this research question.

It is evident that the courts do not hesitate to pierce the 'veneer or veil' between the founder or planner and the trust. The South African courts have very efficiently dealt with numerous cases, which required the courts to go beyond the trust form upon the availability of sufficient proof that the trustees or planners do not manage the trust in a proper manner. In so doing, the courts deal appropriately with such founders, estate planners and trusts that are mismanaged.

The South African legislature has made numerous amendments to the ITA to prevent sham trusts and alter ego trusts from furthering their illicit activities but this appears to be an on-going concern.

However, the Trust Property Control Act has not kept pace in terms of developing sufficiently, considering the steadfast expansion that has taken place in the area of trusts and the need for clarity and regulation relating to common problems that arise from the misconduct of trusts.

The government does, from time to time whenever it deems necessary, appoint a commission to investigate potential reform into the tax systems in South Africa. The last commission was the Davis Tax Commission, with its predecessors being The Katz Tax Commission and The Margo Tax Commission.

When the DTC examined trusts closely, it made the following comment and recommendations:[265]

"It would appear that SARS does not examine trusts at the time that they are registered or when assets are transferred into trusts. This represents an opportunity for taxpayers to shed substantial value from their estates without the payment of donations tax or CGT. The DTC recommends that such transactions be comprehensively examined by competent SARS officials." The author is in complete agreement with this recommendation.

[265] DTC op cit note 55 at 29.

6.3. Conclusion

In concluding this dissertation, the answer to the last research question encapsulates the author's final remarks and opinion.

- An evaluation of the feasibility of utilizing a trust as a tax planning and estate planning tool

"As Le Puelle puts it: Trusts have now prevailed on all fields of social institutions in common law countries. They are like those extraordinary drugs curing at the same time toothache, sprained ankles and baldness, sold by peddlers on the Paris Boulevards; they solve equally well family troubles, business difficulties religious and charitable problems. What amazes the skeptical civilian is that they really do solve them."[266]

The author is of the very strong opinion that despite the adversities that appear to hover over trusts, trusts are still a significant and relevant tax planning and estate planning tool. As long as a trust is utilized for sound purposes and objectives, there is no mismanagement by the trustees, no control over trust affairs by the founder or estate planner, no abuse and exploitation of loopholes in the system trusts will serve an important role in tax and estate planning. All the trustees need to do is manage the trust within the legal framework.

From a taxation perspective, trusts in certain respects may perhaps not be as advantageous considering the high tax rates applicable to trusts in respect of income and capital gains. However, the benefit that arises from the growth of assets held in trust should not be overlooked. The growth takes place in the trust and not in the personal estates of the founder or estate planner. This can contribute to a tremendous savings in estate duty and CGT. Furthermore, income splitting as discussed above can be advantageous. To this extent, trusts do provide a tax-planning benefit.

From a non-taxation perspective, the benefits discussed in chapter 5 have grown since the inception of trusts. Each generation is more innovative than the previous in the use of trusts. This is in order as long as the management of trusts are sound and proper. It is for these reasons the author is of the view that trusts are certainly significant in estate planning.

Strengthening the legislation that is, the Trust Property Control Act, pertaining to trust administration will provide clarity particularly in respect of the appointment of independent

[266] Honiball cit note 9 at 305.

trustees as well as relinquishing control of trust assets and general management of the trust affairs by the founder or estate planner. These issues arise far too often and is perhaps the root cause of the problems associated with trusts. The conduct of the parties to a trust is what needs to be addressed stringently and this should be from inception of the creation of a trust rather than applying a blanket –approach such as punitive tax legislation only when a problem arises. The latter affects all trusts, both legitimate and illegitimate trust.

The author is in complete agreement with the recommendation made by the DTC quoted above. Resources should be made available for SARS to have a dedicated department to examine trusts and to ensure there is tax compliance from the outset. However, in addition to this, resources should also be extended to the Masters Office with a dedicated team of officials making their 'presence felt' through audits being conducted on trusts to ensure proper compliance in terms of management of trusts and the conduct of the parties to a trust. Alternatively, perhaps creating a Trustee Conduct Authority Regulator similar to the Financial Services Conduct Regulator to serve the purpose of keeping a 'watchful eye' on trustee conduct and management of trusts.

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