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Date: February 2014

Dissertation Topic:

The taxation of income and expenditure of trusts in South Africa.

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## Introduction

The use of trusts remains popular in South Africa. Trusts are often perceived to solve all problems but the tax law provisions applicable to trusts are often highly complicated causing the person making use of the trust to be stepping into a minefield<sup>1</sup>.

The formation of a trust has for many years been a very popular financial planning tool for various reasons<sup>2</sup>. SARS has been clamping down on trusts and with the introduction of capital gains tax and transfer duty the use of trusts has lost some of its appeal. Trust has however remained a very useful estate planning tool, so useful that the Katz Commission proposed that the use of trusts as a “generation skipping device” should be curtailed and that trusts should be subject to a capital tax at periodic intervals on the market value of their net assets<sup>3</sup>. This has not been implemented yet but should be kept in mind for the future.

This research paper has an in depth look at the taxation of the income and expenditure of trusts as it currently stands.

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<sup>1</sup> M Honiball, L Olivier, *The Taxation of Trusts in South Africa*, Siber Ink, 2009, p xxiii

<sup>2</sup> M Botha, L Rosinni, W Geach, B Goodall, L du Preez, *The South African Financial Planning Handbook*, LexisNexis, 2013, p 811

<sup>3</sup> Ibid.

# Chapter 1

## Introductions to trusts

The law of trusts evolved during the Middle Ages from within the body of English Law known as “equity” which is the body of the law developed by the Court of Chancery, as opposed to the Courts of Common Law<sup>4</sup>. With its dual system of legal and beneficial ownership the trust is linked to the English Law of property which is a foreign concept to Roman Dutch Law in terms of which only one kind of ownership can exist in the same thing<sup>5</sup>.

After the British occupation of the Cape it is no surprise that the English trust was incorporated into the South African legal system<sup>6</sup>. However it is important to remember that even though the English trust as an institution was incorporated into South African law, the English law of trust was never incorporated<sup>7</sup>. Over the years our South African courts have created unique South African trust law which has little resemblance to its English counterpart<sup>8</sup>.

## Definition of South African Trusts

### General definition

In South Africa we have three different kinds of trusts. The first is the so called “ownership trusts” where the founder or donor transfers ownership of property to a trustee to be held for the benefit of beneficiaries who are defined or determinable<sup>9</sup>. Then we have the “bewind trust” where ownership of the properties is transferred to the beneficiaries by the founder but control over the property lies within the trustees<sup>10</sup>. Thirdly we have the kind of trust where someone is entrusted with the affairs of

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<sup>4</sup> Honiball, p 2

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid.

<sup>9</sup> Honiball, p 3

<sup>10</sup> Ibid.

another, for example where a curator has been put in charge of a mentally handicapped person's estate<sup>11</sup>.

### Statutory definition

Trusts are defined in section 2 of the Trust Property Control Act as:

“Trust: means 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 provisions of the trust instrument or for the achievement of the object stated in the trust instrument; or
- b) To the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument, but does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965 (Act 66 of 1965)<sup>12</sup>.”

It is clear that the definition of “trust” in the Trust Property Control Act includes trusts in the wide sense, so called bewind trusts as well as trusts in the strict sense. It also refers to a “trust instrument”. As such it includes both testamentary and *inter vivos* trusts, but excludes oral trusts<sup>13</sup>.

### The parties to a trust

It is clear from the definition of a trust that there are three main parties to a trust, the founder, the trustees and the beneficiaries.

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<sup>11</sup> Honiball, p 3

<sup>12</sup> Trust Property Control Act 57 of 1988 s1

<sup>13</sup> Botha, p814

The founder of the trust who is also known as the donor or settler of the trust is the person who created or established the trust<sup>14</sup>. In the case of an *inter vivos* trust, the founder must be capable of entering into a contract<sup>15</sup>. In the case of a testamentary trust, the founder must be capable of making a will<sup>16</sup>.

The trustees are responsible for the administration of the trust property<sup>17</sup>. They must act within the law and must comply with the provisions of the trust deed<sup>18</sup>. It should be remembered that irrespective of the provisions of the trust deed, even though the trustees are the owners of the trust property they have no beneficial interest in such property and that they have a fiduciary duty towards the beneficiaries<sup>19</sup>. The trustee may also be a beneficiary but it is clear from recent legal judgments that one of the essentials of a trust is that there must be a separation of enjoyment of trust assets, from the control of those trust assets<sup>20</sup>.

The beneficiaries are the persons who benefit from the trust. They derive their rights be it discretionary or vested, from the terms of the trust deed<sup>21</sup>. The beneficiaries of a trust must also be identifiable as a trust without a beneficiary or objective is a nullity<sup>22</sup>. Beneficiaries can exist at the time a trust is formed or they can still be created or born<sup>23</sup>. However, this can be problematic with testamentary trusts as the creation by trustees of new beneficiaries may be regarded as an abdication of testamentary power which may therefore be invalid in terms of South African Law<sup>24</sup>.

There are a number of rights a beneficiary can have, these are for example, rights to income, rights of use of a trust asset or assets, rights to capital, conditional or discretionary rights, vested rights, existing rights, future rights,

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<sup>14</sup> Botha, p 812

<sup>15</sup> WD Geach, J Yeats, *Trusts Law and Practice*, Juta, 2007, p 38

<sup>16</sup> Ibid

<sup>17</sup> Botha, p 812

<sup>18</sup> Ibid.

<sup>19</sup> Honiball, p 15

<sup>20</sup> Geach, p 39

<sup>21</sup> Botha, p 812

<sup>22</sup> Geach, p 44

<sup>23</sup> Ibid

<sup>24</sup> Ibid.



limited rights, variable rights, fixed rights, annuities and any combination of the above<sup>25</sup>.

Generally the rights of a beneficiary are not real rights but personal rights<sup>26</sup>. However, this is not the case with the bewind trust where the beneficiary actually has the real right in the form of ownership in an asset<sup>27</sup>. There is also often confusion in practice and in tax law about the so called vested right<sup>28</sup>. A beneficiary has a vested right when that beneficiary has the right to claim an asset from the trustees and this right is a personal right or a right *in personam*<sup>29</sup>. However if a beneficiary has ownership in an asset, they have a real right or a right *in rem* which is a right in the asset itself<sup>30</sup>.

#### The legal nature of trusts

A trust is either created by a contract (*inter vivos* trust) or a will of a testator (a testamentary trust)<sup>31</sup>. Even though the provision of the Trust Property Control Act<sup>32</sup>. does not regulate the formation of a trust the way the Companies Act regulate companies, it has a direct influence on trusts, particularly on the duties of trustees<sup>33</sup>.

In *Crookes v Watson*<sup>34</sup> it was accepted that an *inter vivos* trust is a contract for the benefit of a third person, a so-called *stipulatio alteri*<sup>35</sup>. However, a testamentary trust is a legal institution in its own right<sup>36</sup>. It is created by the Last Will and Testament of the deceased who will be the founder of the trust and even though it is not a contract it will come into being on the death of the founder<sup>37</sup>. In *Braun v Blann & Botha NNO & Another*<sup>38</sup> it was accepted that a

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<sup>25</sup> Geach, p 62

<sup>26</sup> Ibid.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid

<sup>29</sup> Geach, p 63

<sup>30</sup> Ibid.

<sup>31</sup> Botha 814

<sup>32</sup> Trust Property Control Act 57 of 1988

<sup>33</sup> Botha 814

<sup>34</sup> *Crooks v Watson* 1956 (1) SA 277 (A); Botha, p 814

<sup>35</sup> Botha, p 814

<sup>36</sup> Ibid.

<sup>37</sup> Ibid.

<sup>38</sup> *Braun v Blann & Botha NNO & Another* 1984 (2) SA 850 (A); Botha, p 814

testamentary trust has its own unique legal nature and characteristics and that it is not a *fideicommissum*.

Although in theory a trust is not a separate legal person, in practice it comes very close to being one<sup>39</sup>. The Trust Property Control Act<sup>40</sup> does give a definition of a “trust” and also regulates the actions of trustees. The Trust Property Control Act also states that the trust property does not form part of the trustees personal estates, and in the case of a discretionary trust the beneficiaries only have discretionary rights, the conclusion is thus inescapable that the “trust” itself has some legal standing<sup>41</sup>. Section 1 of the Income Tax Act<sup>42</sup> defines a trust as a “person” for the purposes of income tax and the Companies Act<sup>43</sup> defines a trust as being a “juristic person”, however outside statute a trust does not possess juristic personality.

#### The formation of a trust

A trust can be created by agreement, this will be an *inter vivos* trust or in terms of a will, called a testamentary trust.

There are certain essential elements that must be present when creating a valid trust. Firstly there must be the intention by the founder to create a trust and an obligation on the trustees. The object of the trust must also be lawful and the trust property clearly defined<sup>44</sup>. The trust property must be “made over” or bequeathed to the trustees and an obligation on the trustees to administer the trust assets on behalf of the beneficiaries created<sup>45</sup>. The beneficiaries must also be ascertained or ascertainable and the trust object must be certain and clearly defined. In the case of testamentary trusts, requirements of making a valid will must be complied with<sup>46</sup>.

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<sup>39</sup> Honiball, p 9

<sup>40</sup> Trust Property Control Act 57 of 1988

<sup>41</sup> Botha, p 815

<sup>42</sup> Income Tax Act 58 of 1962; Botha, p 815

<sup>43</sup> Companies Act 71 of 2008, s 1; Botha, p 815

<sup>44</sup> Botha, p 815

<sup>45</sup> Ibid.

<sup>46</sup> Ibid.

In terms of the Trust Property Control Act<sup>47</sup>, a copy of the trust deed must be lodged with the Master of the High Court and a trustee cannot perform a valid act unless authorised by the Master to act as trustee by the issuing of a letter of authority.

When a valid trust has been created control and ownership of the assets has passed from the founder to the trustees and the trustees ascertained certain obligations in terms of the trust deed. The beneficiaries also have certain rights however not the beneficiaries nor the founder control trust or its assets<sup>48</sup>.

The flexibility of a trust allows for a trustee to also be a beneficiary and the founder of the trust<sup>49</sup>. The only restriction is that the founder may not be the sole trustee and the sole beneficiary<sup>50</sup>.

These are however many instances where parties believe they created a trust where in law they didn't and they created something else such as a partnership or they even transferred property to another without imposing any trust obligations<sup>51</sup>. "Every trust imports the element of holding or administering property for a person or object other than the trustee himself"<sup>52</sup>.

In *Land & Agricultural Bank of South Africa v Porter & Others*<sup>53</sup> Cameron stated the following:

"Though a trustee can also be a beneficiary the central notion is that the person entrusted with control exercises it on behalf of and in the interests of another. This is why a sole trustee cannot also be the sole beneficiary, such a situation would embody an identity of interests that is contrary to the trust idea and no trust would come into existence"<sup>54</sup>.

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<sup>47</sup> Trust Property Control Act 57 of 1988 s 4(1); Botha, p 815

<sup>48</sup> Botha, p 816

<sup>49</sup> DM Davis, C Beneke, RD Jooste, *Estate Planning*, LexisNexis, Service Issue 36, p 5-6 (3)

<sup>50</sup> Davis, p 5-6 (4)

<sup>51</sup> Botha, p 816

<sup>52</sup> Davis, p 5-6 (4)

<sup>53</sup> *Land & Agricultural Bank of South Africa v Porter & Others* 2005 (2) SA 77 (SCA); Davis, p5-6(4)

<sup>54</sup> *Ibid.*

In *Thorpe & Others v Trittenheim & Another*<sup>55</sup>, the court also referred to *Land and Agricultural Bank of SA v Parker & Others* and Scott JA stated the following:

“Modern business or family trusts in which there is a blurring of the separation between ownership and enjoyment, a separation which is the very core of the idea of a trust. Those who choose to conduct business through the medium of trusts of this nature do so no doubt to gain some advantage whether it is in estate planning or otherwise. But they cannot enjoy the advantage of a trust when it suits them and cry foul when it does not”<sup>56</sup>.

It is also clear from recent legal judgements that one of the key requirements of a trust is that there must be a separation of beneficial ownership from control, and that the trustees are required to administer the assets under their control for the benefit of beneficiaries<sup>57</sup>.

### Different types of trusts

Trusts can be categorized in a number of different ways, based on different criteria<sup>58</sup>. Depending on when the trust takes effect, a trust can broadly be categorised as either an *inter vivos* trust or testamentary (*mortis causa*) trust<sup>59</sup>. An *inter vivos* trust takes effect or is created during the lifetime of the founder where a testamentary or *mortis causa* trust takes effect after the death of the founder and is created in terms of the provisions of a will.

Besides this broad distinction, a trust may also be categorised as either a vested or a discretionary trust. For income tax purposes it is extremely important to determine whether the nature of a beneficiary’s right to income received by or accrued to a trust whose beneficiaries have vested rights or discretionary rights<sup>60</sup>.

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<sup>55</sup> *Thorpe & Others v Trittenheim & Another* 2007 (2) SA 172 (SCA); Botha, p 816

<sup>56</sup> Davis, p 5-8

<sup>57</sup> Botha, p 816

<sup>58</sup> Geach, p 17

<sup>59</sup> Honiball, p 4

<sup>60</sup> *Ibid.*

### Inter Vivos trusts

An *inter vivos* trust is created by way of contract during the lifetime of the founder as a result of the founder making over assets to the trustees<sup>61</sup>. This is done in accordance with the terms of a trust deed, whereby the trustees contractually agree to take ownership of the assets, which will be held and administered by the trustees on behalf of the beneficiaries<sup>62</sup>. These trusts are often referred to in law as being created by a *stipulatio alteri* (a contract in favour of a third person)<sup>63</sup>. Because of this equation it is important to understand the law relating to an *inter vivos* trust.

The variation of a trust deed must be resolved in accordance with the principles of the law of contract<sup>64</sup>. The founder of an *inter vivos* trust may vary or revoke the trust if he has reserved the right to do so in the trust deed. The trustees can also vary the trust in terms of a right to do so reserved in the trust deed. However the founder of the trust and the trustees can't agree to vary the trust if the beneficiaries have already accepted their benefit in terms of the trust deed<sup>65</sup>. If the founder has become incapacitated or is dead, the trustees cannot vary or revoke the trust deed by agreement<sup>66</sup>.

### Vested trusts

A vested or vesting trust refers to a trust in which the beneficiaries have vested rights to the income or capital and the trustees have no discretion as to whether to distribute trust income or capital to them<sup>67</sup>. A vested trust does not mean that ownership of the trust assets vests in the beneficiaries, ownership still vests in the trustees the beneficiaries merely have a vested right to, for example income<sup>68</sup>. If the beneficiary dies before the income accrued to him, his deceased estate acquires the right to the income<sup>69</sup>.

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<sup>61</sup> Geach, p 26

<sup>62</sup> Ibid.

<sup>63</sup> Ibid.

<sup>64</sup> Davis, p 5-10

<sup>65</sup> Ibid.

<sup>66</sup> Ibid.

<sup>67</sup> Davis, p 5-12

<sup>68</sup> Honiball, p 5

<sup>69</sup> Ibid.

### Discretionary trusts

A discretionary trust refers to a trust where distribution of income and capital to the beneficiaries is within the discretion of the trustees<sup>70</sup>. The degree to which the trustees have a discretion is dependent on the terms of the trust deed<sup>71</sup>. Where a beneficiaries' right to trust capital and/or income is dependent on the exercise of the trustees discretion the right is a contingent right and is therefore not transferred to the beneficiaries' successors on either death or insolvency<sup>72</sup>.

### Testamentary trusts

A testamentary trust is formed in terms of the last will and testament of a testator or testatrix. This is a *mortis causa* trust also known as a testamentary trust or will trust. As we have freedom of testation in South Africa, it is very difficult for any person to contest the terms and conditions of a testamentary trust<sup>73</sup>. The discretion conferred upon the trustees of a testamentary trust cannot be too wide as a too wide discretion could be regarded as a delegation of testamentary power which is not allowed in South African Law<sup>74</sup>. Clauses of a testamentary trust that are regarded as amounting to a delegation of testamentary power will be invalid as held in *Braun v Blann and Botha NNO*<sup>75</sup>.

A testamentary trust only comes into existence after the founder's death and the document containing the terms and ambit of the trust is the founder's last will and testament. Due to this all the formalities prescribed in the Wills Act for a valid will must be followed.

Testamentary trusts are often used as a vehicle to protect minor beneficiaries' inheritance until they reach majority or the age as prescribed in the founders' last will and testament.

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<sup>70</sup> Honiball, p 5

<sup>71</sup> Honiball, p 6

<sup>72</sup> Davis, p 5-13

<sup>73</sup> Davis, p5-14

<sup>74</sup> Geach, p 26

<sup>75</sup> *Braun v Blann & Botha NNO* 1984 (2) SA 850 (A); Geach, p 26

### Special trusts

Section 1 of the Income Tax Act<sup>76</sup> sets out the definition of a special trust. It is defined as either an *inter vivos* or testamentary trust set up solely for individuals with serious mental or physical disability who are incapable of managing their own affairs<sup>77</sup>. A testamentary trust set up solely for a relative or relatives of the testator where the youngest beneficiary is under the age of 21 will also fall within the definition of a special trust<sup>78</sup>.

Unlike the income tax provision of a normal trust, a special trust is taxed as an individual at the same rate that applies to individuals, except a special trust is not allowed to claim the primary rebate<sup>79</sup>. With regards to capital gains tax, paragraph 1 of the Eighth Schedule of the Income Tax Act also defines a special trust<sup>80</sup>. The definition is however more restrictive and special trusts created for individuals with serious mental and physical disabilities will have the inclusion rate of 33.3% as well as qualify for the annual exclusion available to natural persons as well as the primary residence exclusion<sup>81</sup>. Special trusts for relatives which are minors<sup>82</sup> only qualify for the favourable capital gains of 33.3% and not for the exclusions<sup>83</sup>.

### Business or trading trusts

A business or trading trust has not been defined but there is a growing tendency to use a trust as a business vehicle<sup>84</sup>. The reason for the popularity is that most of the benefits of a company or closed corporation, for example perpetual succession and limited liability can be enjoyed without the onerous duty of complying with the Companies<sup>85</sup> or Close Corporations Act<sup>86</sup>.

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<sup>76</sup> Income Tax Act 58 of 1962

<sup>77</sup> Honiball, p 233

<sup>78</sup> Ibid.

<sup>79</sup> Honiball, p 234

<sup>80</sup> Honiball, p 235

<sup>81</sup> Honiball, p 236

<sup>82</sup> Par 10(1) of the Eight Schedule of the Income Tax Act 58 of 62

<sup>83</sup> Honiball, p 236

<sup>84</sup> Davis, p 5-14(4)

<sup>85</sup> The Companies Act 71 of 2008; Davis, p 5-14(4)

<sup>86</sup> The Close Corporations Act 69 of 1984; Davis, p 5-14(4)

Business trusts are used for various purposes, for example: for trading, holding property, housing purposes, estate planning, voting trusts for controlling companies, investment trusts, share incentive trust and realisation trusts to name but a few<sup>87</sup>.

The fact that trusts are mainly unregulated leads to one of the biggest disadvantages as persons using a trust can never predict how disputes arising from the trust will be settled. With the legislature's eye also being on the use of trusts to obtain tax benefits the use of business trusts may give rise to negative tax consequences<sup>88</sup>.

### Offshore trusts

Internationally the term offshore trust is used to describe trusts which are set up in law or tax haven jurisdictions<sup>89</sup>. In South Africa the term includes any non-South African or non residence trust that has its place of effective management outside the republic<sup>90</sup>.

There are both tax advantages and disadvantages with regards to offshore trusts<sup>91</sup>. Offshore trusts and offshore based trustees are not taxed in the home jurisdiction of the founder or beneficiaries as they are non-resident in such jurisdictions, unless anti-avoidance provisions apply<sup>92</sup>. In South Africa there are both general and specific anti-avoidance provisions that can negatively impact the use of offshore trusts<sup>93</sup>.

### Charitable trusts

Charitable trusts can be set up for the advancement of religion or education<sup>94</sup> or for any other purposes beneficial to the community<sup>95</sup>. Since the amendments of the Taxation Law Amendment Act<sup>96</sup> all registered public benefit institutions will qualify for tax relief<sup>97</sup>.

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<sup>87</sup> Davis, p 5-14(4)

<sup>88</sup> Honiball, p 313

<sup>89</sup> Honiball, p28

<sup>90</sup> Ibid.

<sup>91</sup> Honiball, p 53

<sup>92</sup> Ibid.

<sup>93</sup> Honiball, p 54

<sup>94</sup> Honiball, p 56

<sup>95</sup> Ibid.

<sup>96</sup> Taxation Law Amendment Act 30 of 2000

<sup>97</sup> Honiball, p 207



Section 30 stipulates which institutions qualify as a public benefit organisation<sup>98</sup> as not all entities can be used to conduct a public benefit organisation<sup>99</sup>.

In terms of section 30(1) the following entities may be used<sup>100</sup>: “a trust established in the Republic and which is registered with the Master of the High Court, the founding document of which is a trust”<sup>101</sup>. It is thus clear that both *inter vivos* and testamentary trusts can qualify as a public benefit organisation<sup>102</sup>.

## Chapter 2

### The taxation of trust income

#### Introduction

A trust is a person for tax purposes as referred to in Section 1 of the Income Tax Act<sup>101</sup>. Even though a trust is defined as a person for tax purposes it is treated differently from corporate persons such as a company or close corporation<sup>103</sup>. Income received by or that accrued to a trust is not always taxed in the hands of a trust and can be taxed in the hands of the beneficiary, founder or someone who has made a disposition to the trust depending on the circumstances<sup>104</sup>.

When discussing the taxation of trusts, the following definitions are relevant:

- i. Person<sup>105</sup>: - the definition of “person” includes any trust<sup>106</sup>. This definition therefore recognises a trust as a separate entity distinct and apart from the trustees and beneficiaries<sup>107</sup>. A trust as a person can be liable for income tax and capital gains tax<sup>108</sup>.

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<sup>98</sup> Honiball, p 208

<sup>99</sup> Honiball, p 209

<sup>100</sup> Ibid.

<sup>101</sup> Ibid.

<sup>102</sup> Income Tax Act 58 of 1962; Geach, p 232

<sup>103</sup> Geach, p 233

<sup>104</sup> Davis, p 6-3

<sup>105</sup> Geach, p 234

<sup>106</sup> Ibid.

<sup>107</sup> Geach, p 233

<sup>108</sup> Geach, p 234

- ii. Connected person<sup>109</sup>:- a connected person in relation to a trust includes the following:
- Any beneficiary of that trust
  - Any relative of such beneficiary
  - Any other trust of which a beneficiary or relative is a beneficiary. Transactions between connected persons are regulated by several provisions in the Income Tax Act<sup>110</sup>. These provisions seek to ensure that transactions between connected persons take place at market value to counter tax avoidance transactions<sup>111</sup>.
- iii. Trust<sup>112</sup>: - a trust is defined as including a written, verbal, *inter vivos* and testamentary trust<sup>113</sup>. “Every type of trust will be treated as a person for tax purposes even verbal or oral trusts, which are not regarded as trusts in terms of the Trust Property Control Act.77 of 1988”<sup>114</sup>.
- iv. Special trust<sup>115</sup>: - “a special trust is treated differently from a normal trust and as far as taxation is concerned a special trust is taxed as a natural person”<sup>116</sup>.
- v. Beneficiary<sup>117</sup>: - a beneficiary is defined to include beneficiaries with vested as well as discretionary rights<sup>118</sup>.
- vi. Resident<sup>119</sup>: - a resident trust is a trust established or formed in South Africa or a trust that has its place of effective management in South Africa<sup>120</sup>. If a foreign trust is controlled by South African residents, the effective management of the trust will be in South Africa and

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<sup>109</sup> Geach, p 234

<sup>110</sup> Ibid.

<sup>111</sup> Ibid.

<sup>112</sup> Ibid.

<sup>113</sup> Ibid.

<sup>114</sup> Ibid.

<sup>115</sup> Ibid.

<sup>116</sup> Ibid.

<sup>117</sup> Ibid.

<sup>118</sup> Ibid.

<sup>119</sup> Ibid.

<sup>120</sup> Ibid.

will this foreign trust be regarded as a resident for South African tax purposes<sup>121</sup>.

Trusts are taxed at a flat rate of 40% and do not qualify for the interest exemption or personal rebates<sup>122</sup>.

### Section 25B – Income of trusts

Section 25B of the Income Tax Act is the principal taxing section relating to trusts<sup>123</sup>. This section provides that the income of a trust is taxed either in the trust or in the hands of beneficiaries<sup>124</sup>. Section 25B is however subject to Section 7 of the Income Tax Act<sup>125</sup> and if section 7 applies some other person instead of the trust or beneficiaries may be taxed<sup>126</sup>.

Section 7 deeming provisions will apply if income has been received by virtue of any “donation, settlement or gratuitous disposition” made by any person<sup>127</sup>. Any income arising from such donation, settlement or disposition will, generally speaking, be taxed in the hands of the person who made the donation<sup>128</sup>.

The term gratuitous disposition applies to any disposition where there was a considerable element of liberality or generosity<sup>129</sup>. Donations and interest free or low interest loans will be gratuitous transactions.

Section 25B embodies the “conduit principle”, and provides that income which is received by, or which accrued on behalf of a beneficiary, who has a vested right to such amount during such year, shall be deemed to be an amount which has accrued to the beneficiary and will be taxed in the

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<sup>121</sup> Geach, p 234

<sup>122</sup> P Haupt, *Notes on South African Income Tax*, H&H Publications, 2013, p 795

<sup>123</sup> Haupt, p 796

<sup>124</sup> Ibid.

<sup>125</sup> Income Tax Act 58 of 1962

<sup>126</sup> Haupt, p 796

<sup>127</sup> Botha, p 831

<sup>128</sup> Ibid.

<sup>129</sup> Ibid

hands of the beneficiary. In *Armstrong v CIR 1938 (AD)* the court held that income received by a beneficiary from a trust retains its nature<sup>130</sup>. The trust is viewed as a conduit pipe through which the income flows. For example, it retains its nature as interest income in the hands of the beneficiary<sup>131</sup>.

The conduit principal was first mentioned in *CIR v Polonsky*<sup>132</sup> where the court found that the trustees were no more than a “conduit pipe” and did not have any material interest in the income of respondents’ wife<sup>133</sup>.

In *SIR v Rosen*<sup>134</sup> the conduit pipe principal was extended to trust income vesting in a beneficiary in the form of an annuity<sup>135</sup>. It is however specifically provided in section 10(2) that the exemptions in respect of interest referred to in section 10(1)(h) and dividends referred to in section 10(1)(k), do not apply to annuities<sup>136</sup>. For example, if a beneficiary is entitled to an annuity which is paid out of dividend income, the income will not be exempt in terms of section 10(1)(k)<sup>137</sup>.

The conduit pipe principle was again confirmed in *Estate Dempers v SIR*<sup>138</sup> where the court held that income accumulated by the trustee retained its identity despite a specific provision in the trust deed that the income would in such a case form part of the trust capital<sup>139</sup>.

Section 25B is therefore not an anti-avoidance provision but rather a regulatory provision in the sense that it determines who will be taxed on trust income, and when<sup>140</sup>.

Prior to the case of *Friedman NO v CIR*<sup>141</sup> trust income was taxed in the hands of the trust unless it vested in the hands of the beneficiaries

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<sup>130</sup> Honiball, p 72

<sup>131</sup> Davis, p 6-6

<sup>132</sup> *CIR v Polonsky* 12 SATC 11; Honiball, p 72

<sup>133</sup> Honiball, p 72

<sup>134</sup> *SIR v Rosen* 1971 (1) SA 172 (A); Honiball, p 72

<sup>135</sup> Davis, p 6-6

<sup>136</sup> *Ibid.*

<sup>137</sup> *Ibid.*

<sup>138</sup> *Estate Dempers v SIR* 36 SATC 95; Honiball, p 72

<sup>139</sup> Honiball, p 72

<sup>140</sup> Honiball, p 73

<sup>141</sup> *Friedman NO v CIR* 1993 (1) SA 353 (A), 53 SATC 166; Honiball, p 73

whereby it was then taxed in the hands of the beneficiaries. This practice was challenged in the Friedman case on the grounds that the trust was not a taxable entity and therefore the trustees were not representative taxpayers<sup>142</sup>. This challenge was upheld by both the lower court and Appellate Division, resulting in the amendment to the definition of “person” to include a trust and resulting in the inclusion of Section 25B into the Income Tax Act<sup>143</sup>.

### Anti-avoidance provisions

#### Section 25B (2A)

Section 25B(2A) is aimed at the accumulation by an offshore discretionary trust of foreign income beyond a year end with the idea that it will be distributed as capital, a non taxable award to a resident beneficiary<sup>144</sup>. The trust as a non resident cannot be taxed on the income<sup>145</sup>. Thus section 25B(2A) overrides any possible argument that when the accumulated income vests in the beneficiary it is of a capital nature and therefore taxable<sup>146</sup>.

The wording of section 25B(2A)(a)(ii) makes it clear that section 25B(2A) applies to foreign amounts<sup>147</sup>. It is however not only applicable to foreign amounts as it is clear from section 25B(2A)(i) that it also applies to South African source amounts<sup>148</sup>. However most South African source amounts will be subject to tax in South Africa in terms of the other provisions of the Income Tax Act and will be excluded by section 25B (2A)(a)(b)<sup>149</sup>.

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<sup>142</sup> Honiball, p 73

<sup>143</sup> Ibid.

<sup>144</sup> Davis, p 6-8(8)

<sup>145</sup> Ibid.

<sup>146</sup> Ibid.

<sup>147</sup> Ibid.

<sup>148</sup> Ibid.

<sup>149</sup> Ibid.

Section 25B(2A) only applies when a resident beneficiary acquires a vested right to the trust income<sup>150</sup>. The tax and liability is thus delayed until the acquisition of a vested right<sup>151</sup>.

At first glance the reference to “any previous year of assessment” in section 25B(2A)(a) indicated that section 25B(2A) can only apply to a foreign amount that was received or accrued to the trust in a year prior to the coming into effect of section 25B(2A)<sup>152</sup>. However, in terms of section 25B (2A)(a)(ii), the provision can only apply to such a receipt or accrual if it would have constituted income if the trust had been a resident at the time of the receipt or accrual.<sup>153</sup> Not only was the section 25B(2A) introduced into the Income Tax Act on 01 January 2001, but this date also marks the change from taxing South African persons on a source basis to taxing them on a residence basis<sup>154</sup>. Due to this section 25B(2A) cannot apply to pre-1 January 2001 receipts and accruals because, being a non-South African source, it would not have constituted “income” at that time<sup>155</sup>.

It is however clear from section 25B(2A)(b) that if the accumulated foreign amount has been taxed in terms of section 7(5) or 7(8) of the Income Tax Act, that it cannot be taxed again in terms of section 25B (2A)<sup>156</sup>.

For section 25B(2A) it is also not a requirement that there must have been a donation, settlement or other disposition, as required for the anti-avoidance provisions in section 7 to apply<sup>157</sup>. It is however essential that the beneficiary in whom the capital is

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<sup>150</sup> Honiball, p 77

<sup>151</sup> Ibid.

<sup>152</sup> Davis, p 6-8(8)

<sup>153</sup> Idbid.

<sup>154</sup> Honiball, p 78

<sup>155</sup> Ibid.

<sup>156</sup> Davis, p 6-9

<sup>157</sup> Ibid.

vested had a contingent right to the amount in the year that it accrued to the trust, for section 25B (2A) to operate<sup>158</sup>.

There has however been some debate about the meaning of “contingent right” in this context<sup>159</sup>. There is little doubt that the term is used in its technical sense and in contrast to the term “vested right”<sup>160</sup>. In *Durban City Council v Association of Building Societies*<sup>161</sup> judge Watermeyer JA pointed out that the word “contingent” as opposed to “vested” is used to describe the conditional nature to describe the conditional nature of someone’s title to right<sup>162</sup>. It is immaterial whether the beneficiary was a resident or not during the period prior to distribution, the only requirement is that they must have had a contingent right in one or more prior tax years<sup>163</sup>. If the income accrued to the non resident trust in a previous tax year and he or she had no “contingent right” the beneficiary will have no liability under section 25B(2A) even if he or she was a South African tax resident at the time<sup>164</sup>. The implication of 25B(2A) could therefore be potentially onerous for new immigrants to South Africa<sup>165</sup>. In this regard the burden of proof is also upon the resident beneficiary<sup>166</sup>.

#### Section 7: Tax – back provisions

Various anti-avoidance provisions are contained in Section 7 of the Income Tax Act<sup>167</sup>. These provisions determine certain circumstances when income is deemed to have accrued or to have been received by persons who never actually received the income nor did it accrue to them<sup>168</sup>.

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<sup>158</sup> Davis, p 6-9

<sup>159</sup> Ibid.

<sup>160</sup> Ibid.

<sup>161</sup> *Durban City Council v Association of Building Societies* 1942 AD 27; Davis, p 6-10

<sup>162</sup> Davis, p 6-10

<sup>163</sup> Honiball, p 79

<sup>164</sup> Ibid.

<sup>165</sup> Ibid.

<sup>166</sup> Ibid.

<sup>167</sup> Honibal, p 84

<sup>168</sup> Ibid.

The section 7 deeming provisions will apply if income has been received by virtue of any donation settlement or gratuitous disposition made by any person<sup>169</sup>.

The expression “other disposition” applies to any gratuitous disposition or a disposition in where there is a considerable element of liberality or generosity as stated in *Ovenstone v CIR*<sup>170</sup>. Gratuitous transactions are thus donations, interest free or low interest loans. These interest or low interest loans often arise when assets are sold by the founder to the trust<sup>171</sup>. This way donations tax will be avoided however interest free or low interest loans, are regarded as gratuitous dispositions, thus the provisions of section 7 can apply to such transactions<sup>172</sup>. It was held in *Joss v Sir*<sup>173</sup> that if a disposition is partly commercial and partly gratuitous, for example a low interest loan rather than an interest free loan that an apportionment is possible<sup>174</sup>. If apportionment is not possible the disposal will usually because of its liberality, simply be treated as a gratuitous disposition falling within the scope of section 7<sup>175</sup>.

Section 7 therefore attempts to ensure that if a person gratuitously divests himself of an asset, that the income from that asset will be taxed in the hands of the donor.

#### Section 7(2)(a)

Section 7(2)(a) of the Income Tax Act deems any income received by or accruing to a recipient spouse to be income accrued to the donor spouse if such income was derived by the recipient spouse in consequence of the following:

- a donation, settlement or other disposition made by the donor spouse on or after 20 March 1991; or

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<sup>169</sup> Botha, p 831

<sup>170</sup> *Ovenstone v CIR* 1980 (2) SA 721 (A); Botha, p 831

<sup>171</sup> Botha, p 831

<sup>172</sup> *Ibid.*

<sup>173</sup> *Joss v SIR* 1980 (1) SA 664 (T); Botha, p 831

<sup>174</sup> Botha, p 831

<sup>175</sup> *Ibid.*



- a transaction, operation or scheme entered into or carried out by the donor spouse on or after that date; and
- the sole or main purpose of such donation, settlement or other disposition, or transaction, operation or scheme was the reduction, postponement or avoidance of the donor spouses tax liability;
- which, but for such donation, settlement or other disposition, or transaction, operation or scheme, would become payable by the donor under the Income Tax Act<sup>176</sup>.

There must be either a donation, settlement or other disposition or a transaction, operation or scheme for section 7(2)(2) to be applicable<sup>177</sup>. Section 7(2)(a) is therefore an anti-avoidance provision which prevents spouses splitting income between them and thereby reducing their combined tax liability<sup>178</sup>.

Where a trust is interposed between two spouses this provision could apply, for example, if one spouse donates assets to a trust of which the other spouse is a vested beneficiary<sup>179</sup>.

### Section 7(3)

Section 7(3) provides that income is deemed to have been received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child, the income has been received or has accrued to or in favour of that child or has been expended

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<sup>176</sup> Davis, p 6-10(3)

<sup>177</sup> Honiball, p 84

<sup>178</sup> Ibid.

<sup>179</sup> Davis, p 6-10(4)

for the maintenance, education or benefit of that child, or it has been accumulated for the benefit of that child<sup>180</sup>.

The object of section 7(3) is to prevent income splitting between a parent and minor child to take advantage of the child's lower tax rate<sup>181</sup>.

This provision could apply to trusts where, for example, a parent sets up a vesting or a discretionary trust for the benefit of his minor children, in which case the parent will continue to be taxed on the income, and not the trust nor the minor children beneficiaries of the trust<sup>182</sup>.

#### Section 7(4)

Section 7(4) deals with the situation where the reason for income being received by or accruing to a minor is a donation, settlement or other disposition made by a third person who, or whose family, in turn, is the recipient of a donation, settlement or other disposition or other consideration from the minor's parent<sup>183</sup>. This income received by or accruing to the minor will be deemed to be the parents<sup>184</sup>. This section was introduced to prevent parents from circumventing the provisions of section 7(3) by introducing a third party to make the donation, settlement or other disposition<sup>185</sup>.

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<sup>180</sup> Honiball, p 85

<sup>181</sup> Davis, p 6-12

<sup>182</sup> Honiball, p 85

<sup>183</sup> Davis, p 6-13

<sup>184</sup> Ibid.

<sup>185</sup> Honiball, p 85

### Section 7(5)

Section 7(5) is one of the most important anti-avoidance provisions applicable to trusts<sup>186</sup>. This section provides that if any person has made a donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by that person or by anyone else, to the effect that the beneficiaries or some of them shall not receive the income or some portion of the income until the happening of some event, fixed or contingent, then so much of the income as would, but for the stipulation or condition, be received by or accrued to or in favour of the beneficiary in consequence of the donation, or disposition, or settlement, is deemed to be the income of the maker of that donation, settlement or disposition until the happening of the event or until death, whichever takes place first<sup>187</sup>.

This section requires two conditions for it to be invoked:

- The donation, settlement or other disposition is subject to a stipulation or condition made by any person; and<sup>188</sup>
- The stipulation or condition has the effect that one or more of the beneficiaries will not receive the income or a portion of the income until the happening of some event<sup>189</sup>.

“The amount to be included in the person’s income is the amount that would have accrued to the beneficiary but for the stipulation or condition imposed,”<sup>190</sup> and the income

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<sup>186</sup> Honiball, p 85

<sup>187</sup> Davis, p 6-14

<sup>188</sup> Honiball, p 86

<sup>189</sup> Ibid.

<sup>190</sup> Ibid.

will be deemed to be that of the donor until the event occurs or the donor dies, whichever takes place first<sup>191</sup>.

In *Estate Dempers v SIR*<sup>192</sup> it was made clear that where income is deemed to be that of the donor in terms of section 7(5), its subsequent distribution to the beneficiaries does not cause that income to be taxed in the hands of the beneficiaries. This is because, once it has been deemed to be that of the donor, it can never accrue as income to the beneficiaries<sup>193</sup>.

In the Dempers case it was said that, “the question which faces the court in applying section 7(5) is whether in the absence of the stipulation withholding trust income, the income would have been received by or have accrued to the beneficiary.”<sup>194</sup> If a beneficiary has a vested right to the income, it is difficult to see how section 7(5) can be invoked, because even in the absence of a stipulation the beneficiary will have a right to income<sup>195</sup>.

“In practice the position is that where a trust deed provides that the income or any part thereof is accumulated by the trustee because the trust deed prevents the income from being paid to the beneficiary or because the trustees have exercised their discretion to accumulate the income, a stipulation exists within the meaning of section 7(5) and the income so accumulated will be taxed in the hands of the donor<sup>196</sup>.

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<sup>191</sup> Honiball, p 86

<sup>192</sup> *Estate Dempers v SIR* 1977 (3) SA 410 (A); Botha, p 833

<sup>193</sup> Botha, p 834

<sup>194</sup> Davis, p 6-15

<sup>195</sup> Davis, p 6-15

<sup>196</sup> *Ibid.*

### Section 7(6)

In terms of section 7(6), the donor will be taxed whether the income has been received by a beneficiary or has accrued to a beneficiary of the trust but the donor has the power to cancel the right of any beneficiary to receive the income of the trust, or to confer the right to receive income upon others<sup>197</sup>.

Section 7(6) deems income to be that of the person that has retained the powers as envisaged by this section for as long as that person retains those powers<sup>198</sup>. This section therefore has the effect to deem a person to have received income even though no income has been received or accrued in reality<sup>199</sup>. The provisions of section 7(6) will cease to apply when the donor ceases to have those powers, which may be as a result of death, renunciation or some reason in the trust deed itself<sup>200</sup>.

The objective of section 7(6) is to counter the method of tax avoidance where the donor decides on an annual basis in whose hands the trust income will be taxed<sup>201</sup>. It is however important to note that this section will only be applicable where the right to revoke has been retained expressly and not where it had been retained per implication as held in *ITC673*<sup>202</sup>.

### Section 7(7)

Section 7(7) is applicable where there has been a donation, settlement or other disposition and investment income has as a result of a cession by the donor, been received by

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<sup>197</sup> Botha, p 834

<sup>198</sup> Ibid.

<sup>199</sup> Ibid.

<sup>200</sup> Ibid.

<sup>201</sup> Davis, p 6-18

<sup>202</sup> ITC 673 16 SATC 230; Honiball, p 93

another, the donor will be taxed on that investment income if the donor has retained the right to regain the property in future<sup>203</sup>. This provision will be applicable if the investment income ceded to another or the asset producing the income is transferred to another with a right to regain the property in future<sup>204</sup>.

This section was mainly introduced to counter tax avoidance schemes in terms of which untaxed income could be added to a charity, thus ensuring that the donor was not taxed on that income<sup>205</sup>.

#### Section 7(8)

Section 7(8) of the Income Tax Act<sup>206</sup> ensures that any income which has been received by, or accrued to a non resident due to a donation, settlement or gratuitous disposition by a South African resident, is deemed to be that of the resident<sup>207</sup>. This section does not only apply to donations to offshore trusts, it also applies to donations to any other non resident persons, for example individuals, companies, trust, etc<sup>208</sup>.

For this section to apply there needs to be a donation, settlement or gratuitous disposition, and the status of a “resident” by one person and “non- resident” by the other<sup>209</sup>. It is not a requirement of this section that the resident and non-resident be “connected persons” as defined in section 1 of the Income Tax Act<sup>210</sup>.

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<sup>203</sup> Botha, p 834

<sup>204</sup> Ibid.

<sup>205</sup> Ibid.

<sup>206</sup> Income Tax Act 58 of 1962

<sup>207</sup> Honiball, p 95

<sup>208</sup> Ibid.

<sup>209</sup> Botha, p 835

<sup>210</sup> Ibid.

Section 7(8) ensures that if a South African resident makes an interest free loan to a non-resident, any income which arises as a result of the loan will be deemed to be that of the resident<sup>211</sup>. This section once again allows the Commissioner to tax a person, even though that person never received the amount nor did it accrue to him in reality<sup>212</sup>. It is also important to note that section 7(8) only applies if the donor was a South African resident at the time when the donation, settlement or gratuitous disposition was made<sup>213</sup>.

### Capital Gains Tax

A trust is a non-natural person and will be taxed on its undistributed capital gains<sup>214</sup>. 66.6% of the net capital gain is included in taxable income, unless it is a special trust<sup>215</sup>.

The tax rate which is double that of the tax rate which applies to individuals is an example of how trusts have been singled out for harsher tax treatment<sup>216</sup>.

Trusts which are not special trusts do not qualify for the interest exemption, CGT annual exclusion, or any of the rebates individuals qualify for<sup>217</sup>.

Capital gains tax only applies to a discretionary trust if there has been a “real” or “deemed” disposal by the trust<sup>218</sup>. Assets of a discretionary trust are treated as the assets of the trust itself for capital gains tax purposes, until the asset has vested in a beneficiary unconditionally<sup>219</sup>. Any disposal of the asset by the trust until such vesting will be a capital

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<sup>211</sup> Botha, p 835

<sup>212</sup> Ibid.

<sup>213</sup> Haupt, p 800

<sup>214</sup> Haupt, p 911

<sup>215</sup> Ibid.

<sup>216</sup> Honiball, p 123

<sup>217</sup> Ibid.

<sup>218</sup> Ibid.

<sup>219</sup> Ibid.

gains tax disposal for the trust itself<sup>220</sup>. When the trust asset vests in a beneficiary, such vesting itself is a disposal for capital gains tax purposes, and will be deemed to be a market value disposal as stated in paragraph 11(1)(d) read together with paragraph 38, as the trust is a connected person in relation to the beneficiaries<sup>221</sup>.

#### Capital gain distributed to a beneficiary

Capital gain is not an economic concept like profit and the trust deed must specifically give the trustees the power to distribute the capital gain or parts of the gain<sup>222</sup>.

Paragraph 80 of the Eighth Schedule which is subject to paragraphs 68, 69, 71 and 72, provides that if a trust distributed an asset to a beneficiary (who is a South African resident), the gain made by the trust on the disposal of that asset is taxable in the beneficiaries hands and not in the trusts hands<sup>223</sup>. This is subject to the anti-avoidance provisions where the beneficiary is a spouse (paragraph 68) or minor child (paragraph 69)<sup>224</sup>.

If the trust sells an asset and makes a capital gain, the trust will not be taxed on the gain if it vests the gain in a South African beneficiary as provided in paragraph 80<sup>225</sup>. It is important to note that the gain must be vested in the same tax year that it arises, if only a portion of the capital gain is vested in a beneficiary, he or she will only be taxed on that portion and the rest will be taxed in the trust<sup>226</sup>. There are however certain exceptions to this rule. If the gain is vested in a non-resident beneficiary trust will be taxed<sup>227</sup> and the same applies if the gain is vested in a tax-exempt public benefit organisation, or tax exempt recreational club, or in the Government, or any provincial organisation<sup>228</sup>. The trust

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<sup>220</sup> Honiball, p 123

<sup>221</sup> Ibid.

<sup>222</sup> Haupt, p 911

<sup>223</sup> Haupt, p 220

<sup>224</sup> Ibid.

<sup>225</sup> Ibid.

<sup>226</sup> Ibid.

<sup>227</sup> Ibid.

<sup>228</sup> Ibid.



will also be taxed if the gain vested in any entity exempt from tax in terms of section 10(1)(b), (cA), (cE), (d) or (e)<sup>229</sup>.

Where a South African resident beneficiary of a non-resident trust acquires a vested right to an amount representing the capital of the trust which arise from a capital gain of the trust or from an amount which would have constituted a capital gain of the trust had the trust been a resident, the South African resident will be taxed on the gain in terms of paragraph 80(3)<sup>230</sup>.

This does not apply if the gain has already been subject to tax in South Africa<sup>231</sup>. Where the gain has arisen in a previous year of assessment, the South African resident is only taxed on the distribution of the capital gain which he or she receives if he or she had a contingent right to that capital in the previous year when the capital gain was made by the offshore trust<sup>232</sup>. Where foreign tax was paid on the gain, the resident will be able to claim a section 6quat rebate of the foreign tax against the resulting South African tax<sup>233</sup>. If a South African trust distributes a gain to a non-resident beneficiary the trust will be taxed on the gain, subject to the attribution rules under paragraph 72<sup>234</sup>.

#### Distributions from one trust to another

Paragraph 80 is applicable where a trust makes a capital gain during the year and vests it in trust and this gain will be deemed to be the gain made by the other trust as beneficiary<sup>235</sup>. However if this trust distributes the gain to its beneficiaries paragraph 80 will not be applicable as this second trust did not dispose of the asset and did not make the original capital gain<sup>236</sup>.

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<sup>229</sup> Haupt, p 92

<sup>230</sup> Honiball, p 134

<sup>231</sup> Haupt, p 913

<sup>232</sup> Ibid.

<sup>233</sup> Ibid.

<sup>234</sup> Ibid.

<sup>235</sup> Ibid.

<sup>236</sup> Ibid.

### Capital gains retained by the trust

Paragraph 70 deals with gains retained in the trust and states that where a South African resident makes a donation, settlement, or similar disposition to a trust, for example a interest free loan and the trust makes a capital gain as a result of that donation or disposition, the resident is taxed on the capital gain instead of the trust if the gain is not distributed to or vested in a beneficiary who is a South African resident<sup>237</sup>.

### Attribution of capital gains distributed by a trust

Paragraph 71 states that if a distribution of a capital gain is made to a beneficiary and the donor has the right to revoke the beneficiary's right to the capital distribution, the donor will be taxed on the gain so distributed to the extent that it is attributable to the gratuitous disposition made by the donor of the trust<sup>238</sup>.

### Capital gains attributed to donor

According to paragraph 73, where both an amount of income and a capital gain are derived by a reason of, or are attributable to a donation, settlement or other disposition, then the capital gain attributed to the "donor" may be limited to what the trust earned by reason of the fact that the donor did not charge a market related rate of interest<sup>239</sup>.

### Trust and capital gains tax: the "connected person" rule

It is important to realise that any disposal of an asset to a beneficiary is subject to the connected persons rule<sup>240</sup>. A trust and its beneficiaries are "connected persons" which means, for example, that if a trust sells an asset to a beneficiary any price agreed between the parties will be ignored and the market value of the asset will be substituted for that price<sup>241</sup>. Capital losses arising from transactions between connected

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<sup>237</sup> Haupt, p 914

<sup>238</sup> Ibid.

<sup>239</sup> Ibid.

<sup>240</sup> Botha, p 839

<sup>241</sup> Ibid.

persons are also “ring fenced”<sup>242</sup>. Such losses can only be offset against gains made by that same connected person and only then if they are still connected persons when the gain is made<sup>243</sup>.

### Donations tax

Donations tax is a tax on the transfer of income<sup>244</sup>. It imposes a tax on persons who tried to avoid normal income tax or estate duty by donating their assets to others<sup>245</sup>. Donations tax is levied at 20% of the value of the asset or amount of money donated<sup>246</sup>. Donations tax is payable by the donor<sup>247</sup>. However section 59 states that if the donor fails to pay the tax within the prescribed period, the donor and donee become jointly and severally liable for the tax<sup>248</sup>. Donations tax provisions do not apply to non-residents even if they donate South African assets<sup>249</sup>.

For purposes of donations tax, “donation” means any gratuitous disposal of property or any gratuitous waiver or renunciation of a right<sup>250</sup>. A donation only exists where the disposition was not made to comply, for example, with a legal obligation<sup>251</sup>. For a disposition to be regarded as a donation, it has to have been motivated by pure liberality or generosity<sup>252</sup>. In a trust context this means that where, for example, a trust is set up to comply with the donor’s statutory duty to provide for minor children after divorce or upon death, the donor will not be liable for donations tax<sup>253</sup>. Section 57 and 58 provides for deemed donations. In terms of section 58, if a property is disposed of for inadequate consideration, a deemed donation will arise to the extent that the property was disposed of for inadequate consideration<sup>254</sup>. In practice, SARS

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<sup>242</sup> Botha, p 839

<sup>243</sup> Ibid.

<sup>244</sup> Haupt, p 734

<sup>245</sup> Ibid.

<sup>246</sup> Ibid.

<sup>247</sup> Ibid.

<sup>248</sup> Haupt, p 735

<sup>249</sup> Ibid

<sup>250</sup> Honiball, p 177

<sup>251</sup> Ibid.

<sup>252</sup> Ibid.

<sup>253</sup> Ibid.

<sup>254</sup> Ibid

applies a market value test to determine whether property was disposed of for inadequate consideration<sup>255</sup>.

A donation is deemed to take effect when all legal formalities have been complied with, for example, offer and acceptance, delivery and registration as stated in section 53(3)<sup>256</sup>. A donation is a contract and the normal law of contract applies, except for executor contracts of donation<sup>257</sup>. Only executor contracts therefore needs to be in writing and witnessed in order to take effect, all other donations takes effect when accepted by the donee<sup>258</sup>.

### Exemptions

Section 56 provides for several exemptions from donations tax<sup>259</sup>. The aim of successful estate planning is to reduce the value of an estate during the taxpayer's lifetime without attracting any donations tax and this is often attempted by setting up a trust<sup>260</sup>.

Only exemptions that could have a specific application to trusts will be discussed.

### Casual gifts

Section 56(2)(a) states that donations tax is not payable by a trust in respect of casual gifts made by a trust outside the context of the trust deed that do not exceed R10 000 in value per tax year<sup>261</sup>. This exemption only applies to donor's other than natural persons and is substantially less than the R100 000 limit that applies to natural persons in terms of section 56(2)(b)<sup>262</sup>.

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<sup>255</sup> Honiball, p 177

<sup>256</sup> Haupt, p 736

<sup>257</sup> Ibid.

<sup>258</sup> Ibid.

<sup>259</sup> Honiball, p 177

<sup>260</sup> Ibid.

<sup>261</sup> Honiball, p 178

<sup>262</sup> Ibid.

### Maintenance

Section 56(2)(c) states that donations tax is not payable in respect of so much of any bona fide contribution made towards the maintenance of any person, other than the beneficiary of the trust, as the Commissioner considers to be reasonable<sup>263</sup>. This exemption is also not only restricted to natural persons and is also available to trusts<sup>264</sup>.

### Donatio mortis causa

Even though a trust is not a separate entity under South African common law, assets donated to it will not form part of the deceased estate of the donor<sup>265</sup>. This is however only the case with inter vivos trusts<sup>266</sup>. Where the trust is a testamentary trust and only comes into existence on the donor's death, the assets donated to such trust still form part of the deceased estate for estate duty purposes<sup>267</sup>. As these assets will be subject to estate duty, a donation *mortis causa* is exempt from donations tax under section 56(1)(c) of the Act<sup>268</sup>.

### Donations under which the donee will not obtain any benefit until the death of the donor

Section 56(d) provides that donations tax shall not be payable in respect of the value of any property which is disposed of under a donation in terms of which the donee will not obtain any benefit until the death of the donor<sup>269</sup>.

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<sup>263</sup> Honiball, p 178

<sup>264</sup> Ibid.

<sup>265</sup> Honiball, p 179

<sup>266</sup> Ibid.

<sup>267</sup> Ibid.

<sup>268</sup> Ibid.

<sup>269</sup> Geach, p 279

In *ITC11372*<sup>270</sup>, it was made clear that this section does not apply to the donation of a property to a trustee for the benefit of a beneficiary, in terms of which the whole operation of the donation is to be suspended until the donor's death or thereafter<sup>271</sup>. The court came to this conclusion because section 56(d) uses the word "donee" and not "beneficiary" or any another word. It is therefore clear that the exemption from donations tax that is provided for in section 56(d) does not apply if property is donated to a trustee of a trust<sup>272</sup>.

Transactions where property is disposed of under, and in pursuance of, any trust

Section 55(1) defines a "donee" as including a trustee of a trust<sup>273</sup>. This means that if a donation is made to a trustee of a trust, this will result in donations tax, even though it has been made clear that a donation to a trustee is meant to benefit a beneficiary, and not the trustee as held in *Estate Welch v Commissioner for SARS*<sup>274</sup>. With this section 56(1)(l) ensures that there will be no double taxation<sup>275</sup>. When an amount is distributed or allocated to a beneficiary, section 56(1)(l) ensures that no further donations tax liability arises<sup>276</sup>. It also ensures that no distribution to a beneficiary will attract donations tax provided that the distribution is made by trustees in accordance with the terms and conditions of the trust deed<sup>277</sup>.

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<sup>270</sup> Unreported judgement of the Cape Income Tax Special Court 23 August 2004; Geach, p 279

<sup>271</sup> Geach, p 279

<sup>272</sup> Ibid.

<sup>273</sup> Ibid.

<sup>274</sup> *Estate Welch v Commissioner for SARS* (2004) All 586 (SCA); Geach, p 279

<sup>275</sup> Geach, p 279

<sup>276</sup> Ibid.

<sup>277</sup> Ibid.

### Transfer duty

Transfer duty is a tax levied on the registration of transfer of immovable property in the Deeds Office<sup>278</sup>. Transfer duty is levied by section 2(1) of the Transfer Duty Act<sup>279</sup> on the value of any property acquired by any person by way of a transaction or in any other manner<sup>280</sup>. Transfer duty is also levied on the amount by which the value of any property is enhanced by the renunciation of an interest in or restriction upon the use or disposal of that property<sup>281</sup>.

Transfer duty is payable by the purchaser, and has to be paid within 6 months of the date of acquisition of the property as stated in section 3 of the Transfer Duty Act<sup>282</sup>.

The rate of transfer duty is set out in section 2 of the Transfer Duty Act as follows:

- 0% on the first R600 000 of the purchase price
- Plus: 3% on the next R400 000 of the purchase price
- Plus: 5% on the next R500 000 of the purchase price
- Plus: 8% on the excess of the purchase price over R1,5 million<sup>283</sup>

With effect from 23 February 2011 a legal person such as a company or trust pays transfer duty at the same rate as a natural person<sup>284</sup>.

As previously discussed, a trust is not a separate legal person in terms of South African trust law<sup>285</sup>. Therefore the definition of “person” in section 1 of the Transfer Duty Act expressly includes any trust<sup>286</sup>. As a result, a trust will be liable for transfer duty in its own right in respect of any property acquired by it by way of a transaction or in any other

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<sup>278</sup> Honiball, p 224

<sup>279</sup> Transfer Duty Act 40 of 1949

<sup>280</sup> Honiball, p 224

<sup>281</sup> Ibid.

<sup>282</sup> Haupt, p 986

<sup>283</sup> Ibid.

<sup>284</sup> Ibid.

<sup>285</sup> Honiball, p 225

<sup>286</sup> Ibid.

manner<sup>287</sup>. Transfer duty is also payable by a trust on the amount by restriction upon the use or disposal of property<sup>288</sup>.

Transfer duty will also be payable by any trust which acquires property irrespective of whether the trust is a tax resident or not for income tax purposes, and irrespective of the legal nature of the trust<sup>289</sup>. There are several important exemptions from transfer duty in relation to trusts, namely section 9(4)(a) to (d)<sup>290</sup>.

Section 9(4)(a) provides that no transfer duty shall be payable in respect of the change in the registration of property required as a result of the termination of the appointment of an administrator of a trust under a will or written instrument, or a trustee of an insolvent estate<sup>291</sup>. This exemption also clearly applies to both *inter vivo's* and testamentary trusts<sup>292</sup>.

Section 9(4)(b) provides that no transfer duty shall be payable where trust property is transferred by the administrator of a trust in pursuance of the will or other written instrument in terms of which the administrator was appointed, to persons entitled thereto under such will, or to a relative as contemplated in the definition of "relative" in section 1 of the Estate Duty Act<sup>293</sup>. In the latter the exemption only applies if the trust was founded in terms of a written instrument *inter vivo's* by a natural person for the benefit of the relative and no consideration is paid directly or indirectly by the relative for the trust property<sup>294</sup>.

Section 9(4)(c) states that no transfer duty is payable where property is restored by a trustee of an insolvent estate to an insolvent<sup>295</sup>.

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<sup>287</sup> Honiball, p 225

<sup>288</sup> Ibid.

<sup>289</sup> Honiball, p 226

<sup>290</sup> Ibid.

<sup>291</sup> Ibid.

<sup>292</sup> Ibid.

<sup>293</sup> Honiball, p 227

<sup>294</sup> Ibid.

<sup>295</sup> Honiball, p 228



Section 9(4)(d) provides that no transfer duty is payable in respect of the registration of trust property in the name of a trustee in his capacity as trustee, if such property is held by such trustee as a trust property at the date of commencement of the Trust Property Control Act<sup>296</sup> and such registration is required in terms of section 11(2) of the said Act<sup>297</sup>.

There is also a further transfer duty exemption which is granted to public benefit organisations exempt from income tax under section 10(1)(N) of the Income Tax Act<sup>298</sup>. This exemption is however granted per transaction upon application to SARS<sup>299</sup>.

## Chapter 3

### Conclusion

In the National Budget, tabled in Parliament on 27 February 2013, the Minister of Finance, Pravin Gordhan indicated that government was proposing several legislative measures regarding trusts to curtail perceived tax avoidance associated with trusts<sup>300</sup>. A concern regarding the use of trusts to avoid estate duty was also indicated by the Treasury<sup>301</sup>.

Regarding trusts, the question most frequently asked these days is if trusts still have a role to fulfil in estate planning?<sup>302</sup>.

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<sup>296</sup> Trust Property Control Act 57 of 1988, s 11(2); Honiball, p 228

<sup>297</sup> Honiball, p 228

<sup>298</sup> Ibid.

<sup>299</sup> Ibid.

<sup>300</sup> Beric Croome 'The future of trusts'. Available at <http://www.thesait.org.za/news/130111/The-future-taxation-of-trusts.htm> (Accessed 27 November 2013)

<sup>301</sup> Ibid.

<sup>302</sup> Francois van Gijsen 'What will happen to trusts now after the 2013/4 South African Budget. Available at <http://read.gaaaccounting.com/news/what-will-happen-to-trusts-now-after-the-201314-south-african-budget/>. (Accessed 28 November 2013)

A trust, as a taxpayer in its own right, pays tax at the highest rate for both capital gains tax and other taxable income<sup>303</sup>. The effective capital gains tax rate is 26.6% and the income tax rate 40%<sup>304</sup>. A trust is not regarded as a natural person and also does not qualify for any tax rebates or any of the capital gains tax exclusions as earlier discussed<sup>305</sup>.

The proposed changes seek to prevent the application of the “conduit principle” to trusts by ensuring that discretionary trusts will only be able to distribute “taxable income”<sup>306</sup>. The effect of this is that when a trust distributed an amount, the amount will now be “taxable income” and no longer retain its original identity<sup>307</sup>.

In the past, one of the main ways in which trusts were used to obtain a tax advantage was through the use of the “conduit principle” embedded by section 25B and paragraph 80. This was done by vesting the trust income or capital gain for the tax year in favour of the trust beneficiaries<sup>308</sup>. The beneficiary would then be taxed and not the trust. First, as we have seen, an individual enjoys more exemptions than a trust, for example, the local interest exemption<sup>309</sup>. Secondly, when calculating capital gains in the hands of an individual, the R30 000 annual exclusion will apply and the inclusion rate is only 33,3% and not 66.6% as in the case with trusts<sup>310</sup>.

What is clear from the proposed changes is that keeping assets in a trust for tax purposes would become extremely tax inefficient<sup>311</sup>. However, it is important to note that these proposed amendments will not apply to trusts that have been set up to tend to the needs of minor children and people with disabilities<sup>312</sup>.

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<sup>303</sup> Fiona Zerbst ‘ Why trust reform will affect your tax planning’. Available at <http://www.fanews.co.za/article/front-page-features/25/featured-story/1147/why-trust-reform-will-affect-your-tax-planning/13374> (Accessed 28 November 2013)

<sup>304</sup> Ibid.

<sup>305</sup> Ibid.

<sup>306</sup> Ibid.

<sup>307</sup> Ibid.

<sup>308</sup> Francois van Gijzen ‘What will happen to trusts now after the 2013/4 South African Budget. Available at <http://read.gaaaccounting.com/news/what-will-happen-to-trusts-now-after-the-201314-south-african-budget/>. (Accessed 28 November 2013)

<sup>309</sup> Fiona Zerbst ‘ Why trust reform will affect your tax planning’. Available at <http://www.fanews.co.za/article/front-page-features/25/featured-story/1147/why-trust-reform-will-affect-your-tax-planning/13374> (Accessed 28 November 2013)

<sup>310</sup> Ibid.

<sup>311</sup> Ibid.

<sup>312</sup> Ibid.

The formation of a trust has for many years been a very popular financial planning tool for a number of reasons. The use of a trust can effectively result in so-called “estate freezing”<sup>313</sup>. Here a person would for example, sell growth assets to a trust and any increase in the value of those assets will be excluded from any capital gains tax that can arise on the death of the person and the assets will also be excluded from the persons estate for estate duty purposes because the growth takes place in the trust<sup>314</sup>.

A trust can also be used to protect assets<sup>315</sup>. This is achieved because a trust can allow for a person, who is a beneficiary of the trust to enjoy the use or benefits of an asset, which is held in trust whilst not having ownership of the trust<sup>316</sup>. The manner in which assets are transferred is also important and relevant to the extent of the protection<sup>317</sup>. For example, if you transfer an asset on loan account, the amount of the loan account will remain an asset in your estate until the trust repays you<sup>318</sup>. That means that the amount of the loan account will not be protected from creditors, only the increase in the value of the asset during the period of the trusts ownership of it<sup>319</sup>. However, over a period of time, as the value of the trust assets increase and the value of the loan account decreases the benefit of asset protection will be established<sup>320</sup>.

Trusts still remain a great tool to offer protection of assets and should it be used for its intended charitable purpose, it will remain a useful estate planning tool<sup>321</sup>. It offers the planner a means of benefitting designated beneficiaries, while the trustees who administer the assets offer a measure of protection against creditors and often

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<sup>313</sup> Botha, p 811

<sup>314</sup> Ibid.

<sup>315</sup> Ibid.

<sup>316</sup> Ibid.

<sup>317</sup> Tanya Cohen “Estate Planning Essentials: Inter vivos Trusts – Advantages and disadvantages” Available at

<https://www.sanlam.co.za/wps/wcm/connect/57d2aa004486de2196defefe69008348/Estate%2BPlanning%2BEssentials%2B-%2BInter%2Bvivos%2Btrusts%2B-%2BOctober%2B2010.pdf?MOD=AJPERES&CACHEID=57d2aa004486de2196defefe69008348>

(Accessed 25 November 2013)

<sup>318</sup> Ibid.

<sup>319</sup> Ibid.

<sup>320</sup> Ibid.

<sup>321</sup> Ibid.

against the squandering tendencies of beneficiaries<sup>322</sup>. However, with the looming changes as mentioned in the budget speech, if the trust was merely used in an attempt to avoid tax, it is doubtful that trusts will in future satisfy expectations.

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<sup>322</sup> Francois van Gijsen 'What will happen to trusts now after the 2013/4 South African Budget. Available at <http://read.gaaaccounting.com/news/what-will-happen-to-trusts-now-after-the-201314-south-african-budget/>. (Accessed 28 November 2013)

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