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**DISSERTATION : MASTER OF LAWS DEGREE:**

**UNIVERSITY OF CAPE TOWN**

**COURSE:**

Tax Law I (CML609W)

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**TOPIC:**

A brief excursus through the concept of the trust, dealing with its origins and history and generally traversing taxation of a trust and its implications for the taxpayer.

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## [A] INTRODUCTION

A 'trust' is defined in the Income Tax Act [1] at section one as 'any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person'.

This is a recent introduction to the Act, coming into affect in respect of years of assessment ending on or after 1 January 1993 and sums up reasonably satisfactorily what the various authorities have said to date regarding trusts.

In Estate Kemp v McDonald's Trustee [2] judge Solomons referred to the fact that in a trust the 'legal dominium of property is vested in the trustee' but that they have 'no beneficial interest in it but are bound to hold and apply it for the purpose of some persons or for the accomplishment of some purpose' [3].

In Thome & Molenaar NNO v Receiver of Revenue, Cape Town [4] a trust was described as being 'created by contract, very often by contract of donation ... or by way of a will. It is created in respect of defined property transferred to a trustee, who is burdened with the obligation to administer the property for the benefit of a third person' [5].

In the case of Goodricke and Son (Pty) Ltd v Registrar of Deeds, Natal [6] the court held that the concept of a valid trust revolved around the removal of dominium (ownership) from the beneficiaries and placing it in the hands of the trustees [7]. '...[A] trust exists when property is to be held or administered by one person on behalf of another, or for some purpose other than his own benefit' [8]. The court went on to say that the essential elements which made up a trust were 'segregation of the trust assets by the founder' and the 'creation of an obligation to administer otherwise than purely for oneself.' [9]

Article 2 of the Hague Convention of Law applicable to Trusts and their Recognition (January 1986) provides that 'trust' refers to the legal relationship created either inter vivos or on death by the founder, donor or settlor of the trust, who places assets under the control of a trustee for the benefit of a third party or a specified purpose/impersonal object (the "beneficiary").

From these extracts it seems as if the underlying principle of a trust (which will be dealt with in greater detail below) is simply that the founder commits his assets to the care of another person for the benefit of a (designated) beneficiary. Thus it involves an intermediary ('tussenpersoon' [10]), who acts in terms of the express wishes of the founder, who is placed in control of property which he is empowered to administer, not for his own personal benefit but for a third party beneficiary which could well be a natural person or an 'impersonal object' [11].

The trustee's powers are severely limited by the fact that he is required to act strictly in accordance with the instructions of the founder. Thus a 'fiduciary' relationship as referred to in the Income Tax Act [12] exists between the trustee (or "administrator" as a trustee is known in a mortis causa trust) and the beneficiary. Despite the fact that ownership (in one form or another) of the property which forms the basis of the trust vests in the trustee he may only deal with it in his official capacity. A trustee is entrusted (as owner or otherwise) with the control of property with which he is bound to deal for the benefit of others [13].

Trusts are often utilized for the purpose of avoiding or reducing the incidence of taxation, to enable the taxpayer to derive the best possible benefit of and most enjoyment from his assets. Any taxpayer can arrange his affairs in such a manner to avoid becoming liable for tax under the Act without contravening any legal provisions and further without acting against the public mores. 'Belastingvermyding is dikwels 'n belangrike oorweging wanneer 'n trust opgerig word' [14] and a working knowledge of the concept of a trust and its tax implications is essential in determining whether any benefit will be derived from its use.

It [is] the clear intention of the legislation that income the subject of a trust should be taxable in some person's hands' [15]. Depending on the circumstances and the manner in which the trust is established the income will be taxable either in the hands of the founder of the trust, in the hands of the trust or partly in the hands of the beneficiary and partly in the hands of the trust.

It is generally the case that the founder/settlor/donor who creates the trust finds himself in a situation where he is taxed at a high rate. We have a "progressive" system of taxation in South Africa. This means that every extra rand accruing (this concept is discussed in detail later) to the taxpayer raises the rate at which he is taxed and this higher rate then includes all the previous rands of income already accrued to him. Thus the more income which accrues, the higher the rate at which he is liable to tax. To avoid this somewhat invidious position the founder attempts to place the burden for tax liability for at least part of his estate on to another person in whose hands it will be taxed at a lower rate thus leading to a tax-saving. A further important ancillary function of the trust is to allow the donor/settlor/founder to transfer assets out of his estate, to be administered by other parties (namely the trustees). The importance thereof is that it places a ceiling on the donor/settlor/founder's liability for tax. It does this by "pegging" the estate at a specific amount. This means that the value of any property transferred out of the estate is taken into consideration for tax purposes (ie : estate duty) but not any growth which may occur therein. Thus the assets which have been transferred (or the value thereof) may well have to be returned for inclusion in the estate for determination of estate duty etc but the growth which has occurred in those assets due to investment etc falls outside of the estate and is not taxed in the hands of the donor/settlor/founder. The benefit of this is clearly twofold : the donor/settlor/founder's capital has been allowed to work for him but he is not taxed on the increase in its value. Thus he can benefit others without being penalised for his benevolence as he does not increase his liability to tax by doing so. The trust beneficiaries on the other hand are taxed only on the income they receive (ie : the growth) from the utilisation ( by investment etc) of the trust assets/capital.

Thus, despite the fact that a much larger capital sum has been used to produce it, they are only taxed on the "profit". They don't have to own the capital to benefit therefrom and therefore don't have the concerns of depreciation etc. The trust is an excellent vehicle for putting such tax avoidance scheme into operation. Since the legal ownership of the property transferred (in terms of the trust instrument) vests in the trustees (or in the beneficiary as discussed above) and no longer in the donor, it follows that the income derived from the property is received by or accrues to the trustees, as administrators of the trust (which is now taxed in its own right as a 'person' is the Income Tax Act, section 1) or the beneficiaries and is taxable in their hands. It would therefore be beneficial for a taxpayer to enter into 'arrangements which have as their purpose the splitting of ... income among a number of different parties so as to negative the effect of the system of progressive rates of tax' [16]

The donor/founder/settlor is therefore not pushed into a higher tax-bracket by the growth due to investment etc of his capital but can still fully benefit others by allowing them the use thereof.

To determine who exactly will be liable for tax on trust income it is important to look at the definition of gross income as a departure point. The definition in section 1 of Act 58 of 1962 reads as follows: 'gross income ... means, in the case of any person, the total amount, in cash or otherwise, received by or accrued to or in favour of such person during the year of assessment, from a source within or deemed to be with the Republic, excluding receipts or accruals of a capital nature. 'It is this amount of gross income less exemptions and deductions which will be held to be taxable income for income tax purposes. It is clear therefore that tax is levied on income 'received by or accrued to' the taxpayer during the year of assessment, and there must be a receipt or an accrual of income before there can be any liability to tax'. [17] The reason that the trust is such an outstanding method of splitting income and thus deriving tax-savings lies in the concepts of "accrual" and "receipt."

Ordinarily, once income has accrued to or is received by a person it is taxable in that person's hands despite any intention on his part to utilise it for the benefit of another party. Thus for an income-splitting mechanism to achieve its goal of tax-saving the arrangements must be 'entered into before the income legally vests or accrues to the taxpayer' [18].

This is where the trust is extremely valuable. It allows the donor/settlor/founder to make provision that future income will accrue to or be received by another person in whose hands it will be taxed by transferring ownership of an asset which will generate the income to the trustee as representative of the trust. It is that asset which will be the source of the income mentioned above but, being outside of the estate of the founder/settlor/donor will not lead to him being taxed on any growth/increase in value thereon.

Therefore one must ascertain to whom the income has accrued or by whom it has been received to determine the incidence of taxation. However, although this is the general rule, there are circumstances in which tax is imposed on amounts which have neither been received nor accrued by the person being taxed. An excellent example of this is where income which is received by or accrued to or in favour of a minor child by virtue of a donation, settlement or any other disposition by his parent is deemed to have been received by the parents and is therefore taxable in his hands in terms of section 7(3) of the Income Tax Act. [19]

A further example is section 7(5) of the same Act in terms of which income which is made over by virtue of a donation, settlement or other disposition, subject to a condition in terms of which no income will be received until fulfilment of said condition, shall be deemed to be the income of the donor until the happening of the event necessary to fulfil the condition or the death of the donor. These sections, amongst others, are specifically designed to cover situations where the donor would ordinarily avoid liability for tax. Through them he is now made liable as he is the main "prize" sought by the Revenue, being most often in a stronger financial position and thus liable (usually) in a higher tax bracket than the other parties to a trust. Consequently, a conclusion as regards the party who has received or to whom the income has accrued needs to be reached before one is able to say in whose hands the income is taxable and when.

For a receipt to have occurred, the taxpayer must receive the income 'in such circumstances that he becomes entitled to it' [20] for his own benefit. Therefore if a trustee receives money on behalf of another person he does not receive on his 'own behalf' [21] or for his own benefit and therefore it will not be taxed in his hands.

An example of this will be where a trust deed which makes provision for the maintenance and/or education of children allows for payment of money to a parent or guardian to be used for the outlined purposes of the trust. In such circumstances the income he receives may be taxed in his hands if it becomes evident that he need not account to the children for any expenditure, surplus etc. However, if the trust instrument provides that the income actually accrues to the children but is simply paid out to the trustee parent to use to their best advantage, then the money clearly "belongs" to the children and is taxed in their hands.

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The concept of 'accrual' has not developed without controversy but can now be considered to be laid to rest with the decision in CIR v People's Stores [22] which accepted the principle evinced in Lategan v CIR [23] that nothing more is necessary for an accrual than that the taxpayer concerned has become unconditionally entitled to the amount in question in that 'he acquires the right to claim payment' [28] of such amount, despite the fact that said payment may only occur in the 'future' [24]. This overrides the obiter contention in Hersov's Estate v CIR [25] that accrued to means 'due and payable'. The effect therefore is that accrual occurs not in the year of assessment in which the taxpayer is actually entitled to be paid but that it occurs in that year of assessment in which he acquires a right to payment 'irrespective of whether it is immediately enforceable or not' [26].

## [B] THE HISTORY OF THE TRUST\_\_

The famous English legal authority, F.W. Maitland, referred to the trust as 'the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence' [27]. The concept developed out of the basic situation where one person held property as owner at the instance of another, for the benefit of a third person and not for his personal benefit. Olivier [28] feels that this concept is in effect the grounding concept (literally 'grondidee' [29]) of the European Treuhander which ultimately was the predecessor of the modern day trust. Although it is the Treuhander upon which we will focus it is important to realise that other systems were also developing innovative methods of dealing with restrictions in respect of property. The Romans, for instance, utilised the fideicommissum in their law to overcome prohibitions relating to inheritances in respect of non-citizens (aliens, the Roman "peregrinus"). A Roman citizen would bequeath his estate to another citizen with the proviso that the property be handed over by that person to the non-citizen involved.

It must be borne in mind that although this is not strictly speaking a trust it does possess some of the elements and exists, in combination with the English trust, as the modern South African trust.

The Treuhander is Germanic in origin, more specifically part of the culture of the Franks. It developed as a means of circumventing the law relating to deceased estates as applied by the Germanic peoples. They were unable to relate to the notion of people dealing with their property as they saw fit because the idea of private property was originally alien to them. Property belonged to families not to individuals and passed into the hands of the family as a unit and not to any individual member on death. (The concept of testamentary succession was a Roman one which only came to the fore in the twelfth century.) Further, the Germanic belief was that heirs were not to be chosen by the deceased but were determined according to birthright and that property therefore devolved by destiny and not according to the will of an individual.

These general "rules" of the Franks were grouped together in a written document called the Lex Salica ("Salic Law"). Special provision was made for those who wished property to devolve to persons who would not ordinarily inherit by law. An owner who owned his own property could transfer it to an intermediary who would transfer it to a named beneficiary on the death of the original owner. The intermediary was known as the "Treuhander" and he became owner of the property not for his own personal benefit but swore an oath to carry out his duty to make over the property to the named beneficiary.

It is clear that this is exactly the notion on which the trust is based, passing ownership over property in a limited form to an intermediary who was to administer that property for the benefit of a third person.

After the Battle of Hastings in 1066, with the defeat of the Anglo-Saxons, England fell under Norman rule. Thus, with the feudal system in full force, a new concept was developed based on the Treuhander. Under feudalism land was all-important and belonged entirely to the regent of the day with no private ownership of land acknowledged.

Rights in the land were granted to the nobles allied to the regent (usually for services rendered or to ensure their continued loyalty) who in turn granted them to lesser nobles and following further grants rights in the property were transferred all the way down the feudal pyramid to the serfs and vassals at the bottom. All ownership in land vested in the ruler and all those subordinate to the ruler were merely owners of a right in the land, for which they were subjected to feudal levies (known as "fees") which in the case of the lower echelon became increasingly oppressive. The tenants therefore attempted to rid themselves of the crushing burden of the feudal dues demanded by the lords by utilising a version of the Continental Treuhand, known as a "use".

A number of reasons have been suggested for the coming to the fore of the use. It has been postulated that it was initially an instrument employed by the crusading knights who wished to provide for the management of their estates while on sustained absences from the country. Also, it was an important method employed by the major land-owners during the civil wars in England to allow them to avoid having their property confiscated for acts which would have been deemed to be treasonable. Another reason put forward was that it circumvented the problems of Franciscan monks who needed a place to live but were not allowed to own property. Shrand [30] embroiders on this particular theory and ascribes to it the origins of the "use". He refers to difficulties experienced by religious bodies who were in danger of having their land expropriated by the Crown. Religious institutions were exempted from paying taxes to the Crown in respect of the land they held and thus denied the Crown the income they would ordinarily receive were the land held by private citizens. To avoid being stripped of their entitlement these religious organizations entered into agreements with ordinary landowners whereby the landowner 'became the legal owner of the land and the religious body occupied the position of beneficiary which entitled it to the beneficial occupation of the land' [31].

Whatever the actual reason (it was probably a combination of them all and others now forgotten with the elapse of time) the position was very much the same in all these situations: "A" would transfer property to "B" (the transferee, known as the "feoffee") to the use of C, making B the owner of the property, not for his own benefit but for the benefit of C. As the "use" began to be used successfully in the above examples, it became more and more popular. The way in which the "use" was used to avoid the choking levies was for the feoffee to refuse to pay any levies or render services because he was not contractually bound to the "lord of the manor". The feoffee would carry out his rights and obligations with regard to the property in terms of the arrangement with the transferor and would have no ties or duties in respect of the "lord". Eventually the "use" served to undermine the entire foundation upon which the feudal system had been built and was put to some ingenious, albeit illegal, uses in terms of which a debtor was able to transfer his assets to a feoffee to avoid liability to his creditors.

Further developments in the system of "use" were sparked by the existence simultaneously of two court structures: the Common law court (strictly applied legal principles) and Chancery court (decisions made according to principle of equity). Because of the rigid application of legal precepts by the common law courts which afforded no protection to the beneficiary of a use in which a feoffee reneged on his duties to hold land for the beneficiary, the aggrieved party was forced to approach the chancery court for assistance.

The chancellor would compel the feoffee to comply with the terms of the use or face imprisonment. The chancellor would thus force the feoffee to make over the land to the beneficiary. The results, however, were unexpected. 'It was natural for the chancellor to seek to enforce uses. What was unforeseen was that his efforts gave rise to the view that the beneficiary was entitled to a type of equitable ownership or proprietary interest in the land' [32] held by the feoffee.

Thus two types of property right with regard to "uses" grew up in English law, those protected by the common-law court, (mainly in favour of the feoffee who was seen as the legal owner of property) and those upheld by the Chancery court (mainly those rights of the beneficiary known as the "equitable estate").

The use was not looked upon favourably by the monarchy, whose coffers were being sorely depleted by its continued application and they attempted to ban it by introducing legislation (The Statute of Uses) which cut out the feoffee completely by vesting the legal ownership ("legal estate") and the equitable ownership ("equitable estate") in the beneficiary directly.

However a creative method was found to circumvent this legislation. The transferee ("A") would transfer property to the feoffee ("B") "to the use of" a beneficiary ("C") who would hold it "to the use of" a further beneficiary ("D"). Clearly the first use was struck by the legislation but not the second use, with "C" keeping the "legal estate" and "D" the "equitable estate". The second use (the "use upon a use") gradually became known as a trust, "C" becoming known as the trustee and "D" the beneficiary.

It is evident that the separation of the ownership of the property (which goes to the trustee) and the benefit (which goes to the beneficiary) which forms the basis of a trust stems from the development through the centuries of the "use" in its variations.

During the course of British colonial expansion South Africa became part of the empire on which the sun never set (at the expense of the Dutch) and the trust was introduced here, as it was in various other places in the world. It took root despite its basis in a legal system which was not tied to the Roman law because of the enormous, all-pervading influence which English law had in the Cape Colony. English was seen as the official language, the English civil and criminal law procedures were imported and the government and the civil service were based on the English model. Thus the Roman-Dutch law which existed at the time soon assimilated many English law characteristics. However, it was not just the fact that the English ideas were pressed upon the people against their will that led to the acceptance of such concepts as the trust. The fact is that despite the glaring dissimilarities between English and Roman Dutch law that certain fundamental notions are shared. Thus it was that the trust could become accepted into South African law with little difficulty despite the fact that it seems to clash with fundamental Roman-Dutch law principles. The concept of usufruct and fideicommissum clearly draw a distinction between different types of what can loosely be referred to as "ownership". The basic tenets of the usufruct and fideicommissum are making over of property to one person which is intended at a later stage to benefit a third party.

Under English law the trust entailed two different types of ownership: the trustee was known as the legal owner of the property and the beneficiary was known as the equitable owner. However, under Roman law there could not be two owners in the same thing at the same time (although this is debatable if one considers the basic premise of the Roman usufruct). However, the trust dealt historically with property that was owned ultimately by the ruler of the day and therefore neither the trustee nor the beneficiary could have any right of ownership in it. Therefore what grew up to be defined as ownership of the property under the trust agreement was nothing more than ownership of two different types of interest in the property and not full ownership of the property itself. However, not too much time need be spent on this line of argument, which is the province of the legal purist, except to say that whatever labels each system wishes to ascribe the cardinal element of the trust is the separation between formal ownership and enjoyment of benefits by a person other than the personal owner. This basic concept has been accepted with open arms into our law (as well as into many other systems) and is the basis upon which our law of trusts is established. In *Estate Kemp v McDonald's Trustee* [33] the Appellate Division ruled that although the English law regarding trusts did not form part of our law it did not mean that the trust could not be recognised and accepted according to principles of our own law. The court's ruling was not based to any large extent on a reactionary reflex towards the English law of trusts but rather on the fact of its objections towards the concept of dual ownership espoused the trust's basic English form. The court utilised a form of the fideicommissum to bring the trust in line with Roman-Dutch concepts. Known as a "fideicommissum purum" it entailed an almost instantaneous transfer from the fiduciary to the fideicommissary and the trustee ("fiduciary") merely served as a 'conduit-pipe' through which the property was passed, and could have 'no beneficial interest' in it [34].

Despite the fact that this decision was heavily criticised and pronounced categorically incorrect it can still be considered to be a landmark decision in that it allowed the authoritative introduction of a testamentary trust into South African law, which concept will be discussed later with that of inter vivos trusts. The case which put "inter vivos" trusts "on the map" was *Crookes v Watson* [35] where the Appellate Division decided that an inter vivos trust is brought into being via a contract between trustee and settlor/founder/donor in favour of the third party beneficiary.

Eventually in the case of *Braun v Blann and Botha* [36] an unanimous Appellate Division accepted for the first time that the trust could be considered to be something unique and for this reason the court rejected that there was any historical or legal basis to liken a trust to a fideicommissum or a trustee to a fiduciary. Further the court held that the concept of the trustee had been accepted into our law but that our courts had developed the concept in line with our own Roman-Dutch law roots and that the development was an ongoing process. The importance of these findings lies in the fact that the trust could now be accepted exactly as it is and need not by slipped through a "back-door" into our law, clad in another guise. Clearly the Appellate Division was saying that the basic tenets of the *Treuhand* (as discussed earlier) could apply equally in our law as it did in countless other legal systems throughout the world and that each system could utilise the fundamental core of the trust adapting it to specific rules and needs and that the end result would be a workable, useful and completely indigenous product.

## [C] CHARACTERISTICS OF A TRUST

The basic elements of a trust are as follows: (1) the creator of the trust must specifically intend to bring a trust into existence; (2) there must be clearly defined property (ie: identifiable subject matter); and (3) there must be clearly identifiable beneficiaries.

### (1) Formation of a trust

For a trust to come into existence the founder must act with the 'uitgesproke bedoeling om 'n trust te skep' [37]. In other words 'an intent to create a trust is essential' [38] and he must act in such a manner as to bring the trust to life. The founder need not, however, specifically refer to a trust to create one, if his clearly expressed intentions either in a will or in a trust agreement can be seen as creating the rights and duties as regards clearly defined property which are the characteristics of a trust.

A trust can be created in a number of ways. It may be set up in the founder's will, the so-called testamentary trust or trust "mortis causa". The basis of the trust is set up during the lifetime of the testator (i.e.: trust property earmarked, trustees appointed, beneficiaries identified etc.) but it is "suspended", designed only to come into operation 'when the will by which it was created comes into operation, that is when the testator dies' [39].

This allows the testator the freedom during his life to deal with his assets as he sees fit and he may at any time revoke or change his will. Since the trust forms part of the will of the founder it is essential that the will be upheld as legally valid for the trust to be upheld and further the trust deed must meet the requirements of a valid will.

Another method of creating a trust is by bringing it into action during the lifetime of the founder. This is known as the "inter vivos" trust [40].

'Such a trust is created by way of agreement' [41] between the founder and the trustee. This contract must be registered with the the Master of the Supreme Court in terms of section 4 of Trust Property Control Act [42] and must also comply with the formalities which are required for the type of contract which is used. The trustee agrees to administer assets, transferred by the founder, on behalf of the beneficiaries and the trust can be revoked or altered with the consent of the trustees at any time before the beneficiaries accept the benefit. However, once the beneficiaries have accepted the benefit their consent will be necessary before any revocation or amendment can be effected and an attempt to do so without their permission/consent will amount a 'breach of contract against the beneficiaries' [43].

The inter vivos trust was accepted into South African law in the case of *Crookes v Watson* [44] where it was likened to a stipulation in favour of a third party and the law regarding that concept was transposed onto an inter vivos trust. A trust may also come into existence in terms of legislation as in the instance of the Development Trust set up under Act 18 of 1936. A trust may also be created by an order of court where the court utilises a trust to remedy a specific situation or to provide a solution in a specific set of circumstances. The trust is not, therefore, created *mero motu* on a whim alone by the court but forms part of the order which is handed down.

## (2) Trust Assets

For a trust to exist it needs assets which form the subject of the trust. Die hele geskiedenis van die ontwikkeling van 'n trust hou met 'n besondere beskikking oor goed verband en dus is 'n trust sonder duidelik omskrewe goed nie bestaanbaar nie' [45]. Thus it is essential that the assets which form the subject matter of the trust are clearly identifiable, otherwise the trustee will be unable to fulfil his task of providing for the beneficiaries because he will not be able to identify the 'necessary means (trust assets)' [46]. The assets which eventually make up the trust property may consist of movables, immovables, corporeals or incorporeals; in fact any asset which can be owned and once alienated will result in a cash realisation [47] can be a trust asset and as such includes cedable rights. The only requirement is that it must be possible to identify the assets with 'reasonable certainty' [48].

## (3) Separation of Assets

The assets which form the trust property must also be separated from the control of the founder by being placed under the control of the trustee. Thus it could be transferred by way of a 'legally valid mode of transfer such as delivery' [49] from the founder to the trustee. Further the founder could bind himself or another person to hand over the property to the trustee at a later stage or upon the happening of a certain event. A good example of this is a trust set up in terms of a will by virtue of which the executor of the deceased estate is bound to hand over the trust property after the death of the founder to the trustee.

It must, however, be borne in mind that transfer of the property earmarked for the trust is not a prerequisite for the coming into existence of either a testamentary or an inter vivos trust. A testamentary trust is created via the will of the founder and comes into existence on his death and the property, although already identified as the subject matter of the trust, will only come into the hands of the trustee later, once the executor has carried out his duties, one of which will be the transfer of the property to the trustee.

In the case of an inter vivos trust it is created on the date upon which the agreement which brings the trust into effect is reached, despite the fact that the property may only be transferred at a later stage (ie: in the case of immovables on registration etc). As referred to above in the case of an inter vivos trust the founder proposes to bind the trustee to certain obligations and it is only once the trustee accepts those obligations which form part of the trust conditions that the trust is created.

Segregation of the trust property from the control of the founder into the hands of a trustee for the benefit of a third party is the basic idea behind a trust. As such it is clear that the founder cannot continue to own the property in his capacity as founder although he may still exercise control over it as co-owner if he is appointed as co-trustee under the trust deed. He may not, however, appoint himself as sole trustee from the inception of the trust, although if he became sole trustee after the trust has been created this will not extinguish the trust unless he is also the sole beneficiary because this will mean that no separation of power over the property exists.

Honore insists that it is 'essential that the founder should actually divest himself... of a part at least of his legal power over the trust property' [50] and let the trustee administer the property (at least partially) for a person/impersonal object other than the founder himself.

#### (4) Ownership of Assets

Another very important aspect of the South African law of trusts is that 'ownership of the assets may be vested in the trustee...or in the beneficiary according to the way in which the instrument is expressed' [51] and this principle has been accepted into our law in the Trust Property Control Act 57 of 1988. Therefore the founder may bequeath ownership of assets directly to the beneficiary (the so-called "bewind" trust) instead of the more customary transfer to the trustee. However, the founder still allows control over such assets to vest in the trustee who administers them for the beneficiary in a valid form of a trust. This is because control over assets is one of the essential elements of a trust and not ownership per se [52].

Therefore the founder who doubts that his beneficiaries will be able to deal responsibly with the property which he wishes to leave them or fears that they lack the knowledge/expertise to derive maximum benefit from it will still be able to vest the ownership rights in the property in the beneficiaries while allowing a more capable or better qualified person to manage the property to derive the absolute maximum gain for the beneficiary. Thus the trust can be used to protect beneficiaries from their own improvidence. It ensures that the person in charge of the assets is possessed of 'a measure of specialisation' [53] in handling the property.

Honore feels that the above system is clearly a type of trust because the fact that ownership vests in the trustee (or does not as the case may be) is not a telling factor in determining the rights and duties of the trustee; it is the trust instrument which dictates his actions as regards the property and he is subject to the same controls whether he owns the property or not [54].

#### (5) Subject-matter and Parties

A fairly self-evident characteristic is that the subject matter of the trust, its object and the parties to the trust must all be clearly defined. The description of the beneficiaries is particularly important. 'A trust will be null and void if there are no clearly indicated beneficiaries or if the impersonal objectives cannot be clearly ascertained' [55]. This does not necessarily mean that the beneficiary or cause to be benefited must be mentioned by name because a "pool" of beneficiaries may be referred to from which the beneficiaries will be drawn (ie: the beneficiaries described in a will as "my grandchildren" without specifically naming them) [56].

Therefore especially in the case of a trust mortis causa it will be difficult if not impossible to give effect to the testator's intention of benefiting something or somebody, if that person/object is not identifiable.

The situation is different in respect of the trustee because 'die hof sal nie aarsel nie om 'n persoon as trustee aan te stel sodat daar aan die bedoeling van die erflater gevolg gegee kan word' [57] in the situation where the testator has failed to appoint a trustee or the trustee is unable to accept his position. Thus a trust will not necessarily fail because a trustee has not been specified.

Further it often happens that the appointment and conduct of the trustee can be reviewed by our courts and if the trustee is found wanting in the exercise of his duties he can be dismissed and replaced by another trustee who will be designated by the court. The trustee can also be dismissed by the Master of the Supreme Court if he is found to be insolvent, mentally incapable etc. Thus the position of the trustee is not immutable and should he fail, it would not lead to the immediate collapse of the trust as would be the case were the beneficiaries to fail. Olivier ascribes this to the fact that the 'trustee dra ten alle tye twee baadjies' [58] in that as trustee he is an office bearer in a position of trust while on the other hand he is a private individual with all the normal rights, obligations etc. completely separate from the trust. In essence he is a facilitator (we will see the trustee referred to later as a "conduit-pipe") ; while the existence of a trustee is an essential component for a trust to be valid his identity is of little concern (in a trust mortis causa). He merely acts in his capacity as a trustee to give effect to the wishes of the testator.

However, in the situation of an inter vivos trust which is set up by agreement the identity of the trustee is clearly much more important because it entails a meeting of the minds of the founder of the trust and the specific trustee, whom he has approached to administer it and who must accept his appointment.

Further the trustee must undertake, upon acceptance and confirmation of appointment to his position, to administer the property which forms the subject matter of the trust for the benefit of another party and not for his own benefit. 'A trustee shall in the performance of his duties and the exercise of his powers act with the care, diligence and skill which can reasonably be expected of a person who manages the affairs of another' [59].

As such it is evident that the trustee occupies a fiduciary position in relation to the beneficiaries and he is always under the scrutiny of the Master of the Supreme Court and the courts (as mentioned above) to ensure that he fulfils his duties as stipulated under the trust instrument.

The trustee also has a duty, 'as far as possible, to keep trust assets separate from his own assets or from other assets which do not belong to the trust' [60].

#### [D] TAX AVOIDANCE

It is often an excellent idea to harness the trust as a tax-planning mechanism so that the 'planner and his dependants ... reap the maximum benefit from the proceeds of [their] assets' [61]

Tax planning involves the arranging of the tax-payer's affairs 'within the framework of the South African income tax laws' [62] in such a manner 'that no more tax is payable than is necessary' [63]. In other words tax planning is a technique whereby the tax-payer manages his affairs so that less tax would be payable than if he implemented no tax planning at all. Silke refers to this tax-saving as the 'consequential prejudicial effect' of tax-planning on the 'public revenue' [64]. However it is important to bear in mind that although the citizen bears 'a civic duty to pay taxes' he is under absolutely no duty whatsoever to pay 'unnecessary taxes' [65]. 'No obligation rests upon a taxpayer to pay a greater tax than is legally due ... and a taxpayer is not debarred from entering into a genuine or bona fide transaction which ... has the effect of avoiding or reducing liability to tax' [66]. It is the primary function of the Receiver of Revenue to extract the full amount of tax from the taxpayer and such state-levied tax can often involve 'large amounts which will have a material effect on the value of the assets [of the taxpayer which remains is his estate] for the [benefit of] beneficiaries' [67]. One should not feel duty-bound to fulfil the task of the Receiver of Revenue for him or make it easier because he receives enough assistance from the legislature (and sometimes even the courts!). By failing to engage in tax-planning one is actually paying more than one's allotted portion of tax. Lord Tomlin states the principle excellently when he said: 'It is trite law that His Majesty's subjects are free, if they can, to make their own arrangements so that their cases may fall outside the scope of the taxing Acts. They incur no legal penalties and, strictly speaking, no moral censure, if, having considered the lines drawn by the legislature for the imposition of taxes, they make it their business to walk outside them'.

'No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow - and quite rightly - to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, as far as he honestly can, the depletion of his means by the Revenue'.

'Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow-taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax' [68].

One should set out at all times to preserve one's assets for future generations and this includes protecting them against the ravages of all the various taxes. 'Tax planning is an important function, for the burden of tax is nowadays so great that taxation must be regarded as one of the major costs of production; and enterprising and productive schemes are often made possible only by intelligent tax planning' [69].

Tax planning, in whatever form and including those methods involving trusts, generally hinges around tax avoidance which must from the outset be distinguished from tax-evasion [70]. The state levies taxes in order to fund its various operations. To evade those taxes would mean that the taxpayer intentionally involves himself in schemes and activities which improperly and illegally allow him to circumvent liability for tax on his income in various ways. These generally include falsification of books of account (including claiming non-exempt/personal deductions), concealment of facts regarding, and amounts of, income (ie. non-declaration of income) and entering into simulated/mock transactions. Such acts are considered to be illegal and need not be specifically provided for by statute to be struck by severe penalties.

Tax avoidance, however, signifies that the tax-payer has arranged his affairs in such a manner to legally reduce the amount of tax for which he will be liable. This may come about because he is engaged in an activity not provided for by fiscal statute and thus falls outside of the frame of reference of the Receiver of Revenue. (This happens less and less frequently but theoretically such loopholes may exist because the imposition of taxation is regulated by statute and where the statute has not provided for a specific situation, the courts may not interfere and substitute their own decision to fill the legislative lacuna.)

This is done following the principle that no taxpayer is obliged to pay any greater amount of tax than that which is actually legally due under tax legislation. It has been suggested that 'tax avoidance of this kind is not only unobjectionable: it is commonsense' [71]. It is also this writer's contention that as long as one operates within the limits imposed by law that one should invoke no moral censure were one to implement a scheme whereby less tax was to be paid.

Problems arise in this area, however, because the parameters within which one can legally avoid tax are not always clearly defined. 'By die bepaling van die belastingaanspreeklikheid ten opsigte van die inkomste van 'n trustfonds moet noukeurig gelet word op die bepalings van die trustakte, die toepaslike bepalings van die Inkomstebelastingwet en die regsbeginsels insake die vestiging van regte' [72]. The Receiver of Revenue utilises the general ambit of section 103 of the Income Tax Act to attack such tax-avoidance schemes not covered by other specific sections while the unsuspecting taxpayer was not aware that he was falling foul of the law. However, trusts are still popular in estate and financial planning. 'Mits sodanige beplanning met die nodige kundigheid uitgevoer word, kan daar in die meeste gevalle vir die boedeleienaar en sy erfgename belastingbesparing bewerkstellig word' [73]. It is generally the case that property is passed from one person who would be liable at a high tax-rate to another, through the medium of the trust, who is taxed according to a lower rate, resulting in a saving in estate duty and/or income tax while still allowing substantial control over the assets of the taxpayer's estate. This control remains because the trustee is usually someone appointed by the founder and in whom the founder has the confidence that he will administer the assets according to the founder's wishes.

Knowing the internal mechanisms and workings of trust law can thus be highly beneficial when determining how to maximise one's income while not falling foul of the various anti-avoidance provisions in the Act. A trust is created when the originator/"architect" of the trust (called the founder, donor or settlor) makes property available to another person (called the administrator in a testamentary trust or the trustee in inter vivos trusts), for the benefit of a person or an 'impersonal object' [74] like a charity (called a beneficiary). The trustee manages and distributes the original property itself or the proceeds thereof to the beneficiary, depending on the intention and instructions of the founder/donor/settlor. The underlying principle of a trust therefore is the committal to another's care of your assets for the benefit of a third person.

Thus we have the situation of an intermediary ('tussenpersoon' [75]) acting strictly in accordance with the instructions of the founder/donor/settlor and within the limits thus placed on his power being placed in control of property which he administers, not for his own personal benefit but for the benefit of a specified beneficiary (be it a person or impersonal object as above) Thus a fiduciary relationship exists between the trustee and the beneficiary. Ownership of the property which forms the basis of the trust vests in the trustee but only in his official capacity.

'Since the legal ownership of the property transferred vests in the trustees and no longer in the donor, it follows that the income derived from the property is received by or accrued to the trustees. But in whose hands is it taxable?' [76]. It is essential to determine who will be liable for tax when devising a scheme to avoid tax because one wishes to place the income in the hands of the person who will allow maximum enjoyment and use of it by incurring the least tax. It can be taxed in the hands of the beneficiary, in the hands of the trust, or partly in the hands of beneficiary partly in the hands of the trust or in the hands of the donor of the trust.

#### Multiple Trusts

A word should be said at this juncture about multiple trusts. A good tax-avoidance measure is the splitting of one's income between a number of trusts. Thus the income generated by the trusts from the assets will not be taxed in one person's hands (ie; the founder) but in the hands of a number of taxable entities. The founder is therefore able to reduce his liability to tax by placing himself in a lower tax-bracket.

By utilising a number of trusts one also limits the tax liability of the trusts in question. Obviously one trust taxed on the full amount of income would pay tax at a higher rate than a few trusts taxed on the same amount of income distributed amongst them.

Having thus traversed generally the concept of trusts, it rests on the writer to further expand on the concept, the reasons for and possible uses of trusts, and the different types of trusts which one encounters.

## [E] TAXATION OF THE TRUST

The focus of this paper is the relationship between income tax and the trust but it must be remembered that other types of tax affect the trust. A brief discussion of estate duty and donations tax in respect of the trust therefore follows below.

### (1) Estate Duty

To determine liability for estate duty it is necessary first to ascertain what the estate of the deceased consisted of at the time of death. This is done by adding together all the property and deemed property of the deceased as at death. Sections 3 (2) (a) and (b) of the Estate Duty Act 45 of 1955 interest us in that they affect property held by the deceased immediately prior to his death, upon which death an advantage passes to another person. Such an advantage is contemplated in section 11 of the same act and where it accrues to a person on the death of another, the person to whom it accrues will be liable to tax on it.

Thus where a person sets up a trust and the trust-deed provides that the income of the trust will be paid to a certain party, upon whose death it will be paid to another party, then when the original beneficiary dies the third party beneficiary who then receives the income will be liable for estate duty thereon.

### (2) Donations Tax

This is an important consideration when dealing with trusts as this tax was introduced in the first place with a view to preventing tax-evasion by means of disposal of property via donations. Donations would ordinarily be used by the taxpayer to reduce his liability to tax by transferring assets out of his estate and splitting the income derived therefrom between a number of taxpayers.

Thus where a donor wishes to make over an asset of appreciable value to a trust a donation would be considered to be the most effective manner of doing so. However, such a donation attracts donations tax at the rate of 15 percent. Any amount of donations tax paid by the deceased on any property donated during his lifetime is deductible for estate duty purposes and once paid by the donor no other party such as a trust beneficiary will be liable for donations tax thereon. It may well therefore benefit the tax-payer were he to pay the initial donations tax on an amount ascertainable at present to avoid increased liability at a later stage on an amount which has grown due to investment etc (the "pegging" concept).

Any attempt to avoid donations tax liability will result in the coming into operation of the oppressive section 103. Thus it is that even the most ardent, creative taxplanners are thwarted. Further, a trustee to whom assets are donated to be administered for a beneficiary will be liable to tax in his representative capacity as he is considered to be the donee of said assets.

Bearing in mind the basic principles set out above the taxation of trusts will be split up into a general section and then specific sections dealing with tax in respect of testamentary and inter vivos trusts separately. There are certain basic differences between a testamentary trust and an inter vivos trust, although once those are settled the essential elements are the same.

The testamentary trust comes into being upon the death of the testator and transfer of property only occurs later. Thus it is not necessary that property be transferred for the trust to be created. The deed does not have to make any provisions for estate duty or donations tax. These issues have been dealt with by the executor while winding up the deceased estate and he then passes over the residue to the administrator. The assessment to tax of the trust therefore will be based solely on any growth (capital appreciation) on the capital residue received from the executor.

The trust inter vivos is trickier in that donations tax and estate duty considerations must be borne in mind on top of provision for income tax.

### (3) Testamentary trusts

Under a will the testator specifies the particular assets which he wishes to form the subject-matter of the trust and which his executor will be charged with handing over to the trustees as appointed upon his death. Further the testator will nominate those beneficiaries who will receive a benefit in terms of the trust deed and he also appoints trustees etc.

Ordinarily under a will the residue of a person's estate or specific assets will be divided amongst beneficiaries. However, under a will incorporating a testamentary trust such assets/property will be held by trustees for the benefit of beneficiaries. As discussed previously the income emanating from capital appreciation in respect of the trust assets will be taxable in the hands of one of three parties: the trust (taxed as an unmarried person in respect of Act 58 of 1962, represented by the trustee); the beneficiary or the donor or a combination of these parties.

Taxation of the donor in a testamentary trust is ruled out because, as explained above, his estate has made good any liability in respect of estate duty and/or donations tax. The income thus generated under a testamentary trust is taxed either in the hands of the trust where under the will there has been 'an irrevocable disposition of property' [77] to it and the income stemming from which vests therein, or in the hands of the beneficiaries.

The beneficiaries are most commonly held liable to tax (under any type of trust) because it is usually for their sake that the trustees are empowered to deal with the assets in the first place. Thus where the beneficiaries have received an entitlement to any income (ie: an "accrual") from the trust they are taxed therein.

From what has been said above it is evident that it is largely the trustee around whom much of the "action" in the trust revolves. He is usually a reference point in deciding who will be liable for tax on income flowing from the trust or the subject matter of the trust because 'it is not always clear under what circumstances income that is the subject of a trust is to be taxed in the hands of the trustee as representative tax-payer and in what circumstances the beneficiary will be liable to tax' [78]. The trustee is the "representative taxpayer", as envisaged in section one of the Income Tax Act [79] in those situations where the beneficiaries do not acquire an unconditional right to the income the subject of a trust. He is also the starting point because it is he who will be making payments to the beneficiaries etc and he is also in most cases the owner of the assets and the person 'in whom the rights and liabilities in a trust normally vest' [80]. The trustee is the 'eienaar van trustbates en slegs hy kan 'n eis om betaling van trustinkomste instel' and therefore 'behoort trust inkomste die trustee in die eerste plek toe te val' [81] and because of this accrual ("toevalling") he is therefore 'prima facie taxable' [82] Honore 362 on the trust income as the representative taxpayer [83]

It must be borne in mind that a trust encompasses the transfer of asset, for the benefit of a third party, into the hands of a trustee. It is the trustee in whom ownership of said property vests and it is the trustee who is charged to administer it for the benefit of said third party in terms of the instructions per the trust deed. 'Since the legal ownership of the property transferred vests in the trustees ... it follows that the income derived from the property is received by or accrues to the trustee. But in whose hands is it taxable?' [84].

Because the trust deed forms part of the will it is usually the case that the testator has given some thought to whom he will be leaving the various benefits contemplated therein. Thus where the beneficiaries are clearly ascertainable and have a vested right in the property ('gevestigde reg') [85] the trustee (or administrator as he is known in testamentary trusts) 'is required to pay ... [the] ... income to ... [the] ... beneficiary 'which income 'accrues to the beneficiary' and he is 'the person to be assessed to tax in respect of the income ...' [86]. In other words where the testator has made provision for a benefit to pass to a beneficiary unconditionally and free of any contingencies, he has a 'vorderingsreg op trustinkomste wat ter sprake is' [87], it is his income and he will be liable for tax on it.

As discussed accrual means "unconditionally entitled to" ('n onvoorwaardelike reg op he' [88]). In most cases it cannot be said that a trustee has a vested right in the income; he is empowered to deal with the property which is the subject matter of the trust only in so far as he does so for the benefit of the beneficiary. The trust deed will normally specify to whom various payments of trust income must be made etc and thus it is evident that the trustee does not have an unconditional entitlement to said income. Thus it is not often that the trustee is liable for tax (as the living embodiment of the trust) because he normally must fulfil the condition/responsibility of handing over of income to the beneficiary.

However, where the founder of the trust has for example attached various conditions to the payment of trust income to the beneficiaries they do not acquire a vested right to the income until those conditions are met. Until then the income vests in the trust. As such it is the case that the trustee will then be liable to tax in his capacity as the representative tax-payer of the trust.

In other words where the beneficiaries have been specified and have a vested right to the trust income, then it is the beneficiaries in whose hands it will be taxed. This is the case because said income is considered to "have accrued to or in favour of the beneficiaries. Despite the fact that it may not physically have been paid out, they are still 'entitled' to it [89] and as such are taxed on it.

The trustee in such circumstances cannot be assessed in respect of the income because at the time of receipt or accrual of the income by the trustee, he is 'legally obliged to pay over the income ... or to accumulate or expend the income ... for the benefit of any person specified in the trust deed as the beneficiary of the income' [90] and that person will be liable to tax.

This is because our courts have on many occasions where the beneficiaries have a vested right to the income decided that the trustee is nothing more than a 'conduit-pipe' [91] through which the income, which "belongs" to the beneficiary anyway, flows.

'Die effek van die geleibuisbeginsel is dat, waar 'n begunstigde 'n gevestigde reg op die inkomste het, die inkomste in sy hande ... belasbaar is' [92]. This occurs because even before the income has been paid to the beneficiary it has already accrued to him and once he has received it, he is taxable on it.

Further, '[t]rust income which is taxable in the hands of the beneficiary does not lose its identity due to the fact that it passes through the hands of the trustee first' [93]. Mention has been made of the "conduit-pipe" principle above whereby income in respect of which the beneficiary has a vested right passes straight to him and is taxed in his hands. The concept also encompasses the identity of the income passed. Thus in the case of *SIR v Rosen* the Appellate Division held that income retains its identity when passing through the hands of the trustee on its way to the beneficiary. Clearly following this dictum income in the form of interest, dividends etc retains its identity 'totdat dit ontvang word deur die persone in wie se hande dit belasbaar is' [94].

Thus where the trust income consists of dividends, for example, the beneficiary who has a vested right to such income is deemed to have received the actual dividends via the trustee and as such will be allowed the exemption on dividends. In other words the beneficiary may claim the exemptions and allowances ordinarily allowed to a taxpayer as if the income had been received directly by him. The fact that the income passes through the hands of an intermediary (in the form of the trustee) does not alter the position and the questions that must be asked (ie: whether the income is exempt or not, whether it is from a source in the Republic of South Africa or deemed to be in the Republic of South Africa etc) are not influenced by the fact that the trustee passed the money on to the beneficiary. It may well occur that where the trust-income passed to the beneficiaries they simply claim the exemption to which they are entitled in the ratio of exempt to taxable income.

The situation is considered to be different where the trustee, in exercising the discretion does not pass the income on to the beneficiaries, but retains and accumulates it. It was the view in *SIR v. Rosen* [95] that where this is done and the trustee only pays out the income in a later year to the beneficiaries that the income 'might then lose [its] character and identity' [96].

This means that if the relevant income consisted of dividends that it would not flow via the conduit-pipe to the beneficiary because the pipe would have been "switched off" at the relevant time. 'Nevertheless, if the income is passed on to the beneficiary in the same year in which it accrues to the trustee, it retains its nature in the hands of the beneficiary' [97].

This retention of identity is a very important aspect of the trust for tax-planning purposes. It means that 'any exemption from tax provided in the Act in respect of [the income referred to above] ... will apply to [the] beneficiary' [98] because 'the income remains unchanged in the hands of the beneficiaries' [99]. As such the founder of the trust may provide that only dividend income be passed to the beneficiaries to allow for a tax-saving while still allowing receipt of a substantial benefit.

It has been ascertained that where the beneficiaries are legally entitled to income they will be liable for tax on such income and where they have no such entitlement (ie: a vested right) but a mere contingent right the income does not accrue to them but is taxable in the hands of the trust. What then of the discretionary trust?

A discretionary trust is where the trustee has the discretion to decide whether or not to distribute the income at a specific stage or what amount to distribute. This means that the beneficiary merely has a contingent right to receive the income. Once the discretion has been exercised, however, it will 'constitute a vesting of income in the hands of the beneficiary concerned' [100]. Therefore the 'contingent right thus becomes a vested one' [101] and the beneficiary is liable for tax on the amount which has been paid over to him.

The general rule therefore is that, where the trustee has a discretion, only once it is exercised and he pays out the income will the beneficiary be liable to tax, while any income not paid out and kept back by the trustee will be taxed in his hands as representative taxpayer of the trust. 'Die begunstigdes het nie 'n vorderingsreg op inkomste nie. Inkomste wat deur die trustees terruggehou word, is in hul hande as verteenwoordigende belastingpligtiges belasbaar, terwyl inkomste wat aan die begunstigde uitbetaal word, in die begunstigde se hande belasbaar is' [102]. Thus one may well encounter the situation where both the beneficiary as well as the trustee share liability for tax.

What has been written above will also apply to those situations where the trustee has an absolute discretion. This means that the trustee will have to make a final decision about whether to distribute the income at all and to whom. Honore states that 'pending distribution the income remained income of the trust, If, however, income had actually been distributed it would have been income of the [beneficiaries] receiving it ...' [103]. However two special Income Tax Court cases seem to contradict this: ITC 288 and ITC 887 [104]. In those cases it was held that where income had been distributed in pursuance of the exercise of a discretion the money which had been paid over still formed part of the trust income.

The courts ruled thus on the basis that the beneficiaries (in these cases charitable institutions) had no right to the money but merely a contingent interest and this prevented it being treated as income even once received by the beneficiary. Therefore the beneficiary could not be liable to tax. With all due respect to those learned judicial officers their decisions cannot be regarded as correct. 'Once the discretion has been exercised and the money paid over ... it must be treated as income of the beneficiary, not of the trust' [105]. It is, in any event, Revenue Department practice to tax such income in the hands of the beneficiaries.

Further it is essential that the trustee be aware, where he has a discretion, that a decision to retain the income which is exempt in the year of receipt/accrual may well affect adversely the position of the beneficiary as regards tax liability when he exercises the discretion and pays it out in a later year.

The identity of income is important when analysing the same for tax purposes. There is an exception to the principle of retention of identity of income where the beneficiaries are to receive income in the form of an annuity. The exemption which ordinarily applies to income in the form of dividends {section 10 (1) (k)}, interest on Government Stocks {section 10(1) (h)} etc does not apply to any portion of an annuity {section 10 (2) (b)}. This was a change effected in the law directly after the Rosen[106] decision which allowed even income paid in the form of an annuity to retain its identity. Thus it would be prudent to advise a client that should he wish to make a bequest of an annuity to his beneficiaries that 'any amount received or accrued by way of annuity must be included in the gross income' [107] and as such is taxable even if it originates in exempt dividend income.

A further problem regarding annuities is highlighted by Silke [108]. No attention is paid to whether the annuity is paid out of the income generated or out of the actual capital assets of the trust. This means that where the founder of a trust wishes an annuity to be paid but fails to provide for sufficient income to cover said annuity the annuity will be paid out of capital and thus the beneficiary will pay income tax on funds which are of a capital nature. This is clearly highly undesirable and to be avoided at all costs when advising one's clients with regard to setting up a trust. The legislature is obviously not concerned with the source of the income nor the nature of the assets from whence the annuity is paid and is quite satisfied to tax the income from an annuity as long as it is from a source within the Republic.

#### (4) Inter vivos trusts

While the testamentary trust is created under the last will and testament of the testator and comes into being upon his death it is the case that an inter vivos trust is brought into being by a contract entered into between the founder/settlor/donor and the desired trustee/s for the benefit of a third person [109]. As such it is considered to be regulated by 'the principles of our law of contract' [110]. 'A donation is usually involved in the formation of a trust that is created during the lifetime of the settlor' [111] but it must be borne in mind that the trust inter vivos comes into existence upon conclusion of the contract between founder and trustee and is not dependant upon the transfer of property, which is a major difference between the donation initiating the inter vivos trust and the ordinary donation.

The trust deed may therefore be altered at any time, subject to the principles of contract law. Where the founder has reserved the right to vary the terms of the trust deed he may make any changes he wishes *mero motu*.

Further, because the trust is a contract between founder and trustee the trust deed's terms may be varied upon agreement between both parties, despite the fact that the terms are not usually decided upon by agreement in the first place. This comes about because the trustee, once he accepts his appointment, is duty bound to bear the best interests of the beneficiaries in mind at all times and he is compelled to follow the terms of the trust deed in administering the estate. Thus his consent is necessary where any alterations are sought to the trust deed and the founder has not reserved for himself a right to variation. This follows the basic tenet of a trust which must always be taken into consideration: the trust assets are managed on behalf of and for the benefit of third parties and their concerns are of paramount importance.

The situations mentioned above only come into play if the beneficiaries referred to in the trust deed have not yet accepted the benefit thereunder. Once they do so they too are parties to the contract and their consent is necessary before any alterations can be made to the trust deed.

A donation is normally used as an easy means of transfer of the intended trust assets to the trustees. The difference between a donation in terms of a trust deed and an ordinary Common law donation is that 'it involves the transfer of property by the donor to trustees on certain terms and subject to certain modalities' [112].

As discussed income stemming from investment of trust assets is taxed in the hands of one of three people or a combination of them. These will be discussed in the pages that follow.

[F] INCOME ASSESSABLE TO THE BENEFICIARY

Section 25 B(1) of Act 58 of 1962 states that income received by or accrued to a trustee which is used for the benefit of any 'ascertained beneficiary' who has a 'vested right' to such income is deemed to have accrued to the beneficiary. In other words where the beneficiary is identified and has a right to receive the income, whether in the present or at some future date, (ie: even where not actually paid out to him) he will be taxed on that portion in which he has a vested right [113].

However, any income which is to be distributed in terms of a trust deed which confers a discretion on the trustee will only be taxed in the hands of the beneficiary in so far as it is actually paid out to that beneficiary. Any income which is held back by the trustee in terms of an absolute discretion and is accumulated, to be distributed at a later stage, is taxed in the trustee's hands as the beneficiary only has a contingent right in the income and not a vested right. Pursuant to the principles of the "conduit-pipe" any income accumulated by the trustee and taxed in his hands, once distributed, will retain its identity as a receipt of a capital nature (having already being taxed) and is not then taxed again in the hands of the beneficiary once paid out.

This follows the decision in the Appellate Division in the case of CIR v People's Stores [114] which approved the definition of "accrued" as "entitled to" as espoused in Lategan v CIR [115]. Thus where a beneficiary is "entitled to" income even where not actually paid out but accumulated/capitalized it is still taxable in the hands of the beneficiary.

Furthermore, a beneficiary is also entitled to deductions in respect of income received depending on whether the income received is gross or nett income. This means that where the "conduit-pipe" principle applies and the beneficiary is to be taxed on income accrued to or received by himself he is also entitled to the deductions allowable in respect of said income.

#### [G] INCOME ASSESSABLE TO THE TRUST

Where assets have been made over to the trust and the income therefrom does not vest in either the beneficiary or the founder of the trust it will be assessable to the trust and will be payable at the rate ordinarily payable by an unmarried person. No rebates ordinarily allowed to a natural person are granted to a trust. However, the trustee, in his capacity as representative taxpayer is entitled to deductions incurred in the production of the trust income such as trustee's remuneration, disbursements, premiums paid on the fidelity bond and various other administration costs.

It most frequently occurs that the trust is held liable to tax in those situations where a discretion has been granted to the trustees in respect of distribution of the trust income to the applicable beneficiaries. ' [T]here can be no accrual of an ascertainable amount of income to a beneficiary until the trustee exercises his power of discretion and distributes the income to a beneficiary' [116].

There are circumstances in which the trust is not held liable to pay any tax. This usually occurs when the trust has been created to perform a purely charitable function, but also includes 'certain pension funds' and 'non-profitmaking' organizations and 'educational' and 'ecclesiastical' institutions [117].

#### [H] INCOME ASSESSABLE TO THE DONOR/FOUNDER/SETTLOR

Olivier [118] also notes that in the case of an inter vivos trust it will be highly unlikely that the trust will be taxed on trust income while the founder/donor/settlor is still alive. This is due to the operation of certain sections of Act 58 of 1962, especially sections 7(3) through to 7(5).

This was succinctly dealt with by Judge Corbett in Estate Dempers v SIR [119] where he said that 'certain limitations are placed upon the right to avoid ... liability for the payment of tax'. He was referring to the situation where a taxpayer reduces 'the amount of his income, and thereby the income tax payable, by giving away income producing assets owned by him'. The learned judge specifically stated that limits are imposed where:

1. the taxpayer makes his minor child the beneficiary of income derived from any 'donation, settlement or other disposition' made by the taxpayer himself - section 7(3).  
This is clearly aimed at preventing the taxpayer directly making over assets to a minor child or expending income to maintain that child without being liable to tax on that income or reducing his liability to tax. This is because the parent is obliged to maintain and educate the child anyway and any further benefit far from being a necessity will imply gratuity (discussed later) and tax should be paid on all such amounts.
2. the taxpayer makes a donation, settlement or other disposition (ie: some form of consideration) to a third party in exchange for which, directly or indirectly, the taxpayer's minor child receives income or income accrues to the child - section 7(4).
3. Any income which is the subject of a donation, settlement or other disposition, accrual or receipt of which is postponed due to a stipulation or condition shall accrue to the person making the donation or settlement or disposition until the conditions etc are fulfilled - section 7(5). This prevents any sham transactions whereby the taxpayer goes through the motions of making over property to a beneficiary, while setting a condition which will mean the assets and/or income will never be received by or accrue to that person but will still be placed outside the estate of the taxpayer for tax purposes.
4. In terms of section 7(6) where the donor/founder retains the right of revocation in respect of the donation/settlement/disposition, the income/assets will be taxed in his hands as long as he retains the power to prevent the immediate enjoyment of the income/assets or to curtail it.

Other deeming provisions not referred to in the abovementioned case are:

1. Section 7(2) which deems income received by the donor's spouse to be the income of the donor himself when the donation, settlement or disposition was made after 20 March 1991 and/if the sole purpose of the transaction involved was the reductions, postponement or avoidance of tax liability. This is clearly to prevent sham transactions whereby liability for tax is transferred from a spouse in a high income bracket to his partner who is taxed in a lower bracket.

2. Section 7(7) is a complex section which if not understood and applied correctly can wreak havoc with an otherwise well-planned trust. One of the essential elements of a trust is the separation of trust assets from the donor/founder/settlor. Section 7(7) aims to strike those transactions which do not make a clean break in ownership/control. Thus, where by virtue of a donation/settlement/disposition the donor cedes the right to receive income from a source such as shares, deposits, trademark etc; while still retaining ownership or at the least an interest in the property from whence the income is derived then section 7(7) takes effect and any income will be deemed to be the income of the donor.

Section seven and most of its various subsections revolve around the definition of the phrase 'donation, settlement or other dispositions'. This is especially important because these provisions were expressly introduced to counteract the tax avoidance effect of the trust. "Donation" is clearly aimed at donations to set up a trust.

The words, 'settlement or other disposition' must clearly be interpreted "eiusdem generis" with the concept of 'donation' and as such indicate that an element of gratuity is required before any such transactions is struck by the provisions. This is important otherwise one would be faced with the situation where a perfectly legitimate, arm's-length transaction entered into between parent and child would be "hit" by the provisions.

The matter can be considered to have been authoritatively dealt with by the Appellate Division in *Ovenstone v SIR* [120] where it was decided that the words used indicate that the section requires an appreciable element of gratuity in the donation, disposition or other settlement, before it can come into operation. Thus it would be possible where a donation etc is partly gratuitous and partly of a commercial nature to apportion and to assess to tax accordingly.

## CONCLUSION

As can be seen, the trust is an excellent vehicle with which to provide for one's heirs after one's death or for those self-same heirs or other persons/organizations while one is still alive.

It allows enormous flexibility (in a properly worded trust-deed) in that the trustee is normally imbued with all those powers which the donor/founder/settlor would have had. This means that where circumstances arise which are not specifically dealt with in the trust deed the trustee is in a position to adapt. He may have to meet the changing needs of beneficiaries who are requiring large sums of cash urgently and is able to do so by making payments from the capital to which they would eventually be entitled. Thus the trustee can use his discretion in the administration of the trust, an attribute clearly advantageous to all.

It allows for the investment of the trust assets for the benefit of third parties by skilled, responsible persons with a greater knowledge and understanding of the exigencies involved than those third parties may possess. It removes the stress and narrows the margin of error for the beneficiaries, allowing them to enjoy the benefits without actually physically being concerned with generating them. This is especially important where the beneficiaries are minor children, prodigals, mentally defective or lack the knowledge and/or skill to successfully invest the assets of the deceased.

It also allows for the preservation of the trust assets. Via the investment mentioned above it is possible for one to maintain the capital amount (utilisable in emergencies) while allowing it to work, grow and benefit the beneficiaries.

Further, it usually prevents (to a large extent) embezzlement or other fraudulent dealings because the trustee is subject to the scrutiny of the Master and the courts and must keep the trust assets separate from his own. Thus no creditors of the trustee may attach or realise them, nor may any creditors of any beneficiary act against the assets directly.

Due to the operation of sections 7 and 103, the tax implications of a trust are not major considerations for the tax-planner anymore. This is because Inland Revenue has used them to close most avenues for the inventive souls who wish to pay only what is their fair share.

However, a trust is still effective in allowing the taxpayer to gain the maximum advantage from his assets for himself and others and there are definite tax-savings for those who are wary of the pitfalls.

The trust's strength lies also in the fact that it is not, nor has it ever been a static, dormant concept but remains a dynamic, developing one. As such it is sure to always keep touch with the needs of those whom it is intended to benefit and will probably continue to be an outlet for creativity in avoiding tax.

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