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Dissertation Topic:

The taxation of income and expenditure of trusts in South Africa

- Are they still the cosy vehicles of tax avoidance?

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Introduction

For many decades men have made provisions for their illegitimate children and mistresses by using secret trusts – hiding their embarrassing secrets from their families and friends¹. Many politicians and other public figures have been known to transfer assets to a trustee to manage in secret in order to avoid conflict of interest². Businesses employ trusts to protect the interests of debenture holders, to manage pension funds and to create employee share purchase and management incentive schemes³. Parents set up trusts to preserve funds for their children, others to support a religious or social cause⁴. For decades the trust has been a key tool in estate planning for wealthier individuals and for a very long time trusts have been described as cosy vehicles for tax avoidance. But recently, as a result of the changes in the tax legislation, trusts have received some bad press.

Gone are the days where one could put all their assets into a trust to avoid tax⁵. With the introduction of capital gains tax in 2001 and transfer duty, avoiding tax in a trust these days seems to be a little harder. The tightening of the money- laundering legislation internationally has meant that offshore trusts have also lost their status as safe havens to hide their illegal offshore funds from the Reserve Bank and the Receiver of Revenue⁶. And to top it off SARS has now entered into agreements with 35 tax havens such as the Seychelles, Mauritius, the Bahamas, Bermuda, the Isle of Man, the British Virgin Islands and Liberia, to improve transparency and to establish the effective exchange information in tax matters⁷.

With all these changes and updates in the tax legislation affecting trusts one question arises: are they still the cosy vehicles of tax avoidance?

¹ A. J. Oakley *Parker and Mellows: the modern law of trusts* 7ed (1998) 6

² Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 15

³ Cameron (note 2)

⁴ Cameron (note 2).

⁵ Maya Fisher French 'Be cautious about trust funds.' Available at <http://www.mg.co.za/article/2005-10-14-be-cautious-about-trust-funds> [Accessed 7 June 2009]

⁶ Ibid.

⁷ Simpiwe Piliso 'SARS turns screws on rich tax cheats' Available at <http://www.thetimes.co.za/PrintEdition/Article.aspx?id=954333> [Accessed 4 April 2009]

This research paper explores today's taxation of the income and expenditure of trusts. It digs deep into the mechanics of trusts to see if they are still worth to have. In order to answer all these questions this paper begins by exploring the background of trusts in section A, section B deals with the way they are taxed encompassing all the recent changes. Finally section C aims to answer the questions posed above and exactly why trusts enjoy ever-increasing and considerable popularity, even with all these unfavourable changes in the legislation.

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Section A

The background of trusts

Trusts originated in English law but now they are recognised and employed in most legal systems in the world⁸. After the British occupation of the Cape in 1806, the trust was imported into South African law by common usage⁹. It is now a vibrant and reliable institution of modern South African law, for which the courts have devised distinctively South African rules and principles, and for which new uses are constantly being devised¹⁰.

In the strict sense a trust exists when the founder of the trust has handed over or is bound to hand over to another the control of the property¹¹ which, or the proceeds of which, is to be administered or disposed of by the other (the trustee or the administrator) for the benefit of some person other than the trustee as beneficiary or some impersonal object¹². A trust in this sense creates a fiduciary obligation. In the wide sense a trust exists whenever someone is bound to hold or administer property¹³ on behalf of another or for some impersonal object and not for his or her own benefit¹⁴. Such a person has at the minimum a duty to keep the property administered separate from personal property¹⁵ and to avoid a conflict of interest with the beneficiary or the trust object¹⁶.

The source of our Trust law is the¹⁷:

- Unit Trust Control Act 54 of 1981
- Companies Act 61 of 1973
- Trust Property Control Act 57 of 1988

⁸ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 1-2

⁹ Cameron (note 8) at 2

¹⁰ Cameron (note8) at 2

¹¹ Cameron (note8) at 4

¹² Cameron (note8) at 4

¹³ Cameron (note8) at 3

¹⁴ Cameron (note8) at 3

¹⁵ Cameron (note8) at3

¹⁶ Cameron (note8) at3

¹⁷ Karin Fourie “ CP7_LG ‘Available at

http://www.bankseta.org.za/downloads/fais/business/CP7_LG_SEC4.doc [Accessed 3 August 2009]

Definitions

The Hague Convention on the Law applicable to Trusts and their Recognition of 10 January 1986 provides that the term 'trust' refers to the legal relationship created inter vivos or on the death by a person, the settler, when assets have been placed under the control of a trustee for the benefit of a beneficiary or a specified purpose¹⁸. Though South Africa is not party to the convention, the features of a trust in the strict sense as it developed in our law conform to the definition, which now reflects widespread international understanding and usage in relation to the trust concept¹⁹.

An authoritative statutory definition of "trust" was introduced into South African law by the Trust Property Control Act 57 of 1988, which came into operation on 1 March 1989²⁰. The Act defines the following terms to mean the following:

'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 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 instrument²¹; 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)²²;

¹⁸ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 5

¹⁹ Cameron (note 18) at 5

²⁰ Cameron (note 18) at 2

²¹ Trust Property Control Act 57 of 1988 s1.

²² Trust Property Control Act 57 of 1988 s1

In the law of Income Tax a trust is treated by a statute as a person (the definition of a person in section 1 if the Income Tax Act specifically includes a trust) which means that a trust is subject to normal taxation²³.

'trustee' means any person (including the founder of a trust) who acts as trustee by virtue of an authorization under section 6 and includes any person whose appointment as trustee is already of force and effect at the commencement of this Act²⁴;

'trust property' or **'property'** means movable or immovable property, and includes contingent interests in property, which in accordance with the provisions of a trust instrument are to be administered or disposed of by a trustee²⁵.

Section 1 of the Income Tax Act 58 of 1962 defines a **beneficiary** in relation to a trust as a person who has a vested or contingent interest in all or portion of the receipts or accruals of the assets of that trust²⁶.

In *Estate Kemp v MacDonald's Trustee* Solomon JA said that “the underlying concept of a trust is that while the legal dominium is vested in trustees, they have no beneficial interest but are bound to hold and apply the property for the benefit of some person or persons or for the accomplishment of some special purpose. In the same case Innes CJ held that the English word “trustees” means persons entrusted (as owners or otherwise) with the control of property with which they are bound to deal for the benefit of others”²⁷.

²³ Income Tax Act 58 of 1962 s1.

²⁴ Trust Property Control Act 57 of 1988 s1

²⁵ Trust Property Control Act 57 of 1988 s1

²⁶ Income Tax Act 58 of 1962 s1

²⁷ *Estate Kemp & others v MacDonald's Trustee* 1915 AD 491; David Clegg and Rob Stretch ‘Income tax in South Africa: estates trusts and income arising from gratuitous events’ vol 1 (October 2008) SI 34 Available at [http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed 3 September 2009]

Parties in a trust

There are three parties in a trust, namely the:

Founder - the donor is also known as the founder or testator²⁸. A trust cannot be established without a donor²⁹. Although the donor plays an important role, it is usually very short-lived³⁰. Once the trust is created, the donor plays no role in the management of the trust³¹. The donor may however have a role in the administration of the trust if the trust deed contains provisions to that extent³². However, a donor could also be the trustee and even beneficiary³³. Once the donor has donated the trust property, he/she loses control over the property³⁴. Even if the donor is the trustee as well, his power has ended³⁵. The trust property that the founder donates is any type of property, including moveable and immovable property³⁶.

Trustee - the basic duty of a trustee is to hold legal title to the trust property³⁷. They are bound to hold and apply the property³⁸ for the benefit of one or more individuals or organisations (i.e. the beneficiary, usually specified by the founder) for the accomplishment of some special purpose³⁹. The trustees owe a fiduciary duty to the beneficiaries, who are “beneficial” owners of the trust property⁴⁰. They have the power and duty (in respect of which to he or she may be held) to account, manage, employ or dispose of the trust assets in accordance with the terms of the trust deed and the special duties imposed by law⁴¹. The trustee may also be beneficiary of the trust and even the sole beneficiary but the trustee cannot be both sole trustee and sole beneficiary⁴². This way, every trust therefore imports the

²⁸ Karin Fourie “CP7_LG ‘Available at http://www.bankseta.org.za/downloads/fais/business/CP7_LG_SEC4.doc

²⁹ Ibid.

³⁰ Ibid.

³¹ Ibid.

³² Ibid.

³³ Edwin Cameron et al *Honore’s South African law of trusts* 5ed (2002) 553

³⁴ Karin Fourie “CP7_LG ‘Available at http://www.bankseta.org.za/downloads/fais/business/CP7_LG_SEC4.doc

³⁵ Ibid.

³⁶ Ibid.

³⁷ Wikipedia, the free encyclopedia ‘Trust law’ Available at http://en.wikipedia.org/wiki/Trust_law

[Accessed 15 July 2009]

³⁸ Ibid

³⁹ Ibid

⁴⁰ Cameron (note 33) at 11

⁴¹ Cameron (note 33) at 11

⁴² Cameron (note 33) at 553

element of holding or administering property in part at least for a person or object other than the trustee⁴³.

Beneficiary – any person, born or unborn, natural or juristic, may be a beneficiary of a trust⁴⁴. The trustee may be a beneficiary and even the sole beneficiary⁴⁵ but the trustee cannot be not sole trustee and sole beneficiary⁴⁶, since in that case there would be no element of administration for another and so no trust⁴⁷. The founder may be a beneficiary, even the sole beneficiary, as is often the case with nominee trusts⁴⁸ (a trust created for the purpose of holding property for beneficiaries whose identities are kept secret)⁴⁹.

The beneficiaries may be designated by name or description⁵⁰. If the name or description used does not unequivocally designate any one person or body the court may declare which, on the true interpretation of the trust deed was intended⁵¹. Often beneficiaries are designated as a class, such as ‘X’s children’ or ‘my grandchildren’⁵².

Trusts for unborn descendants of the founder are common and are accepted as valid⁵³. So are trusts for unformed companies, which are not trusts in the strict sense⁵⁴.

Sometimes the designated beneficiary is not a person⁵⁵ but an entity like a trust or unincorporated association which does not possess juristic personality⁵⁶. Such a designation is not invalid but the beneficiaries are taken to be the trustees, committee of the association or members in their capacity as such⁵⁷. They take not for their private benefit but for the purposes of the trust or association⁵⁸.

⁴³ Edwin Cameron et al *Honore’s South African law of trusts* 5ed (2002) 11

⁴⁴ Cameron (note 43) at 553

⁴⁵ Cameron (note 43) at 553

⁴⁶ Cameron (note 43) at 553

⁴⁷ Cameron (note 43) at 553

⁴⁸ Cameron (note 43) at 553

⁴⁹ ‘Trust definition’ Available at <http://dictionary.reference.com/browse/trust> [Accessed 14 July 2009]

⁵⁰ Cameron (note 43) at 553

⁵¹ Cameron (note 43) at 553-554

⁵² Cameron (note 43) at 553

⁵³ Cameron (note 43) at 553

⁵⁴ Cameron (note 43) at 553

⁵⁵ Cameron (note 43) at 553

⁵⁶ Cameron (note 43) at 553

⁵⁷ Cameron (note 43) at 553

⁵⁸ Cameron (note 43) at 553

Some beneficiaries are entitled to receive income from the trust property, or to receive the property itself⁵⁹. The extent of a beneficiary's interest depends on the wording of the trust document⁶⁰. One beneficiary may be entitled to income (for example, interest from a bank account), whereas another may be entitled to the entirety of the trust property when he attains a certain age⁶¹. There is a difference between beneficiaries with vested rights and those with contingent rights⁶². A beneficiary with vested rights will succeed to income or capital and one with contingent rights may never succeed unless the trustees exercise their discretion or an event occurs⁶³. The founder has much discretion when creating the trust, subject to some limitations imposed by law⁶⁴.

A vested right is 'immediate' in the sense that it does not depend on any further contingency such as the survival of the beneficiary to a given age or at the death of a given person⁶⁵. A vested right in this sense is therefore transmissible to the successors of the beneficiary on death or insolvency and forms an asset in the beneficiary's estate⁶⁶. It is generally alienable⁶⁷. In contrast, a contingent right does not form part of an asset in the beneficiary's estate on death or upon insolvency⁶⁸. It is a mere expectation, which can in general be ceded, though the cession by an insolvent of a contingent right is valid only if the insolvent estate is not adversely affected by it⁶⁹.

'Contingent right' has been described by the special court as merely a *spes* – an expectation which might never be realised⁷⁰. From its very nature it could not have a definite present value⁷¹. In the income tax sense, therefore, a vested right is an accrued right⁷².

⁵⁹ Wikipedia, the free encyclopedia 'Trust law' Available at http://en.wikipedia.org/wiki/Trust_law

[Accessed 15 July 2009]

⁶⁰ Ibid.

⁶¹ Ibid.

⁶² Keith Huxham and Phillip Haupt Notes on South African income tax 28 ed (2009) 726

⁶³ Huxham (note 62)

⁶⁴ Wikipedia, the free encyclopedia 'Trust law' Available at http://en.wikipedia.org/wiki/Trust_law

[Accessed 15 July 2009]

⁶⁵ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 556-557

⁶⁶ Cameron (note 66)

⁶⁷ Cameron (note 66)

⁶⁸ Cameron (note 66)

⁶⁹ Cameron (note 66)

⁷⁰ David Clegg and Rob Stretch 'Income tax in South Africa: estates trusts and income arising from gratuitous events' vol 1 (October 2008) SI 34 Available at <http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates&fn=default.htm&vid=mylnb:10.1048/enu> [Accessed 3 September 2009]

The creation of trusts

Trusts can be created by the expressed intentions of the founder⁷³ (the founder can be anyone who has the capacity to undertake contractual obligations⁷⁴) or they can be created by operation of law⁷⁵ (trusts can be set up by the court, by statute, or on statutory authority⁷⁶). Typically, one of the following ways creates a trust:

1. A written trust document created by the founder and signed by both the founder and the trustees (often referred to as an inter vivos trust or 'living trust')⁷⁷;
2. An oral declaration⁷⁸;
3. The will of a decedent, usually called a testamentary trust; or a court order (for example in family proceedings)⁷⁹.

In *Thorne and Molenaar NNO v Receiver of Revenue, Cape Town* Van Wilsen J described the creation of a trust as follows⁸⁰:

...in general a trust is created by contract, very often by a contract of donation or in virtue of an antenuptial contract 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, the latter being accorded a right against the trustee to enforce the trustee's compliance with his obligations towards the beneficiary concerned. Generally trusts contemplate an extended continuation of the administration of the trust property in favour of the beneficiary until terminated on the

⁷¹ David Clegg and Rob Stretch 'Income tax in South Africa: estates trusts and income arising from gratuitous events' vol 1 (October 2008) SI 34 Available at [http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed 3 September 2009]

⁷² Ibid.

⁷³ Wikipedia, the free encyclopedia 'Trust law' Available at http://en.wikipedia.org/wiki/Trust_law [Accessed 15 July 2009]

⁷⁴ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 117

⁷⁵ Cameron (note 74)

⁷⁶ Cameron (note 74) at 118

⁷⁷ Cameron (note 74) at 118

⁷⁸ Cameron (note 74) at 118

⁷⁹ Cameron (note 74) at 118

⁸⁰ *Thorne & Molenaar NNO v Receiver of Revenue, Cape Town* 1976 (2) SA 50 (C); David Clegg and Rob Stretch 'Income tax in South Africa: estates trusts and income arising from gratuitous events' vol 1 (October 2008) SI 34 Available at [http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed 3 September 2009]

happening of some specified future event. A trust can also, of course, be created by statute...

When a trust is being created by way of a written document, the document in question is known as the 'trust document'⁸¹. The trust is governed by the terms of the trust document, which is usually written and occasionally set out in deed form⁸². The trust deed is a legal document created by contract⁸³. It is a contract entered into by a founder who places certain assets under the administration of the trustees for the benefit of beneficiaries⁸⁴. The parties are the founder and the trustees (in certain instances beneficiaries are party to the contract)⁸⁵. The trustee is obliged to administer the trust in accordance with both the terms of the trust document and the governing law⁸⁶.

For a valid trust to be created⁸⁷:

(a) *the founder must intend to create one*⁸⁸ – the intention to create a trust in the strict sense⁸⁹ is whereby the founder intends that the transferee should hold an office⁹⁰ by virtue of which duties attaching to the office will descend to a successor in office rather than to the deceased trustee's executor⁹¹. Such a person is to purely hold the property in an administrative capacity⁹². The intention to create a trust between living persons (inter vivos) must be shared by the founder and the prospective trustee⁹³.

Cameron argues that words such as 'trust' and administrator' point to the creation of a trust but are not conclusive, since they may have been employed by mistake, or may denote trusts

⁸¹ Wikipedia, the free encyclopedia 'Trust law' Available at http://en.wikipedia.org/wiki/Trust_law
[Accessed 15 July 2009]

⁸² Ibid.

⁸³ Ibid

⁸⁴ Ibid.

⁸⁵ Ibid.

⁸⁶ Ibid.

⁸⁷ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 117

⁸⁸ Cameron (note 87) at 118

⁸⁹ Cameron (note 87) at 118

⁹⁰ Cameron (note 87) at 118

⁹¹ Cameron (note 87) at 118

⁹² Cameron (note 87) at 118

⁹³ Cameron (note 87) at 119

or trust-like arrangements only in a wide sense⁹⁴. He refers to the *Conze v Masterbond Participation Trust Managers* case to illustrate his point, where investors advanced money to a company against the issue of debentures secured by a debenture mortgage bond over immovable property and executed in favour of Masterbond as trustee for the debenture holders⁹⁵. Masterbond was referred to throughout the trust deed as the 'trustee'⁹⁶. The full bench of the Cape Provincial Division observed that this usage applied even where, in terms of the trust deed, Masterbond was patently acting as agent for the company to which the moneys invested were advanced⁹⁷. The argument was that the use of the word 'trustee'⁹⁸ in the trust deed with reference to Masterbond, indicated that a trust in the strict sense had been created⁹⁹ but when a testator appointed H 'sole and universal administrator of my estate and effects'¹⁰⁰ with no further directions and appointed J executor it was held that he intended not to create a trust but to appoint H sole heir¹⁰¹.

Cameron further argues that the intention maybe inferred even though no words referring to a 'trust' appear at all¹⁰². He uses the *Coetzee NO v Universiteit Stellenbosch* case as an example where the testator had after the happening of certain events willed the yearly yield of a capital sum as a bursary for the best student in physiology at the University of Stellenbosch¹⁰³. The residual heir sought the nullification of this bequest on the ground of vagueness, pointing out that no trustee had been appointed or named¹⁰⁴. The court upheld the bequest as a peculiar form of trust, observing that the testator is entitled to rely on the machinery of the law, which exists precisely to remedy such an omission¹⁰⁵.

⁹⁴ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 119

⁹⁵ Cameron (note 94)

⁹⁶ Cameron (note 94)

⁹⁷ Cameron (note 94)

⁹⁸ Cameron (note 94)

⁹⁹ Cameron (note 94)

¹⁰⁰ Cameron (note 94)

¹⁰¹ Cameron (note 94)

¹⁰² Cameron (note 94)

¹⁰³ Cameron (note 94)

¹⁰⁴ Cameron (note 94) at 119- 120

¹⁰⁵ Cameron (note 94) at 119- 120

legal effect of lack of intention to create a trust:

When the testator or donor uses words that are held to be indefinite¹⁰⁶, so that an intention to create a trust is lacking, the effect depends on whether the testator or donor intended to benefit the person to whom the property was given¹⁰⁷. If the intention to benefit was present, the supposed trust is disregarded and the legatee or donee takes free of any burden¹⁰⁸. If, on the other hand, the person to whom the property is given is not intended to be a beneficiary¹⁰⁹, the gift is invalid and may be recovered by the founder or his estate¹¹⁰. If the intention to create a trust is lacking because the trustee is insufficiently independent¹¹¹, the maxim that the real transaction prevails over the apparent one applies and the transaction is construed as agency, partnership, sale etc according to the intention of the parties¹¹².

(b) *the founder's intention must be expressed in a mode appropriate to create an obligation-*¹¹³ an intention to create a trust however clearly expressed is not enough unless couched in some form¹¹⁴, such as a will, contract, transfer, statute, treaty or judicial order, which is apt to create a legal obligation¹¹⁵. The obligation is either i) the obligation resting on the trustee to administer the property for the trust object¹¹⁶, or ii) the obligation resting on the founder to ensure that the property is administered by the trustee¹¹⁷.

(c) *the property subject to the trust must be defined with reasonable certainty*¹¹⁸ - The property subject to the trust must be clearly identified¹¹⁹. One cannot, for example, settle "the majority of my estate", as the precise extent cannot be ascertained.¹²⁰ Trust property can be any form of specific property, be it real or personal, tangible or intangible¹²¹.

¹⁰⁶ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 137

¹⁰⁷ Cameron (note 106)

¹⁰⁸ Cameron (note 106)

¹⁰⁹ Cameron (note 106)

¹¹⁰ Cameron (note 106)

¹¹¹ Cameron (note 106)

¹¹² Cameron (note 106)

¹¹³ Cameron (note 106) at 117

¹¹⁴ Cameron (note 106) at 137

¹¹⁵ Cameron (note 106) at 137- 138

¹¹⁶ Cameron (note 106) at 138

¹¹⁷ Cameron (note 106) at 138

¹¹⁸ Cameron (note 106) at 117

¹¹⁹ Wikipedia, the free encyclopedia 'Trust law' Available at http://en.wikipedia.org/wiki/Trust_law

[Accessed 15 July 2009]

¹²⁰ Ibid.

¹²¹ Ibid.

(d) *the trust object, which may either be personal or impersonal, must be defined with reasonable certainty*¹²²- The beneficiaries of the trust must be clearly identified, or at least be ascertainable¹²³. For instance in *Harter v Epstein* the testator appointed executors and trustees¹²⁴, made a specific bequest to his daughter and went on¹²⁵: ‘ the balance of my estate to be left to the discretion of my executors¹²⁶.’ It was held that the balance of the estate went on intestacy¹²⁷ since no valid trust was created nor could it be implied that the daughter was heir to the residue¹²⁸. In the case of discretionary trusts, where the trustees have power to decide who the beneficiaries will be, the settlor must have described a clear class of beneficiaries¹²⁹. Alternatively, the object of a trust could be a charitable purpose rather than specific beneficiaries¹³⁰, and finally

(e) *the trust object must be lawful*¹³¹- the objects of a trust will have to conform with the disavowal of unfair discrimination under the 1996 Constitution and the Promotion of Equality and Prevention of Unfair Discrimination Act¹³².

¹²² Edwin Cameron et al *Honore’s South African law of trusts* 5ed (2002) 117

¹²³ Wikipedia, the free encyclopedia ‘Trust law’ Available at http://en.wikipedia.org/wiki/Trust_law

[Accessed 15 July 2009]

¹²⁴ Cameron (note 122) at 151- 152

¹²⁵ Cameron (note 122) at 152

¹²⁶ Cameron (note 122) at 152

¹²⁷ Cameron (note 122) at 152

¹²⁸ Cameron (note 122) at 152

¹²⁹ Cameron (note 122) at 152

¹³⁰ Wikipedia, the free encyclopedia ‘Trust law’ Available at http://en.wikipedia.org/wiki/Trust_law

[Accessed 15 July 2009]

¹³¹ Cameron (note 122) at 117

¹³² Cameron (note 122) at 117

Types of trusts

In essence, there are two main types of trusts in South Africa. These are the inter-vivos (also known as the “living trust”) and the testamentary trust. A living trust is created during the lifetime of a person and may continue to operate after death¹³³; a testamentary trust is one created upon death, in terms of the provisions of a will of a deceased person¹³⁴.

Testamentary trusts - A testamentary trust is a legal entity created as specified in a person's will, and is occasioned by the death of that person¹³⁵ i.e. it only becomes effective after the founder's death¹³⁶. The guiding document in determining the ambit of the trust is therefore the last will and testament¹³⁷. It is created to address any estate accumulated during that person's lifetime or generated as a result of the death itself¹³⁸, such as a settlement in a wrongful-death suit, or the proceeds from a life insurance policy held on the founder¹³⁹.

As the donor of a testamentary trust is, by definition, deceased by the time the trust becomes active, they confer all powers of trusteeship to another individual, the trustee¹⁴⁰. The trustees will be named in the will, or in a separate document attached to the will but dealing specifically with the provisions of the trust¹⁴¹. It is also because of this reason that the founder will generally not have any influence over the trustee's exercise of discretion¹⁴², however the founder can offer documented instruction or guidance regarding the way in which the trustees should act¹⁴³. This can be done by the donor providing binding instructions

¹³³ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 117

¹³⁴ Keith Huxham and Phillip Haupt *Notes on South African income tax* 26 ed (2007) 579

¹³⁵ Wikipedia, the free encyclopedia ‘ Testamentary trust’ Available at

http://en.wikipedia.org/wiki/Testamentary_trust [Accessed 15 July 2009]

¹³⁶ Ibid.

¹³⁷ ‘General trust info’ Available at http://www.graaffs.co.za/general_trusts.htm

[Accessed on 15 July 2009]

¹³⁸ Ibid.

¹³⁹ Ibid.

¹⁴⁰ Estates or trusts ‘ What is a testamentary trust’

<http://www.estatesortrusts.co.uk/what-is-a-testamentary-trust.html> [Accessed 29 August 2009]

¹⁴¹ Ibid.

¹⁴² Ibid.

¹⁴³ Ibid.

to trustees in the trust deed¹⁴⁴, as well as non-binding guidance in a document known as a ‘letter of wishes’¹⁴⁵.

It is quite common for testamentary trusts to be designed to benefit individuals who are not yet of an age at which they could manage assets that have been given to them in the will¹⁴⁶. The trustee is appointed to direct the trust until a set time when the trust expires¹⁴⁷, such as when the minor beneficiaries reach a specified age or accomplish a deed such as completing a set educational goal or achieving a specified matrimonial status¹⁴⁸.

In practical terms, testamentary trusts tend to be driven more by the needs of the beneficiaries (particularly infant beneficiaries) than by tax considerations¹⁴⁹, which are the usual considerations in *inter vivos* trusts¹⁵⁰. A testamentary trust is taxed on the income it retains and its beneficiaries are taxed on the income it distributes¹⁵¹.

Inter - vivos trust / living trust - The term “inter-vivos” is a Latin term meaning ‘during life’¹⁵², thus, a living trust is constituted during the lifetime of the donor¹⁵³, and also comes into effect within this period. The founding document is the trust deed¹⁵⁴ (a special contract defining all the specifics of the operation of the trust¹⁵⁵). The trust is created by drafting a trust deed, usually in co-operation with an attorney specialising in trust law, and registering the trust with the local High Court¹⁵⁶.

¹⁴⁴ Estates or trusts ‘ What is a testamentary trust’

<http://www.estatesortrusts.co.uk/what-is-a-testamentary-trust.html> [Accessed 29 August 2009]

¹⁴⁵ Ibid.

¹⁴⁶ Ibid.

¹⁴⁷ Wikipedia, the free encyclopedia ‘ Testamentary trust’ Available at

http://en.wikipedia.org/wiki/Testamentary_trust [Accessed 15 July 2009]

¹⁴⁸ Ibid.

¹⁴⁹ Ibid.

¹⁵⁰ Ibid.

¹⁵¹ Keith Huxham and Phillip Haupt *Notes on South African income tax* 26 ed (2007) 579

¹⁵² Wikipedia, the free encyclopedia ‘ Living trust’ Available at

http://en.wikipedia.org/wiki/Testamentary_trust at [Accessed 15 July 2009]

¹⁵³ ‘General trust info’ Available at http://www.graaffs.co.za/general_trusts.htm

[Accessed on 15 July 2009]

¹⁵⁴ Ibid.

¹⁵⁵ Ibid.

¹⁵⁶ Ibid.

To establish a living trust, an individual transfers title of assets from himself as donor¹⁵⁷, to a trustee of the trust to administer for the benefit of himself and at least one other person¹⁵⁸. Assets can be transferred into the living trust by selling it to the trust (through a loan granted to the trust) or donating cash to it¹⁵⁹.

The creation and revocation of inter- vivos trusts and the acquisition of rights by the beneficiaries under them are regulated by the rules of contract law¹⁶⁰. There exist two types of contracts, namely

- A contract between the donor and the trustee¹⁶¹
- A contract between the trustee and the beneficiary(ies)¹⁶²

In the contract between the donor and the trustee, the trustee accepts the duties imposed upon him/her in terms of the trust deed¹⁶³ and the trustee acquires formal ownership of the trust assets subject to the terms prescribed in the trust deed¹⁶⁴. In the contract between the trustee and the beneficiary (ies)¹⁶⁵, the trust benefits are offered to the beneficiary by the trustee and accepted by the beneficiary¹⁶⁶.

The trust is managed by the trustees for the benefit of the beneficiaries¹⁶⁷. Since this trust is formed by a living person that means that the founder could be liable for tax on income received by the trust¹⁶⁸. Once the founder has died they can no longer be taxed, therefore the trust and the beneficiaries will only be able to be the only taxpayers subject to tax¹⁶⁹.

¹⁵⁷ Wikipedia, the free encyclopedia 'Living trust' Available at http://en.wikipedia.org/wiki/Living_trust
[Accessed on 15 July 2009]

¹⁵⁸ Ibid

¹⁵⁹ Ibid

¹⁶⁰ 'General trust info' Available at http://www.graaffs.co.za/general_trusts.htm

[Accessed on 15 July 2009]

¹⁶¹ Karin Fourie "CP7_LG" Available at http://www.bankseta.org.za/downloads/fais/business/CP7_LG_SEC4.doc

¹⁶² Ibid.

¹⁶³ Ibid.

¹⁶⁴ Ibid.

¹⁶⁵ Ibid.

¹⁶⁶ Ibid.

¹⁶⁷ Wikipedia, the free encyclopedia 'Living Trust' Available at http://en.wikipedia.org/wiki/Living_trust
[Accessed on 15 July 2009]

¹⁶⁸ Keith Huxham and Phillip Haupt *Notes on South African income tax* 26 ed (2007) 579

¹⁶⁹ Huxham (note 168)

There are two types of living trusts in South Africa, namely *vested trusts* and *discretionary trusts*¹⁷⁰. A vested trust, is one in which the beneficiaries have a personal right to claim their portion of the benefits from the trustees on the happening of a certain event specified in the trust deed¹⁷¹, whereas in discretionary trusts the trust beneficiaries have no rights whatsoever to claim the trust benefits except until the trustees have exercised their discretion and named the beneficiary and the award¹⁷². Beneficiaries in discretionary trusts are such in name only and are named only as eligible for benefits but not entitled thereto¹⁷³. Because the beneficiary has no rights whatsoever, in the event of death or insolvency¹⁷⁴, nothing can pass to the estate or creditors¹⁷⁵. This structure is therefore effective for estate planning from both the perspective of saving estate duty but also for protecting assets against creditors¹⁷⁶.

Special trusts- in section 1 of the Income Tax Act 58 of 1962 paragraph (a) of the definition of 'special trust' refers to a special trust as a trust that is created solely for the benefit of a person who suffers from a mental illness or a serious physical disability that prevents him from earning sufficient income for his maintenance¹⁷⁷. This type of trust can be created inter vivos or in terms of a will (testamentary)¹⁷⁸.

When the person for whose benefit the trust has been founded dies, the trust will no longer be deemed to be a special trust for the purposes of years of assessment ending on or after the date of death¹⁷⁹.

¹⁷⁰ Wikipedia, the free encyclopedia 'Living Trust' Available at http://en.wikipedia.org/wiki/Living_trust
[Accessed on 15 July 2009]

¹⁷¹ 'General trust info' Available at http://www.graaffs.co.za/general_trusts.htm
[Accessed on 15 July 2009]

¹⁷² 'General trust info' Available at http://www.graaffs.co.za/general_trusts.htm
[Accessed on 15 July 2009]

¹⁷³ Ibid.

¹⁷⁴ Ibid.

¹⁷⁵ Ibid.

¹⁷⁶ Ibid.

¹⁷⁷ Income Tax Act 58 of 1962 s1

¹⁷⁸ Professor Keith Jordaan et al *Silke: South African income tax* (2008) 659

¹⁷⁹ Jordaan (note 178)

When the trust is created in terms of the will of a deceased person¹⁸⁰, solely for the benefit of his relatives who are alive or conceived (even though not yet born) on the date of his death will¹⁸¹, it will also be classified as a special trust if the youngest beneficiary is under the age of 21 years¹⁸² on the last day of the year of assessment of the trust¹⁸³. The trust will cease to be a special trust the year of assessment when the youngest beneficiary attains the age of 21¹⁸⁴.

The benefit of being classified as a special trust is that for income tax purposes the rate will not be the fixed 40% that is applicable to ordinary trusts¹⁸⁵, but the sliding scale that varies from 18% to 40% that is applicable to individuals¹⁸⁶.

Trading trusts - A trading trust is a trust that carries on a business. A trading trust has a trust deed and¹⁸⁷:

can confer wide powers and discretions on trustees, e.g. the power to carry on a business¹⁸⁸, and the power to hold non-diversified, high-risk investments¹⁸⁹. Trading trusts usually have wide borrowing and lending powers¹⁹⁰, they can make provision for a corporate trustee and contain an adequate indemnity for trustees¹⁹¹.

A trading trust may be used as an alternative to other business structures such as the traditional limited liability company¹⁹².

¹⁸⁰ Professor Keith Jordaan et al *Silke: South African income tax* (2008) 659

¹⁸¹ Jordaan (note 180)

¹⁸² Jordaan (note 180)

¹⁸³ Income tax act 58 of 1962 s1 (par (b) of the definition of ‘special trust’); Professor Keith Jordaan et al *Silke: South African income tax* (2008) 659

¹⁸⁴ Jordaan (note 180) at 659

¹⁸⁵ Jordaan (note 180) at 659

¹⁸⁶ Jordaan (note 180) at 659

¹⁸⁷ Inland Revenue ‘ For businesses and employers: trading trusts’ <http://www.ird.govt.nz/yoursituation-bus/bus-aust-nz/types-bus/tradingtrusts/> [Accessed on 17 August 2009]

¹⁸⁸ Ibid.

¹⁸⁹ Ibid.

¹⁹⁰ Ibid.

¹⁹¹ Ibid.

¹⁹² Inland Revenue ‘ For businesses and employers: trading trusts’ <http://www.ird.govt.nz/yoursituation-bus/bus-aust-nz/types-bus/tradingtrusts/> [Accessed on 17 August 2009]

Family trusts- The term family trust refers to a discretionary trust set up to hold a family's assets or to conduct a family business¹⁹³. Generally, they are established for asset protection or for tax purposes¹⁹⁴.

A family trust:

is generally established by a family member for the benefit of members of the 'family group'¹⁹⁵. It can be the subject of a family trust election which provides it with certain tax advantages¹⁹⁶, provided that the trust passes the family control test¹⁹⁷ and makes distributions of trust income only to beneficiaries of the trust who are within the 'family group'¹⁹⁸.

They can assist in protecting the family group's assets from the liabilities of one or more of the family members¹⁹⁹ (for instance, in the event of a family member's bankruptcy or insolvency)²⁰⁰; and they provide a mechanism to pass family assets to future generations²⁰¹; and can provide a means of accessing favourable taxation treatment by ensuring all family members use their income tax "tax-free thresholds"²⁰².

A family trust has many other potential benefits²⁰³, including avoiding issues such as challenges to the will following a death of a senior member of the family²⁰⁴.

The problem with many family and trading trusts²⁰⁵ is that they are often specifically designed to be controlled by the founder²⁰⁶, beneficiaries and / or by their agents for their own benefit²⁰⁷. Unashamed control of a trust in this manner can cause the trust to be regarded as a sham or a front²⁰⁸, with the consequences that the assets under the so-called trust would

¹⁹³ 'Family trust' Available at <http://www.cleardocs.com/extra-family-trust.html> [Accessed on 29 August 2009]

¹⁹⁴ Ibid

¹⁹⁵ Ibid.

¹⁹⁶ Ibid

¹⁹⁷ Ibid

¹⁹⁸ Ibid

¹⁹⁹ Ibid

²⁰⁰ Ibid

²⁰¹ Ibid

²⁰² Ibid

²⁰³ Ibid

²⁰⁴ Ibid

²⁰⁵ Professor Walter Geach ' when a trust is not a trust : trading and family trusts under the spotlight'

Available at <http://www.mba.co.za/article.aspx?rootid=6&subdirectoryid=1607> [Accessed on 3 May 2009]

²⁰⁶ Ibid

²⁰⁷ Ibid

²⁰⁸ Ibid

be regarded as those of the person or persons who control the trust²⁰⁹, and the protection and planning opportunities afforded by trust ownership would be lost²¹⁰.

Public benefit trusts- The definition of a non-profit organisation, according to section 1(1)(x) of the Non- Profit Organisations Act 71 of 1997, is : “ a trust, company or other association of persons established for a public purpose: and the income and property of which are not distributable to its members or office- bearers except as reasonable compensation for services rendered²¹¹.” Section 56 (1) (i) of the Income Tax Act 58 of 1962 exempts any income retained by the trust or distributed by the trust of such nature²¹².

Non- resident trusts- A trust will be a non- resident if it was established outside the Republic and has its place of effective management outside the republic²¹³. The formation of offshore trusts is becoming increasingly popular with South African residents²¹⁴ and there are a significant number of South Africans who have set up trusts offshore in which the majority of beneficiaries are resident in South Africa²¹⁵.

In a study done in the year 2000²¹⁶, it was estimated that about 60% of the world’s transactions took place offshore²¹⁷. It was further estimated that more than 40% of these transactions were done via trusts²¹⁸. This implies that today more than a quarter of the worlds funds are housed in offshore trusts²¹⁹.

²⁰⁹ Professor Walter Geach ‘ when a trust is not a trust : trading and family trusts under the spotlight’

Available at <http://www.mba.co.za/article.aspx?rootid=6&subdirectoryid=1607> [Accessed on 3 May 2009]

²¹⁰ Ibid

²¹¹ Non- Profit Organisations Act 71 of 1997 s 1(1)(x)

²¹² Income Tax Act 58 of 1962 s56 (1) (i)

²¹³ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 729

²¹⁴ Annette Wanyana Oguttu ‘ Curbing offshore tax avoidance: the case of South African companies and trusts’

Available at <http://etd.unisa.ac.za/ETD-db/theses/available/etd-07302008-141314/unrestricted/thesis.pdf>

[Accessed on 28 June 2008]307

²¹⁵ Oguttu (note 214) at 307

²¹⁶ Oguttu (note 214) at 307

²¹⁷ Oguttu (note 214) at 307

²¹⁸ Oguttu (note 214) at 307

²¹⁹ Oguttu (note 214) at 307

There are various reasons for setting up such trusts²²⁰, for instance, non- resident trusts could be used for estate planning purposes²²¹, to protect assets from creditors²²², to avoid exchange control regulations²²³, as a hedge against the devaluation of the currency and political uncertainty²²⁴, to build up funds to finance children's education²²⁵, as a vehicle for overseas retirement funds²²⁶, and also to make it easier to engage in international transactions²²⁷. When a trust is set up in a low tax jurisdiction²²⁸, this often results in some tax advantages that the founders country of residence may try to restrict²²⁹.

²²⁰Annette Wanyana Oguttu 'Curbing offshore tax avoidance: the case of South African companies and trusts' Available at <http://etd.unisa.ac.za/ETD-db/theses/available/etd-07302008-141314/unrestricted/thesis.pdf>

[Accessed on 28 June 2008] 307

²²¹ Oguttu (note 220) at 307

²²² Oguttu (note 220) at 307

²²³ Oguttu (note 220) at 307

²²⁴ Oguttu (note 220) at 307

²²⁵ Oguttu (note 220) at 307

²²⁶ Oguttu (note 220) at 307

²²⁷ Oguttu (note 220) at 307

²²⁸ Oguttu (note 220) at 307

²²⁹ Oguttu (note 220) at 308

Section B

The taxation of trusts

In the law of income tax a trust is treated by the statute as a person (the definition of a person in section 1 of the Income Tax Act 58 of 1962 specifically includes any trust²³⁰) which means that a trust is subject to income tax. Trusts are taxed at a flat rate of 40%²³¹ and special trusts are taxed on a sliding scale that varies between 18% and 40%²³². A trust is not a natural person²³³ therefore it does not qualify for a primary or secondary rebate in terms of section 6 of the Income Tax Act²³⁴ or for the general dividend and interest exemption in terms of S10(1)(i)(xv)²³⁵.

The nature of income from a trust (the conduit pipe principle): Two Appeal court cases, *Armstrong v CIR 1938 (AD)* and *SIR v Rosen (AD)* held that income passing a trust retains its identity²³⁶. The trust merely acts a conduit pipe through which the income flows²³⁷. Therefore, if a trust receives South African dividend income and distributes it to a beneficiary in the year of receipt²³⁸, it retains its nature as a dividend, and is exempt from tax in the beneficiaries' hands²³⁹. In Rosen's case the court held that, even where a beneficiary received an annuity from a trust²⁴⁰, the income would still retain its identity so that if the trust had only dividend income, the full annuity received by the beneficiary would constitute the receipt of a dividend²⁴¹. However, s10 (2) (b) states that the dividend exemption in terms of s10(1)(k) does not apply in the case of dividends received as an annuity²⁴².

²³⁰ Income Tax Act 58 of 1962 s1

²³¹ Professor Keith Jordaan et al *Silke: South African income tax* (2008) 658

²³² Jordaan (note 231) at 659

²³³ Jordaan (note 231) at 659

²³⁴ Jordaan (note 231) at 659

²³⁵ Jordaan (note 231) at 659

²³⁶ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 728

²³⁷ Huxham (note 236)

²³⁸ Huxham (note 236)

²³⁹ Huxham (note 236)

²⁴⁰ Huxham (note 236) at 729

²⁴¹ Huxham (note 236) at 729

²⁴² Income Tax Act 58 of 1962 s10 (2)(b); Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 729

The most important taxes from the point of view of the law of trusts²⁴³ are: a) income tax b) donations tax c) transfer duty and as well as a capital gains tax (which was introduced with effect from 1 October 2001)²⁴⁴.

a) income tax

Income tax is a tax on income received by or accruing to in favour of any person during the year of assessment, excluding receipts or accruals of a capital nature²⁴⁵. In the case of a resident the tax is levied on worldwide income²⁴⁶, while in the case of any person other than a resident the tax is levied on income from a source within or deemed to be within the Republic²⁴⁷. In relation to a trust the word “resident” means a trust established or formed in the Republic or which has its place of effective management in the Republic²⁴⁸.

Section 25B of the Income Tax Act is the principal taxing section relating to trusts²⁴⁹. The section provides that the income received by or accrued to or in favour of any person in his capacity as the trustee of a trust shall, subject to the provisions of section 7, to the extent to which such income has been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, be deemed to be income which has accrued to the beneficiary, and to the extent to which such income is not so derived, be deemed to be income of the trust²⁵⁰. However section 25B is made subject to section 7 of the Income Tax Act, which means that, where section 7 applies, it overrides the provisions of section 25B²⁵¹.

Section 7 is an anti-avoidance provision aimed at taxing in the hands of the donor, any income which has resulted from a donation or similar disposition²⁵². Section 7 effectively seeks to tax the person who introduced the assets into the trust²⁵³ on the income generated by

²⁴³ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 444

²⁴⁴ Cameron (note 243)

²⁴⁵ Cameron (note 243) at 444

²⁴⁶ Cameron (note 243) at 444

²⁴⁷ Cameron (note 243) at 444

²⁴⁸ Cameron (note 243) at 444

²⁴⁹ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 718

²⁵⁰ Income Tax Act 58 of 1962 s25B (1)

²⁵¹ Huxham (note 249) at 720

²⁵² Huxham (note 249) at 720

²⁵³ Huxham (note 249) at 720

those assets i.e. it is concerned with the persons who transferred the assets into the trust and not with who formed or created the trust²⁵⁴.

There are therefore three possibilities as regards the incidence of tax on income that is the subject of a trust²⁵⁵. Such income may be 1) the income of the beneficiary²⁵⁶, or 2) the income of the trust fund which by statute possesses legal personality for income tax purposes²⁵⁷, or 3) the income of the donor²⁵⁸.

The income of the beneficiary

Where the terms of the trust deed are such that the beneficiary has acquired a vested right to any income in consequence of the exercise by the trustee of a discretion vested in him in terms of the trust deed, agreement or will of a deceased person, such income shall be deemed to have been derived for the benefit of the beneficiary²⁵⁹. The income accrues to the beneficiary when the right to receive it²⁶⁰, whether presently or in the future is vested in him in the year of assessment²⁶¹, whether or not the income is actually paid to him in that year²⁶². This means that it is the beneficiary and not the trustee that will be taxed on the income. In *Estate Munro v CIR* it was held that even if income from a trust is not paid directly to the beneficiary but is expended by the trustee for his benefit, the income will be taxed in the hands of the beneficiary²⁶³. This rule also applies where the income is accumulated or capitalised or otherwise dealt with in the beneficiary's name²⁶⁴.

²⁵⁴ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 720

²⁵⁵ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002)

²⁵⁶ Cameron (note 255)

²⁵⁷ Cameron (note 255)

²⁵⁸ Cameron (note 255)

²⁵⁹ Income Tax Act 58 of 1962 s25B(2)

²⁶⁰ Cameron (note 255) at 446

²⁶¹ Cameron (note 255) at 446

²⁶² Cameron (note 255) at 446

²⁶³ *Estate Munro v CIR* 1925 TPD 693; David Clegg and Rob Stretch 'Income tax in South Africa: estates trusts and income arising from gratuitous events' vol 1 (October 2008) SI 34 Available at [http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed 3 September 2009]

²⁶⁴ Ibid.

The principle of taxing the beneficiary and not the trustee will be applicable only if the beneficiary has a vested right to such income during the year in which the income arises or²⁶⁵, if he has no such right and he receives the income on distribution by the trustees, prior to the tax year end in which it has accrued to the trust²⁶⁶. If he has no right, it cannot be said that the income has accrued him²⁶⁷.

Where the beneficiary has a vested right to the income retained in the trust, s7 (1) applies²⁶⁸. This means that the beneficiary is certain to get the income at some time in the future²⁶⁹, only his enjoyment of it has been postponed²⁷⁰. If he dies before the income is paid out to him, it will go to his estate²⁷¹. Therefore as the income is effectively the beneficiary's and nobody else's, he will be taxed on it²⁷².

If the terms of the trust deed are such that no beneficiary is entitled to the trust income at present²⁷³, and such income is accumulated and distributed to the beneficiaries in a later year²⁷⁴, the income is subject to tax in the hands of the trustees as representative taxpayer²⁷⁵.

In the case of a discretionary trust there can be no accrual of an ascertainable amount of the income to a beneficiary²⁷⁶ until the trustee exercises his power of discretion and distributes the income to a beneficiary²⁷⁷, when he becomes assessable on the income so distributed²⁷⁸. The reason for this is that until the discretion of the trustee has been exercised²⁷⁹ the

²⁶⁵ David Clegg and Rob Stretch 'Income tax in South Africa: estates trusts and income arising from gratuitous events' vol 1 (October 2008) SI 34 Available at [http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed 3 September 2009]

²⁶⁶ Ibid

²⁶⁷ Ibid

²⁶⁸ Income Tax Act 58 of 1962 s7(1)

²⁶⁹ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 726

²⁷⁰ Huxham (note 269) at 726

²⁷¹ Huxham (note 269) at 726

²⁷² Huxham (note 269) at 726

²⁷³ David Clegg and Rob Stretch 'Income tax in South Africa: estates trusts and income arising from gratuitous events' vol 1 (October 2008) SI 34 Available at [http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed 3 September 2009]

²⁷⁴ Ibid

²⁷⁵ Ibid

²⁷⁶ Huxham (note 269)

²⁷⁷ Huxham (note 269)

²⁷⁸ Huxham (note 269)

²⁷⁹ Huxham (note 269)

beneficiary has no more than a contingent right²⁸⁰ and it is only on the exercise of this discretion by the trustee that the right to the income vests in the beneficiary and he becomes taxable thereon²⁸¹.

Any deduction or allowance which may be made under the provisions of the Income Tax Act in the determination of the taxable income shall, to the extent to which such income is deemed to be income of the beneficiary be deemed to be a deduction or allowance which may be made in the determination of the taxable income of that beneficiary²⁸². However, the deduction or allowance to which a beneficiary is entitled in a particular year of assessment is limited to the trust income which is deemed to accrue to the beneficiary in that year²⁸³.

Any amount that the beneficiary is precluded from claiming as a deduction or allowance in terms of this provision may be claimed as a deduction or allowance of the trust, provided that the sum of the deductions and allowances shall be limited to the or allowance be carried forward and claimed by the beneficiary in the succeeding year of assessment²⁸⁴.

Receipts and accruals of the trust that are deemed to have accrued to a beneficiary retain the same character in the hands of the beneficiary and is exempt from tax in the beneficiary's hands²⁸⁵. The trustee is regarded as a mere conduit pipe through which the amount passes to the beneficiary²⁸⁶.

²⁸⁰ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009)

²⁸¹ Huxham (note 280)

²⁸² Income Tax Act 58 of 1962 s25B(3) ; Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 449

²⁸³ Income Tax Act 58 of 1962 s25B(3)

²⁸⁴ Income Tax Act 58 of 1962 s25B(5) AND (6) ; Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 449

²⁸⁵ Income Tax Act 58 of 1962 s 10 (1)(k); Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 449

²⁸⁶ *SIR V Rosen* 1971 (1) SA 172; Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 449

The income of the trust

Amounts that are received by or accrue to the trustee are deemed to accrue to the trust and where the income is retained in the trust, it will be taxed in terms of s25B, to the extent to which such income has not been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, in which case it will be taxed in terms of s7 (1) where the beneficiary will be taxed²⁸⁷.

Where a trust receives or accrues income, and it is not paid out to the beneficiaries because there is a stipulation in the trust deed which prohibits the payment to the beneficiaries until the happening of some event s7 (5) will apply and the income will be taxed in the trust²⁸⁸. Where the trust receives income not vested in a beneficiary, and which also cannot be said to arise in consequence of a donation, settlement or similar disposition, the trust will be taxed on such income²⁸⁹. Income not distributed by the trust will be taxed in either in the trust's hands or the donor's hands²⁹⁰, so that if it is distributed after the year- end, it has already been taxed and cannot be taxed again²⁹¹. The accumulated income becomes capital of the trust²⁹².

In the determination of the liability for tax, the trustee may deduct any expenditure incurred in respect of which the trust qualifies²⁹³. This will include expenditure such as trustees' remuneration, interest paid, and the premium on a fidelity bond, and may give rise to an assessed loss²⁹⁴. Any deduction or allowance that may be made under the provisions of the Income Tax Act in the determination of the taxable income derived by way of such income is deemed to be a deduction or allowance that may be made in the determination of the taxable

²⁸⁷ Income Tax Act 58 of 1962 S25B (1); Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 451

²⁸⁸ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 726

²⁸⁹ Huxham (note 288)

²⁹⁰ Huxham (note 288)

²⁹¹ Huxham (note 288)

²⁹² Huxham (note 288)

²⁹³ David Clegg and Rob Stretch ' Income tax in South Africa:estates trusts and income arising from gratuitous events' vol 1 (October 2008) SI 34 Available at [http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed 3 September 2009]

²⁹⁴ Ibid.

income derived by the trust²⁹⁵. In addition any amount that is disallowed as a deduction or allowance by a beneficiary in terms of s25B of the Income Tax Act can be claimed as a deduction or allowance by the trust²⁹⁶.

If income of a non- resident trust does not vest in a beneficiary and is not subject to section 7 it will be subject to tax in the trust if it is from a source or deemed South African source²⁹⁷. If such income is not from a South African source it is not subject to tax in South Africa²⁹⁸.

The income assessable to the donor

There are certain cases where the income that would otherwise be treated as income of the beneficiary²⁹⁹ or of the trust is deemed to income of the donor³⁰⁰, who may be either the founder or funder of the trust³⁰¹. The donor must then pay the tax but can recover the amount from the person entitled, whether on his own behalf or in a representative capacity, to the receipt of the income³⁰². The cases all arise with trust inter vivos³⁰³.

In terms of s7(3) when a parent creates a trust of which the minor child is a beneficiary income that would normally be treated as the child's income is deemed to be that of the parent³⁰⁴. Under the Act income is deemed to have been received by the parent of the minor child if by reason of any donation, settlement or other disposition made by the parent or has accrued to or in favour of the child; or has been expended for the maintenance, education or benefit of the child; or has been accumulated for the benefit of the child³⁰⁵.

²⁹⁵ Income Tax Act 58 of 1962 s25B (3); Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 452

²⁹⁶ Income Tax Act 58 of 1962 s25B (5)(a)

²⁹⁷ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 730

²⁹⁸ Huxham (note 297)

²⁹⁹ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 454

³⁰⁰ Cameron (note 299)

³⁰¹ Cameron (note 299)

³⁰² Income Tax Act 58 of 1962 s90; Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 454

³⁰³ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 454

³⁰⁴ Income Tax Act 58 of 1962 s7(3)

³⁰⁵ Income Tax Act 58 of 1962 s7(3); Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002)

A donation is a wholly gratuitous disposal, made out of the liberality or generosity of the donor³⁰⁶. ‘Donation’ here includes a donation in trust for the child³⁰⁷. A ‘settlement’ is a gratuitous disposal of property subject to specific terms and conditions, usually to the trustees of a trust³⁰⁸. In *Overstone v SIR* ‘disposition’ was interpreted as meaning any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer³⁰⁹. In *Joss v SIR*, Coetzee J indicated that ‘other disposition’ excluded transactions made for full value in money or money’s worth and that there had to be an element of liberality³¹⁰.

S7(4) of the Act deems income to be of the parent when he or she or his spouse makes a donation, settlement or other disposition or gives some other consideration in favour directly of a person who makes a disposition for the benefit of the parent’s minor child³¹¹. This provision is aimed at reciprocal trusts and settlements, as when A creates a trust in favour of B’s minor children in consideration of B’s creating a trust in favour of A’s³¹².

S7(5) states that if someone has made a donation, settlement, interest- free loan, or similar gratuitous disposition to a trust then the income arising out of such a gratuitous disposition is deemed to be the income of the person who made the disposition (if the income is retained in the trust due to a stipulation in the trust deed which states that the income shall not be distributed until the happening of some event)³¹³. This means that the income of a discretionary trust which arises from a donation, settlement or disposition will always be taxed in the ‘donors’ hand in terms of s7 (5) unless it is distributed to the beneficiaries³¹⁴. Such income will only be taxed in the trust once the donor has died³¹⁵.

³⁰⁶ Keith Huxham and Phillip Haupt *Notes on South African income tax* 26 ed (2007) 584

³⁰⁷ Edwin Cameron et al *Honore’s South African law of trusts* 5ed (2002) 454

³⁰⁸ Huxham (note 306) at 584

³⁰⁹ *Overstone v SIR* 1980 (2) SA 721 (A); Huxham (note 306) at 584

³¹⁰ *Joss v SIR* 1980 (1) SA 664 (T); Huxham (note 306) at 584

³¹¹ Income Tax Act 58 of 1962 s7(4); Cameron (note 307) at 584

³¹² Cameron (note 307) at 584

³¹³ Income Tax Act 58 of 1962 s7(4); Huxham (note 306) at 581

³¹⁴ Huxham (note 306) at 581

³¹⁵ Huxham (note 306) at 581

Income is also deemed to be that of the donor if a deed of donation, settlement or other disposition contains any stipulation that the right to receive any income thereby conferred may, under powers retained by the person by whom that right is conferred, be revoked or conferred upon another, so much of any income as in consequence of the donation, settlement or other disposition is received by or accrues to or in favour of the person on whom that right is conferred, shall be deemed to be the income of the person by whom it is conferred, so long as he retains those powers.- s7 (6)³¹⁶

The Woulidge principle- In *C: SARS v Woulidge* the Court found that where a disposition in the form of an interest- free loan leads to income attributable to the creditor, the limitation of the attribution of that income to an amount equal to the capital outstanding on a cumulative basis (based upon a notional interest forgone)must apply³¹⁷ .

The trustee as representative taxpayer

The trustee as representative taxpayer is liable to pay normal tax in respect any income received or controlled by him in his private capacity³¹⁸. The trustee is however entitled to recover the amount from the person on whose behalf it is paid, or to retain out of any moneys that are in his possession or come to him in his representative capacity the amount so paid³¹⁹. But a representative taxpayer is personally liable for any tax payable in a representative capacity, while it remains unpaid, he or she a) alienates, charges or disposes of the income in respect of which the tax is chargeable, or b) disposes of or parts with any fund of money, which is in his or possession or comes to him or her after the tax is payable, if the tax could legally have been paid from or out of that fund of money³²⁰.

³¹⁶ Income Tax Act 58 of 1962 s7(6); Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 458

³¹⁷ *C: SARS v Woulidge* 2002 (1) SA 68 (SCA) ; David Clegg and Rob Stretch ' Income tax in South Africa: estates trusts and income arising from gratuitous events' vol 1 (October 2008) SI 34 Available at [http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates\\$fn=default.htm\\$vid=mylnb:10.1048/enu](http://butterworths.uct.ac.za/nxt/gateway.dll?f=templates$fn=default.htm$vid=mylnb:10.1048/enu) [Accessed 3 September 2009]

³¹⁸ Income Tax Act 58 of 1962 s90 (1)(a); Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 461

³¹⁹ Income Tax Act 58 of 1962 s96 (1); Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 461

³²⁰ Income Tax Act 58 of 1962 s97

Income and capital distributed by the foreign trust

If a trust is formed in an offshore jurisdiction, its income cannot be taxed in South Africa unless it is distributed to a resident beneficiary³²¹. However should the offshore trust be managed in South Africa³²² (i.e. if the trustees carry out the day- to –day management of the trust in the republic)³²³, South Africa may apply the residence basis of taxation to tax the worldwide income of that trust³²⁴.

If the beneficiary of a non- resident trust is a South African resident all of the income which vests is subject to tax in South Africa in that resident's hands³²⁵.

If the beneficiary of a non-resident trust is also a non-resident, one has to determine whether the source of the distribution is the trust itself or the asset owned by the trust³²⁶. This depends on the terms of the trust deed³²⁷. If the obligation on the trustees is to distribute the income arising from the assets to the beneficiaries³²⁸, the non-resident beneficiary would be taxed on the income arising from the South African assets, unless an exemption applies³²⁹.

In terms of s 25B (2A) where during any year of assessment, any resident acquires a vested right to any amount representing capital of any trust which is not a resident, that amount must be included in the income of the resident if; a) that capital arose from any receipts or accruals of the trust which would have constituted income if such trust had been a resident, in any previous year in which the resident had a contingent right to that amount; and b) that amount has not been subject to tax in the republic³³⁰.

³²¹ Annette Wanyana Oguttu 'Curbing offshore tax avoidance: the case of South African companies and trusts' Available at <http://etd.unisa.ac.za/ETD-db/theses/available/etd-07302008-141314/unrestricted/thesis.pdf>

[Accessed on 28 June 2008]

³²² Oguttu (note 321)

³²³ Oguttu (note 321)

³²⁴ Oguttu (note 321)

³²⁵ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 731

³²⁶ Huxham (note 325)

³²⁷ Huxham (note 325)

³²⁸ Huxham (note 325)

³²⁹ Huxham (note 325)

³³⁰ Income Tax Act 58 of 1962 s25B (2A); Huxham (note 325) at 731

b) donations tax

Donations tax is payable on the net transfer of assets from one person to another³³¹, therefore when a donor transfers assets to a trust he/ she is said to have made a donation. The donations tax provisions are contained in section 54 to 64 of the Income Tax Act 58 of 1962³³². Donations tax is not an income tax; it is a tax on the transfer of wealth³³³. The tax fulfils a two – fold function³³⁴; it imposes a tax on persons who may want to donate their assets in order to avoid normal income tax on the income derived from those assets³³⁵, and / or estate duty when those assets are excluded from their estates³³⁶. It is a tax payable on the value of any property disposed of under any donation (at a flat rate of 20%) by a South African resident (the same as estate duty)³³⁷. Donations tax provisions do not apply to non- residents even if they donate South African assets³³⁸.

For tax purposes ‘donation’ means any gratuitous disposal of property or any gratuitous waiver or renunciation of a right³³⁹. The word ‘donee’ means any beneficiary under a donation including, where property is donated to a trustee to be administered by him for the benefit of any beneficiary, such trustee³⁴⁰. ‘Property’ means any right in or to property movable or immobile, corporeal or incorporeal, wherever situated³⁴¹.

A donation takes effect when all the legal formalities have been complied with³⁴². An oral donation takes effect on the date of delivery³⁴³. A promise to donate that has not yet been completed by delivery takes effect when the donor commits the promise to writing and signs the relevant document³⁴⁴. There must be acceptance by the donee for a valid donation to be constituted³⁴⁵. Therefore, a donation will not take effect until it is accepted by the donee³⁴⁶.

³³¹ Professor Keith Jordaan et al *Silke : South African income tax* (2009) 645

³³² Jordaan (note 331) at 645

³³³ Jordaan (note 331) at 645

³³⁴ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 665

³³⁵ Huxham (note 334) 665

³³⁶ Huxham (note 334) 665

³³⁷ Huxham 666

³³⁸ Huxham (note 334) 665

³³⁹ Income Tax Act 58 of 1962 s55

³⁴⁰ Income Tax Act 58 of 1962 s55

³⁴¹ Income Tax Act 58 of 1962 s55

³⁴² Jordaan (note 331) at 647

³⁴³ Jordaan (note 331) at 647

³⁴⁴ Jordaan (note 331) at 647

³⁴⁵ Jordaan (note 331) at 647

The person liable to pay the tax is the donor, but if the donor fails within 3 months of the donation taking effect, the donor and the donee are jointly and severally liable for the tax³⁴⁷. A donee who is a trustee is a representative taxpayer in respect of donations to the trust³⁴⁸, thus the trustee is bound to pay the donations tax if the donor does not³⁴⁹. Even for purposes of exemption the trustee may be treated as donee³⁵⁰.

There is, however, for any given purpose only a single donation to the trustee or beneficiary; otherwise tax would be payable twice³⁵¹. For example³⁵² in *ITC 891* the donor gave R40 000.00 by notarial deed to trustees to pay the income to his daughter until her death or until she abandoned her right, then to her children born or unborn, the capital to be distributed in equal shares to the donor's grandchildren when the youngest attained 21 with provisions for substitution and accrual. The Special Court held that the donor had made a single donation to the trustee, not a series of donations to the various beneficiaries, and was therefore taxable on the basis that he made one donation of R40 000.00.

The Act creates a general of deemed donations. It provides that if in the opinion of the Commissioner property has been disposed of for an inadequate consideration the property is for purposes of donations tax deemed to have been disposed of under a donation³⁵³. The amount of the deemed donation will be the value of the property less the consideration payable by the person acquiring it³⁵⁴.

Exemptions from donations tax:

In terms of s56 (1) of the Act, donations tax is not payable in respect of the value of any property that is disposed of under a donation³⁵⁵ (the following exemptions apply to the law of trusts):

³⁴⁶ Professor Keith Jordaan et al *Silke : South African income tax* (2009) 647

³⁴⁷ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28ed (2009) 671

³⁴⁸ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 462

³⁴⁹ Cameron (note 348) at 462

³⁵⁰ Cameron (note 348) at 462

³⁵¹ Cameron (note 348) at 462

³⁵² Cameron (note 348) at 462

³⁵³ Income Tax Act 58 of 1962 s58

³⁵⁴ Huxham (note 347) at 672

³⁵⁵ Income Tax Act 58 of 1962 s56 (1)

- a) to or for the benefit of the spouse of the donor under a duly registered antenuptial or postnuptial contract or under a notarial contract entered into as contemplated in s21 of the Matrimonial Property Act 88 of 1984³⁵⁶;
- b) to or for the benefit of the spouse of the donor who is not separated from him under a judicial order or notarial deed of separation³⁵⁷;
- *for exemptions (a) and (b) a donation to trustees in trust for the donor's spouse should be treated as a donation to the spouse³⁵⁸. Otherwise there would be an unjustifiable difference between the exemptions available in the case of direct donations to a spouse and indirect donations to a spouse through a trustee³⁵⁹. But the exemption will not apply to that part of the donation that is intended to benefit persons other than the spouse of the donor, eg children of the marriage³⁶⁰.*
- d) in terms of which the donee will not obtain any benefit there under until the death of the donor³⁶¹;
- *the Transvaal special court has decided that, though no beneficiary obtains a benefit until the donors death, the trustees to whom the bare dominium is transferred during the donor's lifetime must pay donations tax on the value of the bare dominium, since the definition of 'donee' includes a trustee and the benefit envisaged need not be a profit but an advantage obtained on behalf of the ultimate beneficiaries³⁶².*
- e) which is cancelled within six months from the date on which it took effect³⁶³
- h) by or to any person (including any government) referred to in s10(1) (a), (b), (cA), (cE), (cN), (d) or (e)³⁶⁴;
- i) by or to any institution for the advancement of science or art or of a charitable, educational or religious nature, if the Minister of Finance is satisfied that the operations of such institution are in the interest of the public³⁶⁵;
- *For example³⁶⁶: Last year the Jacob Zuma trust known as the 'Friends of Jacob Zuma Trust' came under the spotlight when the South African official opposition party the*

³⁵⁶ Income Tax Act 58 of 1962 s56(a)

³⁵⁷ Income Tax Act 58 of 1962 s56(b)

³⁵⁸ Edwin Cameron et al Honore's South African law of trusts 5ed (2002) 465

³⁵⁹ Cameron (note 358) at 465

³⁶⁰ Cameron (note 358) at 465

³⁶¹ Income Tax Act 58 of 1962 s56(d)

³⁶² Cameron (note 358) at 465

³⁶³ Income Tax Act 58 of 1962 s56(e)

³⁶⁴ Income Tax Act 58 of 1962 s56(h)

³⁶⁵ Income Tax Act 58 of 1962 s56(h)

³⁶⁶ I-Net Bridge 'Zuma's trust's implications questioned' Available at <http://www.mg.co.za/article/2006-08-08-zuma-trusts-tax-implications-questioned> [Accessed 7 June 2009]

Democratic Alliance (DA) questioned the then Commissioner of the South African Revenue Services (SARS) whether the trust has been registered as a non-profit organisation and whether SARS would pursue any donors who made donations to the trust for a donations tax. The definition of a non-profit organisation, according to section 1(1)(x) of the Non-Profit Organisations Act 71 of 1997, is: "A trust, company or other association of persons established for a public purpose: and the income and property of which are not distributable to its members or office-bearers except as reasonable compensation for services rendered." Because the purpose of the trust was to fund Jacob Zuma's private interests and since the money generated by the trust would not be distributed to its members, the trust was not benefiting the public and the people who made donations would be subject to donations tax if their donations for the year exceeded R100 000.

- l) if the property is disposed of under and in pursuance of any trust...³⁶⁷
- *literally it renders all donations in trust exempt from tax provided that the donor had previously undertaken to create a trust³⁶⁸. This is because the transfer of property to the trustee is then done; in pursuance of a trust' though not 'under a trust'³⁶⁹. But clearly a more restricted interpretation is called for³⁷⁰. The most obvious application of the exemption is in the case where the trustee pays over income or capital to the beneficiary³⁷¹. It may be argued that though the trustee is not impoverished by making the payment it nevertheless amounts to a donation by him to the beneficiary³⁷². In that case exemption (l) prevents payment attracting donations tax.³⁷³*

The value for donations tax is calculated on a similar basis to that for estate duty³⁷⁴. For purposes of fiduciary, usufructuary or other like interest in property, an amount is determined by capitalising 12 percent the annual value of the right of enjoyment of the property. Annuities are also calculated the same way³⁷⁵.

³⁶⁷ Income Tax Act 58 of 1962 s56(1)

³⁶⁸ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 465

³⁶⁹ Cameron (note 368) at 465

³⁷⁰ Cameron (note 368) at 465

³⁷¹ Cameron (note 368) at 465

³⁷² Cameron (note 368) at 465

³⁷³ Cameron (note 368) at 465

³⁷⁴ Cameron (note 368) at 466

³⁷⁵ Income Tax Act 58 of 1962 s62 (1) (b); Cameron (note 368) at 466

Donations tax is not payable on so much of the sum of the values of all property donated by a natural person as does not during any year of assessment exceed R100 000.00 and it is also not payable on the value of any casual gifts made by a donor (other than a natural person) during the year of assessment is less than or more than 12 months, the R10 000 limit must be adjusted proportionately³⁷⁶.

Tax free donations can also be used to save on estate duty especially for those people with larger estates³⁷⁷. For example: With the amount that can be donated free of donations tax by natural persons having been increased to R100 000 in 2007³⁷⁸, an old estate planning technique once again became attractive³⁷⁹.

The plan works as follows³⁸⁰:

Husband and wife are each allowed to donate R100 000 per year. Because donations between spouses are exempt from donations tax, which means R200 000 per year can be donated per couple. Assuming one spouse is wealthier than the other, the wealthier spouse can donate R100 000 to the poorer spouse, who can then donate the R100 000 as part of his or her tax-free donation.

The couple therefore donates R200 000 per year to a trust. Note that there is no loan account - the money belongs to the trust.

The trust then invests the money in a growth investment. The most ideal vehicle for a trust to invest in is an endowment policy, as then there is no direct tax on the policy for the investor. This means the high rate of tax on a trust is effectively bypassed. In addition, it means that section 7 of the Act is not applicable, as there is no tax to attribute to the donor.

The policy then matures tax free, as that is the current SA Revenue Service practice. The proceeds belong to the trust as the owner. The trust then lends the money back to the donor. The trust deed must make provision for the trust to make loans. There is no need to charge interest on the money, as there is no employer-employee relationship between the trust and the donor. Note that it is important that the donor does not use the loaned money to build up assets, as that would increase his estate and defeat the purpose of the scheme.

³⁷⁶ Income Tax Act 58 of 1962 s56 (2)

³⁷⁷ Bruce Cameron 'a trust is a key tool in planning your estate'. Available at <http://www.persfin.co.za/index.php?fSectionId=706> [Accessed 7 June 2009]

³⁷⁸ Ibid.

³⁷⁹ Ibid.

³⁸⁰ Ibid (PLEASE NOTE: THE ENTIRE EXAMPLE IS FROM REFERENCE FOOT NOTE 377)

The whole idea is that the donor uses the money 'on loan', and when he dies he owes the money to the trust. This is a liability in his estate and reduces his estate duty further. The donor would leave assets to his family trust on death anyway, so there is no prejudice in having to repay the loan to the trust.

Benefits of the scheme:

R100 000 / R200 000 per annum is removed from the donor's estate. It grows in the trust as a "nest egg".

This money belongs to the trust - there are no loan accounts. This makes it harder for creditors of the donor to attach the policy, assuming that no actions were taken to defraud creditors.

The donor still gets use of the money later, just on loan, which reduces the donor's estate duty even further. There is therefore a double estate duty benefit - the money is first removed from the estate, and then the liability is created.

There is no negative capital gains tax effect as the policy is originally owned by the trust, so the proceeds pay out to the trust free of CGT.

If the trust is cancelled under a power contained in the trust deed, the resulting retransfer by the trustee to the donor would be a disposition "in pursuance of a trust"³⁸¹. the Commissioner would not treat the retransfer (of the trust assets to the donor) as taxable, and it may be argued that as the trustee is not impoverished by the retransfer there is no donation³⁸². A trustee who reverts property in the donor pursuant to an agreement to cancel the trust does not make a donation to the donor and needs no statutory protection to avoid payment of donations tax³⁸³.

³⁸¹ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 465

³⁸² Cameron (note 380) at 465

³⁸³ Cameron (note 380) at 465

c) Transfer duty

Transfer duty is an indirect tax paid on the transfer of fixed property in South Africa³⁸⁴. Property is valued for transfer duty purposes either when the consideration is payable by the person who acquires the property, at the amount of the consideration or when no consideration is payable, at its declared value³⁸⁵.

The Transfer Duty Act 40 of 1949, states that transfer duty varying from 0 to 8 percent is payable on the value of any property acquired³⁸⁶. If the acquirer or beneficiary of the renunciation is a natural person, the rate of the duty varies from 0 to 8 percent according to the value of the property³⁸⁷, if a person other than a natural person, i.e. a juristic person, the rate is a flat rate of 8 percent³⁸⁸. For the purposes of s2 of the Transfer Duty Act, a trustee or administration of a trust or any other person acting in a fiduciary capacity is deemed to be a person other than a natural person, in respect of any property acquired by him or any property held by him of which the value is enhanced³⁸⁹.

The duty is payable by the person who has acquired the property or in whose favour or whose benefit any interest in or restriction upon the use or disposal of property has been renounced³⁹⁰. A trustee will normally have to pay transfer duty on the transfer of property to him in trust³⁹¹. If the property is transferred into the name of the trustee, the duty is payable at the rate of 10 percent³⁹².

In December 2002 the transfer duty legislation was amended and in terms of this amendment transfer duty is specifically triggered in discretionary trusts when the names of one or more beneficiaries, with a contingent right to any (residential) property, have been changed or

³⁸⁴ Keith Huxham and Phillip Haupt Notes on South African income tax 28 ed (2008) 890

³⁸⁵ Edwin Cameron et al Honore's South African law of trusts 5 ed (2002) 489

³⁸⁶ Transfer Duty Act 40 of 1949 s2

³⁸⁷ Transfer Duty Act 40 of 1949 s2(b)

³⁸⁸ Transfer Duty Act 40 of 1949 s2 (a)

³⁸⁹ Cameron (note 384) at 486

³⁹⁰ Cameron (note 384) at 487

³⁹¹ Cameron (note 384) at 487

³⁹² Cameron (note 384) at 487

added³⁹³. This amendment was the result of the tax court ruling in Johannesburg case number 11286³⁹⁴.

Though a trustee will normally have to pay transfer duty on the transfer of property that is to form part of the trust property, no further duty is usually payable when the property is later transferred to the trust beneficiary³⁹⁵.

No duty is payable:

- a) in respect of a 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 other written instrument or of a trustee of an insolvent estate³⁹⁶; or
- b) when a trust has been founded by a natural person for a 'relative' as defined in the Estate Duty Act, roughly one within the third degree of that relative³⁹⁷;
- c) where trust property is restored by the trustee of an insolvent estate to the insolvent³⁹⁸

For the exemption to apply not only must the trustee transfer the property to the beneficiary but the transfer must be made in pursuance of the written instrument under which the trustee was appointed³⁹⁹. The transfer of trust property by one trustee or administrator to another is also exempt⁴⁰⁰.

³⁹³ Charlene Clayton 'Trust beneficiaries take sars to court over transfer duty.' Available at <http://www.eprop.co.za/news/article.aspx?idArticle=2162> [Accessed 6 September 2009]

³⁹⁴ Ibid.

³⁹⁵ Edwin Cameron et al Honore's South African law of trusts 5 ed (2002) 488

³⁹⁶ Transfer Duty Act 40 of 1949 s9 (4) (a)

³⁹⁷ Transfer Duty Act 40 of 1949 s9(4) (b)

³⁹⁸ Transfer Duty Act 40 of 1949 s(9) (c)

³⁹⁹ Cameron (note 394) at 488

⁴⁰⁰ Cameron (note 394) at 489

d) capital gains tax

A trust is a non- natural person therefore 50% of the net capital gain is included in taxable income, unless it is a special trust⁴⁰¹. Parts X and XII of the 8th Schedule have provisions which deem the trust's income to be taxable in the hands of a donor or a beneficiary⁴⁰².

A trust will have a disposal for capital gains tax (CGT) purposes in one of two ways: either by concluding a transaction for the disposal with a third party (for example the sale of a trust asset to a third party) or by vesting a trust asset in a beneficiary (par 11(d) of the 8th schedule)⁴⁰³. A transaction with a third party at arm's length will result in a normal capital gain calculation⁴⁰⁴. When an *asset vests in a beneficiary*, the proceeds will be deemed to be the market value, as the trust and the beneficiary are connected persons and the base cost for the trust will usually be the value when the trust acquired the asset, either by way of a bequest, donation or purchase⁴⁰⁵. Paragraph 80, which is subject to paragraphs 68, 69, 71 and 72, provides that if a trust distributes 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 beneficiary's hands and not in the trusts hands⁴⁰⁶, This is subject to anti- avoidance provisions where the beneficiary is a spouse (par 68) or minor child (par69)⁴⁰⁷.

Where the non- resident trust distributes a capital gain (that would have been considered a capital gain had the trust been resident) to a South African resident, the resident is taxed on the gain, whether it arose that year or in a previous year (par 80 (3))⁴⁰⁸. This does not apply if the gain has already been subject to tax in South Africa e.g. if it is from a South African source⁴⁰⁹. If foreign tax has been 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 and if a South African trust makes a gain and distributes it to a non- resident, the trust is taxed on the gain (unless it can be attributed to a resident donor under par 72)⁴¹⁰.

⁴⁰¹ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 824

⁴⁰² Huxham (note 400) at 824

⁴⁰³ Professor Keith Jordaan et al Silke: *South African income tax* (2008) 671

⁴⁰⁴ Jordaan (note 402) at 671

⁴⁰⁵ Income Tax Act 58 of 1962 8th schedule par (38) ; Jordaan (note 402) at 671

⁴⁰⁶ Huxham (note 400) at 824

⁴⁰⁷ Huxham (note 400) at 824

⁴⁰⁸ Huxham (note 400) at 824

⁴⁰⁹ Huxham (note 400) at 824

⁴¹⁰ Huxham (note 400) at 824

Capital gains attributed to the donor- par 73 states that where both an amount of income and capital gain are derived by reason of, or are attributable to a donation, settlement or other disposition, then the capital gain attributed to the “donor” may be limited⁴¹¹ to what the trust earned by reason of the fact that the donor did not charge a market related rate of interest⁴¹².

Capital gain retained by the trust - par 70 states that if a South African resident makes a donation, settlement, or similar disposition to a trust and the trust makes a capital gain as a result of that donation or disposition, the resident is taxed on the capital gain⁴¹³ instead of the trust if the gain is not distributed or vested to a beneficiary who is a South African resident⁴¹⁴. This is beneficial if the resident is an individual as only 25% of the gain is taxed instead of the 50% that would be taxed if the gain was taxed in the trust’s hands and if the resident is a natural person, the capital gain is further reduced by the annual exclusion⁴¹⁵.

Capital gains distributed by the trust- according to par71, if a distribution of a capital gain is made a beneficiary and the donor has the right to revoke the beneficiary’s right to the capital distribution⁴¹⁶, then the creator is taxed on the gain so distributed (to the extent that it is attributable to the gratuitous disposition made by the donor)⁴¹⁷. If the gains are distributed or vest in anon- resident then the South African resident donor/ disposer is taxed on the gain instead of the non- resident or the trust⁴¹⁸.

⁴¹¹ Keith Huxham and Phillip Haupt *Notes on South African income tax* 28 ed (2009) 826

⁴¹² Huxham (note 410) at 826

⁴¹³ Huxham (note 410) at 826

⁴¹⁴ Huxham (note 410) at 826

⁴¹⁵ Huxham (note 410) at 826

⁴¹⁶ Huxham (note 410) at 826

⁴¹⁷ Huxham (note 410) at 826

⁴¹⁸ Huxham (note 410) at 826

SECTION C

So ask we ourselves are trusts really “tax havens”? I guess we could look at it in two ways: Firstly, trusts are in essence a taxpayer of last resort i.e. if there is no beneficiary or donor to tax, and then the trust is taxed. But ultimately someone is taxed and the tax is quite heavy i.e. it is taxed at the highest marginal rate of 40%, the inclusion rate for capital gains tax is at 50% (unlike an individual who’s inclusion rate is 25%) and the transfer duty is higher in a trust as it is levied at a flat rate of 8%. Plus there is no dividend nor an interest exemption because it is not a natural person⁴¹⁹. When the assets are transferred in to the trust, a donations tax is charged and if fixed property is being transferred transfer duty becomes payable. Then there is still the danger of the the loss of legal control of assets- as they are handed over to the trust and managed by the trustees for the benefit of the beneficiaries⁴²⁰.

However, we could look at it from another perspective and focus on the reason that makes them unique even with the unfavourable changes in the legislation: which is that the trust remains the only legal entity which will afford total asset protection and estate duty savings along with a myriad of other benefits⁴²¹. Even with all these changes, it remains separate from its donors or beneficiaries⁴²². A trust is not owned by anyone, it never dies or terminates (unless it is terminated by agreement or it is sequestrated if it is unable to pay its debts)⁴²³. Ultimately this why more than a quarter of the worlds wealth is held in trusts⁴²⁴.

There is a big fallacy that one needs to be wealthy to set up a trust- its misleading and far from the truth, in fact the less one has the more a trust is needed because in most cases the wealthy do just fine when facing a financial crisis, but it’s usually the ordinary people that are most likely to lose everything if not protected⁴²⁵.

⁴¹⁹ Professor Keith Jordaan et al Silke: Soth African income tax (2008) 659

⁴²⁰ Bruce Cameron ‘ a trust is a key tool in planning your estate’. Available at <http://www.persfin.co.za/index.php?fSectionId=706> [Accessed 7 June 2009]

⁴²¹ ‘What is a trust and why the benefits cannot be ignored’. Available at <http://www.evolvepro.co.za/TrustBenefits.asp> [Accessed 6 September 2009]

⁴²² Ibid.

⁴²³ Ibid.

⁴²⁴ Annet Wanyana Oguttu ‘ Curbing offshore tax avoidance: the case of South African companies and trusts’. Available at <http://etd.unisa.ac.za/ETD-db/theses/available/etd-07302008-141314/unrestricted/thesis.pdf> [Accessed 8 July 2009]

⁴²⁵ What is a trust and why the benefits cannot be ignored”. Available at <http://www.evolvepro.co.za/TrustBenefits.asp> [Accessed 6 September 2009]

It is inevitable that most people in life will go through a number of situations which could potentially result in one losing all of their hard earned assets, cash, investments and properties⁴²⁶. For example :

- An existing business, or a new business which ends up in trouble often results in people having to make good to creditors, for unpaid rental agreements, suppliers, staff, the Receiver of revenue, loans, overdrafts and the like⁴²⁷
- surety for any person or on a business would mean that one would be exposed to that claim if it is not settled⁴²⁸.
- Usually in a divorce assets get sold and most of the time it's the assets that one did not intend to part with that are sold⁴²⁹.
- People often face claims by creditors of their spouse if they are married in community of property⁴³⁰.
- Generally if one has creditors, they could lay claim to personal assets if the debt is not paid⁴³¹.
- Financial vulnerability could also be experienced as a result of retrenchment, which could mean that meeting obligations might be a problem thus leaving assets at risk to creditors⁴³².
- The individual can face a claim for damages; this might cause the assets to be attached⁴³³.

⁴²⁶ What is a trust and why the benefits cannot be ignored". Available at <http://www.evolvepro.co.za/TrustBenefits.asp> [Accessed 6 September 2009]

⁴²⁷ Ibid.

⁴²⁸ Ibid.

⁴²⁹ Ibid.

⁴³⁰ Ibid.

⁴³¹ Ibid.

⁴³² Ibid.

⁴³³ Ibid.

The above paints a pretty negative picture but the solution to these frightening situations is simple and they can be avoided or contained through the establishment of a trust, or a combination of trusts⁴³⁴.

The way it works is that once the assets have been moved into the trust, they no longer belong to the individual⁴³⁵. However, there are certain laws that need to be borne in mind before the assets are safe⁴³⁶ for example;

there is a window period prescribed in the Insolvency Act⁴³⁷. It is known to afford creditors protection from delinquent creditors⁴³⁸. It is important that assets are safely moved into a trust, but caution needs to be taken to the time periods so that the assets that have been moved are not liable to attachment under the relevant sections of the Act⁴³⁹. The Insolvency Act states that if a creditor has a claim against an individual who is solvent, and who has moved, sold, transferred or donated assets, the creditor may if the assets were moved within a 6 month period, reverse such transactions and attach the assets and sell them⁴⁴⁰.

If the individual is insolvent at the time of the shifting of assets, the period is then extended to 24 months before the assets are safe from a creditor reversing such transferred assets⁴⁴¹.

But the big benefits of putting assets into a trust are realised upon death as there would be:

No capital gains tax – at the time of death, all the assets that a person owns, including properties, attract CGT at a rate of 10%⁴⁴². The unfortunate part is the fact that the tax is due even though no money has changed hands or been received⁴⁴³. In some cases, this leaves the estate in an illiquid position⁴⁴⁴. However should the assets be placed in a trust, the CGT will not be triggered as the trust does not die⁴⁴⁵. The good thing about a trust (even before death)

⁴³⁴ What is a trust and why the benefits cannot be ignored”. Available at <http://www.evolvepro.co.za/TrustBenefits.asp> [Accessed 6 September 2009]

⁴³⁵ What is a trust and why the benefits cannot be ignored”. Available at <http://www.evolvepro.co.za/TrustBenefits.asp> [Accessed 6 September 2009]

⁴³⁶ Ibid.

⁴³⁷ Ibid

⁴³⁸ Ibid.

⁴³⁹ Ibid.

⁴⁴⁰ Ibid.

⁴⁴¹ Ibid.

⁴⁴² Income Tax Act 58 of 1962 par 40 of the 8th schedule

⁴⁴³ What is a trust and why the benefits cannot be ignored”. Available at <http://www.evolvepro.co.za/TrustBenefits.asp> [Accessed 6 September 2009]

⁴⁴⁴ Ibid

⁴⁴⁵ Ibid.

it that it has the flexibility to transfer the proceeds on the sale of assets to the beneficiaries who then pay the CGT⁴⁴⁶. Although their marginal tax rate may be 40% they will only pay CGT on 25% of the profit and there is no tax charged on the distribution, unlike with the company structure⁴⁴⁷.

No estate duty - Any person (residents and non-residents) who die owning property in the republic will be subject to estate duties. Residents will be taxed on their worldwide assets and non-residents on immovable property situated in the republic. The tax is levied at a rate of 20% of the value of any assets in excess of 3.5 million at the date of death (after certain deductions have been made). As the trust does not die no estate duty will have to be paid. Section s3(3)d of the Estate Duty Act 45 of 1955 could prohibit this benefit from applying if the deceased was immediately before death competent to dispose of the property in the trust for his own benefit or for the benefit of his estate. The deceased is deemed to have been competent to dispose of property if he retained the power under any deed of donation, settlement, trust or other disposition made to him to revoke or vary the provisions of the disposition relating to the property.

There are even more benefits created by trusts upon death, such as:

No executors fees - An executor is the person or company or firm that winds up the estate of the individual, for this task they are entitled to a maximum fee of 3.5 % of the gross value of the estate plus VAT in certain circumstances⁴⁴⁸. Again the solution to this is the formation of a trust, as the individual will not own any assets, and all property will be held by a trust or combination of trusts, the estate should be zero or inconsequential, thereby eliminating the executor's fees payable⁴⁴⁹.

Protection of minors - Our law does not allow for minors to directly inherit⁴⁵⁰, therefore an individual who wants to leave all or any assets to minor persons will not be able to do so⁴⁵¹,

⁴⁴⁶ What is a trust and why the benefits cannot be ignored". Available at <http://www.evolvepro.co.za/TrustBenefits.asp> [Accessed 6 September 2009]

⁴⁴⁷ Ibid.

⁴⁴⁸ Ibid.

⁴⁴⁹ Ibid

⁴⁵⁰ Ibid.

⁴⁵¹ Ibid.

or persons not adequately addressing the issue in their wills or via testamentary trusts will end up with a situation where all the assets will be liquidated into cash⁴⁵². This is the position as the funds or the cash needs to be held by the guardians fund⁴⁵³. The fund can only hold cash as they do not have the ability or resources to administer property, the fund is controlled by the Government, and pays interest of +- 3%⁴⁵⁴. In the event monies are not claimed, they are forfeited to the state⁴⁵⁵. Very often this leads to limited or no access to the fund for the minors needs, education, health, well being housing⁴⁵⁶. As the trust survives your death; any beneficiary may benefit and access assets immediately⁴⁵⁷.

SARS has made various amendments to combat many tax saving practices⁴⁵⁸, and as result a scheme that would result in the avoidance, postponement or reduction of tax liability is presumed to be entered into solely or mainly for the purpose of obtaining a tax benefit⁴⁵⁹. Certain tax avoidance schemes are treated as nullities and disregarded by the Commissioner, who may, if satisfied that the scheme falls within the ambit of s103 of the Income Tax Act⁴⁶⁰. The Commissioner could fix the tax liability as if the schemes had not been entered into or carried out, or in whatever way is deemed appropriate to prevent or diminish the tax avoidance⁴⁶¹.

So are they really cosy tax avoidance measures? Well maybe they are not completely the tax avoidance measure it used to be. In the past trusts were seriously abused for taxed purposes but since 1991 the government has made amendments to combat these practices. In fact it is pretty hard to avoid tax in a trust as SARS looks at them very closely. Without a doubt though they sure do minimize the incidence of tax especially upon death but right now they are not really “the tax havens” they used to be. However they are still the best way for one to protect their assets. They are indeed great estate planning tools. But SARS is closing the loop holes in the tax legislation and pretty soon there will be no place to hide!

⁴⁵² What is a trust and why the benefits cannot be ignored”. Available at <http://www.evolvepro.co.za/TrustBenefits.asp> [Accessed 6 September 2009]

⁴⁵³ Ibid.

⁴⁵⁴ Ibid.

⁴⁵⁵ Ibid.

⁴⁵⁶ Ibid.

⁴⁵⁷ Ibid.

⁴⁵⁸ Ibid.

⁴⁵⁹ Edwin Cameron et al *Honore's South African law of trusts* 5ed (2002) 460

⁴⁶⁰ Cameron (note 458) at 460

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