

**TAXATION OF TRUST  
INCOME**

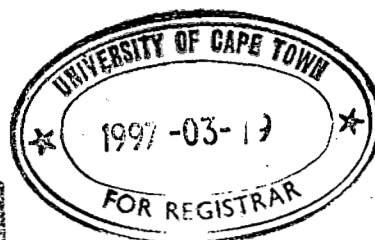
**BY**

**NTOBEKO MNYATHELI**

**SUPERVISOR : PROF. TREVOR EMSLIE**

**LLM DISSERTATION**

The University of Cape Town has been given the right to reproduce this thesis in whole or in part. Copyright is held by the author.



The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

## **FOREWORD**

The content of this paper is based on a prescribed syllabi for the fulfilment of a Master of Law degree. The paper seeks to provide a detailed research on the principles applicable in the taxation of trust income on the present day South African Tax Law and to analyse and criticize them.

Emphasis will be on the relevant sections of the Income Tax Act and Case law.

**NTOBEKO MNYATHELI**

# TAXATION OF TRUST INCOME

## CONTENTS

FOREWORD . . . . .	(i)
ACKNOWLEDGEMENTS . . . . .	(ii)
ABBREVIATIONS . . . . .	(iii)
TABLE OF CASES . . . . .	(iv)
CHAPTER 1 : INTRODUCTION . . . . .	1
CHAPTER 2 : EVOLUTION OF LEGISLATION . . . . .	5
CHAPTER 3 : TYPES OF TRUSTS . . . . .	8
CHAPTER 4 : TRUSTS AND LEGISLATION . . . . .	11
CHAPTER 5 : TAXATION OF TRUSTS . . . . .	17
5.1 THE CONDUIT-PIPE PRINCIPLE . . . . .	17
5.2 INCOME TAXABLE IN THE HANDS OF THE DONOR . . . . .	19
5.3 INCOME TAXABLE IN THE HANDS OF THE BENEFICIARIES . . . . .	25
5.4 INCOME TAXABLE IN THE TRUST . . . . .	27
CHAPTER 6 : TAX AVOIDANCE OPPORTUNITIES . . . . .	30
6.1 NON-RESIDENT SHARE-HOLDER TAX . . . . .	31
6.2 SHARES AS TRADING STOCK . . . . .	32
6.3 ASSESSED LOSSES . . . . .	34
CHAPTER 7 : ANTI-AVOIDANCE PROVISIONS . . . . .	37
i) SECTION 7(1) . . . . .	38
ii) SECTION 7(2) . . . . .	40

---

iii)	SECTION 7(3) . . . . .	42
	a) OTHER DISPOSITION . . . . .	43
	b) BY REASON OF . . . . .	46
	c) INCOME ON INCOME . . . . .	49
iv)	SECTION 7(4) . . . . .	51
v)	SECTION 7(5) . . . . .	52
vi)	SECTION 7(6) . . . . .	56
vii)	SECTION 7(7) . . . . .	57
viii)	SECTION 103(1) . . . . .	60
CHAPTER 8 : INCOME OF TRUST PER SE . . . . .		63
CHAPTER 9 : EXEMPTION FROM TAX OF CERTAIN TRUSTS . . . . .		70
CHAPTER 10 : CONCLUSION . . . . .		75
BIBLIOGRAPHY . . . . .		(v)

## **ACKNOWLEDGEMENTS**

One of the most pleasant aspects for me in reflecting over my research and study are the memories of persons who were the integral part of my academic endeavours.

In this regard I signal my debt and gratitude to Professor Emslie who guided me throughout the preparation of this work.

I wish to convey my heartfelt gratitude to Vanessa who, under difficult circumstances typed and prepared the manuscript.

For support and encouragement may I record my gratitude to Mbeko who unselfishly gave me the support of a "big brother".

For keeping me up to date with the developments of the law I would like to think that he enticed me out of mental complacency and has sharpened my sense of critical enquiry. I record my appreciation and admiration for the support I got from Mandla.

---

Of course one does not live for several years without having the good fortune where strangers become the integral part of his life, for a man that too is an act towards the realities of life. These sentiments I naturally direct them to my better-half Bongie whose support was not confined to the manuscript. I hope that the finished work will compensate in part for the many months taken from our life. I treasure your support and love. Thank you Madiba!

Words and phrases do suffer from several deficiencies such that, what the heart feels cannot be put in words or phrases. I am unable to capture my debt to my mom in words, so I will not even try to do so. Longlive ! Mamashiya !

### ABBREVIATIONS

1. SA - SOUTH AFRICAN LAW REPORTS
2. AD - APPELLATE DIVISION
3. SATC - SOUTH AFRICAN TAX CASES
4. ITC - INCOME TAX CASES
5. SIR - SECRETARY FOR INLAND REVENUE
6. CIR - COMMISSIONER FOR INLAND REVENUE
7. IRC - INLAND REVENUE COMMISSIONERS
8. TPD - TRANSVAAL PROVINCIAL DIVISION
9. AC - APPEAL CASES
10. VAT - VALUE ADDED TAX
11. NRST - NON-RESIDENT SHAREHOLDERS TAX
12. COT - COMMISSIONER OF TAXES

## TABLE OF CASES

1. **ARMSTRONG vs CIR**, 1938 AD, 10 SATC 1
2. **BRAUN vs BLOM AND BOTHA NNO AND ANOTHER 1984** (2) SA 850  
(AD) 859 E
3. **BARNET vs COMMISSIONER OF TAX**, 1959 (2) SA 713
4. **CIR vs MACNEILLIE'S ESTATE**, 1961 (3) SA 621
5. **CIR vs EMARY N.O.**, 1961 (2) SA 621
6. **CIR vs BEROLD**, 1962 (3) SA 748, 24 SATC 729
7. **CIR vs PEOPLES CHOICE**, 1990 (2) SA 353 at 365
8. **CIR vs WIDAN**, 1955 (1) SA 226 (A)
9. **ESTATE SMITH vs CIR**, 1960 (3) SA 375 (A)
10. **ESTATE KEMP vs MACDONALD TRUSTEE**, 1915 ad 491
11. **ESTATE DEMPERS vs SIR**, 1977 (3) SA 410 (A), 39 SATC 95
12. **ESTATE MUNRO**, 1925 TPD 693, 1 SATC 163
13. **GOLDRIKE AND SONS vs REGISTRAR OF DEEDS, NATAL 1974** (1)  
SA 404 (N)
14. **IN RE : THE PHILLIP FRAME TRUST vs CIR 1991** (2) SA 340,  
THE TAXPAYER 206
15. **ITC 1328**, 43 SATC 56, 1981 TAXPAYER, 86
16. **ITC 417**, 10 SATC 264
17. **ITC 826**, 1928 AC 217
18. **ITC 673**, 16 SATC 230
19. **ITC 239 (1952)** 6 SATC 358
20. **ITC 673 1948**, 16 SATC
21. **ITC 1033 1959**, 26 SATC

- 
22. JOSS vs CIR 1980 (4) SA TPD 674 at 737
  23. KOHLER vs CIR 1949 (4) SA 1022 (T)
  24. LEVENE vs IRC [1928] AC 217, 13 TC 486
  25. MANCHESTER vs MACADAM (1896) 3 TAX CASES, 491, 497,  
[1986] AC 500, 511
  26. NATHAN ESTATE 1948 (3) SA 866 (N)
  27. OVENSTONE vs SIR 1980 (2) SA 721 AD at 737
  28. SA BAZAARS (PTY) LTD vs CIR 1952 (4) SA 505, 18 SATC  
328
  29. SIR vs SIDLEY 1977 (4) SA 913 (A), 39 SATC 153
  30. SIR vs ROSEN 1971 AD, 32 SATC 21
  31. SIR vs GEUSTYN, FORSYTH AND JOUBERT 1971 (3) SA 567

## CHAPTER 1

### INTRODUCTION

In Bells South African Legal Dictionary a trust is defined as an equitable obligation, either expressly undertaken or constructively imposed by the Court, whereby the obligor is bound to deal with property over which he has control, for the benefit of persons of whom he may or may not himself be one, and any one of whom may enforce the obligation.

In *Estate Kemp vs Macdonald's Trustee*<sup>1</sup> Judge Solomon referred to the fact that in a trust the legal dominium of property is vested in the trustee but that they have no beneficial interest in it but are bound to hold and apply it for the purpose of some persons or accomplishment of some purpose<sup>2</sup>.

In the case of *Goldrike and Son (Pty) Ltd vs Registrar of Deeds, Natal*<sup>3</sup> the Court held that the concept of a valid trust revolved around the removal of dominium (ownership from the beneficiaries and placing it in the hands of the trustees ... (A) trust exists)<sup>4</sup> when property is to be held or

---

<sup>1</sup>1915 AD 491

<sup>2</sup>AT 508 IBID

<sup>3</sup>1974 (1) SA 404 (N)

<sup>4</sup>OP CIT 410

administered by one person on behalf of another, or for some purpose other than his own benefit. The Court went on to say that the essential elements which made up a trust were 'the segregation of the trust assets by the founder' and the creation of an obligation to administer otherwise than purely for oneself<sup>5</sup>

From these extracts it seems as if the underlying principle of a trust is simply that the founder commits his assets to the care of another person for the benefit of a ..... Thus it involves an intermediary who acts in terms of the express wishes of the founder, who is placed in control of property which he is empowered to administer, not for his own personal benefit but for a third party beneficiary which could well be a natural person or an "impersonal object"<sup>6</sup>.

The trustee's powers are severely limited by the fact that he is required to act strictly in accordance with the instructions of the founder. Thus a fiduciary relationship as referred to in **Income Tax Act**<sup>7</sup> exists between the trustee and the beneficiary. Despite the fact that ownership of the property which forms the basis of the trust vests in the trustee he may only deal with it in his official capacity. A trustee is entrusted with control of the property with which

---

<sup>5</sup>OP CIT 408

<sup>6</sup>IBID

<sup>7</sup>58 of 1962, hereinafter described as "the Act"

he is bound to deal for the benefit of others.

The object of the trust, is the controlling of the trust, how income and capital should be distributed etc. All this information and other relevant information is recorded in a document known as the Trust Deed. The Trust Deed is similar to the memo and articles of a company with one exception, that it goes beyond the memo and articles, because there is no equivalent Companies Act which acts as a base hence a Trust Deed needs to contain such provisions as winding up, etc. which the memo and articles of a company will not contain because there is a section in the Companies Act which caters for this situation.

The assets, fixed property, are recorded in the Trustees names, but the assets do not belong to them, i.e. should the trustee be sequestrated then the assets of the trust do not go into his/her estate.

When the donor, settlor or creator starts a trust normally a donation is made to get the trust going. This is usually made by a small donation so that donation's tax is not payable.

This paper seeks to analyse the consequences of the taxation of trusts and a cursory look will be made at the history of the trusts, i.e. how they were received in South Africa and the evolution of the legislation concerning trusts will be

visited. Eventually the various types of trusts and their taxation will be given consideration.

## CHAPTER 2

### EVOLUTION OF LEGISLATION

Trusts were introduced to South Africa after the British occupation of the Cape in 1815. The British Settlers who arrived at the Cape in the early nineteenth century brought with them the terms "trust" and "trustee".

Although England is the historical source of South African Trusts, many of the rules of South African Trust Law are not derived from English Law. Only a partial reception of English trust law has taken place in South Africa as certain areas are patently non-English<sup>8</sup>.

Another source is the South African common law rules which govern the creation and revocation of Trusts. South African Trusts have also developed from Roman Dutch law from formations such as *fideicommissum*, *fiducia*, *stipulatio alteri* and curatorship. Historically therefore it can be said that the rules of trust law in South Africa have three main sources.

The first controlling legislation promulgated in order to

---

<sup>8</sup>Honore T.S., Cameron E, Honore J. : South African Law of Trusts

---

regulate the utilization of trusts was the Trust Money Protection<sup>9</sup>. The Act dealt essentially with the administrative procedures to be followed when trusts were established and provided for the lodging thereof with the Master of the Supreme Court and the furnishing of security by the trustees of the trust as well as the investigation by the Master of any complaints brought to his attention by any of the beneficiaries of the trust as the diligence or honesty of the trustee in the exercise of his duties in terms of the trust deed.

In 1965 the Administration of Estates Act<sup>10</sup> was enacted which, in Chapter 3 contained provisions regarding trustees. However Chapter 3 never came into operation and it was only when the Law Commission, approximately 15 years later, examined the situation relating to trusts again and the necessity to implement legislation which regulated and controlled the manner in which trusts were utilised in South African law. As a result of the Law Commission's report the Trust Property Control Act was passed in 1988 and came into operation on March 31, 1989. This Act repealed and replaced the Trust Money's Protection Act 1934 and Chapter III of the Administration of Estates Act of 1965. The Act deals essentially with certain supervisory aspects of the establishment of trusts, for instance, the trust deed, the

---

<sup>9</sup>34 of 1934

<sup>10</sup>66 of 1965

authorisation of trustees to act as such, the security to be furnished by the trustees, the manner in which trustees should conduct themselves in their capacity as trustees, the ownership and registration of trust property etc. This Act does not however, assist in determining how income received by a trust should be taxed. In order to establish this regard must be had to the Income Tax Act and to a lesser extent to certain common law principles governing the trust as a separate entity and the vesting of rights.

---

## CHAPTER 3

### TYPES OF TRUSTS

Before going into details about taxation of trusts a brief discussion on the various types of trusts will be made.

A trust is usually either formed by contract when it is known as an inter vivos trust or by a will where it is referred to as a testamentary trust. A distinction between inter vivos and testamentary trust forms the main division between trusts. For many years a testamentary trust was equated with a *fideicommissum*. In *Braun vs Blom and Botha and Another*<sup>11</sup> it was held that a testamentary trust was a *sui generis* institution. Inter-vivos trusts are an occasion referred to as being equivalent to a contract for the benefit of a third person. This merely means that an inter vivos is invariably created by a contract containing a stipulation in favour of a beneficiary who on acceptance has an indefensible right under the trust. An inter vivos trust can be revoked in a similar way as a contract. The creation and revocation of trusts are regulated by contract law while administration and supervision of trusts are governed by Statute<sup>12</sup>.

---

<sup>11</sup>1984 (2) SA 850 AD at 859 E

<sup>12</sup>Honore T.S. Cameron E, Honore's South African Law of Trusts, p 26

A person may create a trust in his will to commence after death, i.e. a testamentary trust, or trust *mortis causa*. This is a unilateral trust in which a person makes a decision alone. Since it is part of his will, a person may amend the provisions of his will and therefore of the testamentary trust at any time without consulting anyone else. A trust is vital to ensure continuity in the management and control of the assets that his minor children are to inherit, especially if him and his spouse were to die shortly after one another. It will prevent his assets having to be converted into money after his death for safekeeping at a low interest rate in the Guardian Fund of the Master of the Supreme Court. A person may also create a trust to operate during his lifetime, i.e. the inter-vivos trust. Here the donor or settler of a trust transfers his assets to the trustees who agree to administer them on behalf of the beneficiaries.

One must have the intention of divesting himself of his assets in favour of the beneficiaries. Once an inter-vivos trust has been created by agreement, the settler must transfer the assets in question. He may repeal or amend the agreement, with the consent of the trustees before the beneficiaries have accepted the benefit. Once they have accepted it, however, even if they should still be minors at that stage, the founder or trustees may no longer unilaterally repeal or amend the agreement. Any attempt to do so would amount to breach of contract against the beneficiaries. With minor beneficiaries,

the Court's consent is needed for any changes. An inter vivos trust must be registered with the Master. Its trust deed is not restricted in any way. It may therefore contain any number of provisions to stipulate very specifically the powers and the authority of the trustees. It is easier and often more beneficial for the estate duty purposes to grant them wide discretionary powers to deal with the assets and the income distributions as they deem fit.

Each of the classifications of trusts, i.e. inter vivos or *mortis causa* may be established as a bebind, vested or discretionary trust. With a bebind trust the beneficiary owns the trust assets, whereas with the other two the trust itself, via its trustees, is the owner of the assets.

Each of the three types vest control and management of the trust assets in the trustees. The bebind and vested trusts are mostly used when the "custodianship of asset factor" is predominant, whereas the discretionary basis is used when in addition to the "custodian factor" there is a need to relinquish ownership of personal and real rights in one's assets in order *inter alia* to save future taxes, duties and fees in respect of these assets. A bebind trust is also a useful tool for management of an asset subject to joint ownership by many persons.

---

## CHAPTER 4

### TAXATION OF TRUSTS AND LEGISLATION

Criticism then can be meted against the Legislature when it comes to trusts in that it has inadvertently, rightly or wrongly, so lacked the general thinking in practice, i.e. by the Courts and even leading tax practitioners as well as academics. This is evidenced by the way in which legislation has moved in this regard. Looking at Section 1 of the Act which deals with definitions of terms used in the application of the Act, the definition of trust was omitted thereby impacting on the taxability of such entity. The absence of any express provision in the Act deeming a trust to be taxable for the purpose of the Act created no liability for tax in respect of the undistributed income of the trust until after the decision in **Friedman and Others vs Commissioner for Inland Revenue In re The Phillip Frame Will Trust vs Commissioner for Inland Revenue**<sup>13</sup> did the Legislature endeavour to clear some of the misconceptions relating to the taxability of trusts. As a result we have seen in the 1991 amendments of "Trust Fund" in the definition of person, a step which is long overdue and was welcomed with delight by most concerned people. What's more noticeable is that this amendment is back

---

<sup>13</sup>1991 (2) SA 340, The Taxpayer 1990 (39) 206

dated to 1 March 1986 thereby impacting on most long standing trusts.

It has long been common practice of revenue to tax trusts as an unmarried person, enjoying the primary rebate as applicable to this class of taxpayers. One wonders, in the light of the decision reached in *Commissioner for Inland Revenue vs MacNeillie's Estate*<sup>14</sup> that a trust is not a legal person, whether this practice was not correct that surprisingly this issue was of pure academic relevance until the Frame Case. As Steyn C J who delivered the judgment in that case, correctly points out that "In regard to the alleged legal personality of a deceased estate for income tax purposes is opposite in regard to the inclusion of a trust as a taxable entity within the meaning of "person" . For the purpose of estate duty like a deceased estate, a trust of it is to be clothed with juristic personality, would be a persona consisting of an aggregate of assets and liabilities." (This he said after finding that a trust is not a person and therefore not a taxable entity).

The pattern of events is not unfamiliar to most tax enthusiasts, as it follows the same pattern as was evident when the very same issue with regard to deceased estates was debated after it was held in both *Estate Smith vs Commissioner*

---

<sup>14</sup>1961 (3) SA 833



- of an ascertained beneficiary with a vested right;
- be deemed to be income accrued to the beneficiary;
- otherwise be deemed to be income of the trust fund.

Section 25B(2)

- where the beneficiary has acquired a vested right;
- in consequence of the exercise by the trustee of a discretion vested in him by the trust deed;
- such income is deemed to be derived for the benefit of such beneficiary.

Section 25B(3)

- any deduction or allowance which may be made under the Act and which relates to the income which has accrued to a beneficiary or to the trust fund, is deemed to be a deduction which is permitted in the hands of the person who is

deemed to have derived the income,  
to the extent to which the income  
is deemed to accrue to the  
beneficiary or to the trust fund.

This section is intended to resolve the uncertainty relating to the taxation of income received by or accrued to or in favour of a trust which is not distributed to the beneficiaries. Where the conditions of this section are not met, the income is simply taxed in the hands of a trust.

Other sections that have a bearing on the taxability of trusts are sections 95 and 96. These sections contain detailed provisions relating to the liability of representative taxpayers for income tax and the rights of such taxpayers in respect of abatements (rebates), deductions and the like. Since a trust is not a natural person, capable of running its own affairs, it must be represented by some natural person for all intents and purposes. In terms of Section 1 of the Act such a person is a "trustee" which is defined amongst other things as "any person having the administration or control of any property subject to a trust". It follows that, a trustee is designated a representative taxpayer and thereby falling squarely under the provisions of these two sections.

On closer scrutiny of the provisions of Section 95(2) which deals with abatements and deductions "which could be claimed

by the "person" represented by the taxpayer" and the provisions of Section 95(3) which limit the representation by the taxpayer" to the extent only of any assets belonging to the "person" whom he represents". It appears as though the trustee is to represent a "person" for him to be taxed as a representative taxpayer. The worst point is, on the findings of the **Frame's case**, a trustee could not, as it was practised by Revenue, have been taxed as a representative taxpayer. However, the counter argument to this would be found in the provisions of Section 195(ii) which states that "every representative taxpayer shall as regards the income to which he is entitled in his representative capacity, ... be subject in all respects to the same duties, responsibilities and liabilities as if the income were income received by or accruing to or in favour of him beneficially and shall be liable to. Assessment shall be deemed to have been made upon him in his representative capacity only". This section, read together with Section 1 (definition of a representative taxpayer) gives a clear indication that the legislature's intention is to recognise the trustee as a representative taxpayer of the trust.

## CHAPTER 5

### TAXATION OF TRUSTS

#### 5.1 THE CONDUIT-PIPE PRINCIPLE

It is appropriate at this point to consider the above principle. One of the most important principles in law of trusts and one typical of vesting trusts is what is called the conduit-pipe principle which states that income passing through a trust retains its identity, the trustee merely being a conduit-pipe through which income flows.

In *Armstrong vs CIR*<sup>17</sup> Stratford C J held "In the simple case I am now examining, namely that of a trio comprising a company, the intervening Trustee and the beneficiary it is manifest that in the truest sense the beneficiary derives his income from the company and the trustee can neither increase nor diminish it, he is a mere conduit-pipe." It is clear from this judgment that the principle is of particular relevance to vesting trusts and not necessarily so to discretionary trusts. This view was confirmed obiter by Trollip J A

---

<sup>17</sup>1938 AD, 10 SATC

in **SIR vs Rosen**<sup>18</sup> where he stated "The trust deed may ... entitle or oblige the trustee to administer the dividends in such a way that he is not a mere conduit-pipe for passing them on to the beneficiary that in his hands their source as dividends can no longer be identified or they otherwise lose their character and identity as dividends and that the beneficiary is thus entitled to receive mere trust income in contra distinction to the benefit of the dividend rights in terms of the above crucial phrase." In other words a discretionary trust may be treated as the *fons et origo* of the income instead of being the conduit-pipe linking the beneficiary to the originating cause. The example given by Trollip JA in **Rosen**<sup>19</sup> decision of loss of character and identity of dividend income where the trustee is not a mere conduit-pipe, is of particular importance for tax planning. In view of the fact that dividends are exempt from income tax (normal tax) in terms of Section 10(1)/2 the taxpayer who received dividend income via a trust would prefer the conduit-pipe principle to apply in his case and would thus prefer that a vesting trust rather than a discretionary trust be set up for the purpose.

From the foregoing discussion it is apparent that

---

<sup>18</sup>1971 (1) SA 173 (A), 32 SATC 249

<sup>19</sup>IBID

there are three possible scenarios in the taxation of income subject of a trust viz in the hands of the donor, in the hands of beneficiary or in the hands of the trustee. The first two instances are clear since they are governed by the Act, i.e. Section 7(5) and 7(1) respectively. The latter remained a moot point until the decisions in the **Frame's**<sup>20</sup> case and the quick response of the legislature by enacting Section 25B.

## 5.2 INCOME TAXABLE IN THE HANDS OF THE DONOR

Section 7(5) sets out exactly when is income subject of a trust deemed to be income of the donor. The Act goes as far as to give such donor a remedy, in terms of Section 90 to recover any tax payable on the income deemed to be his from the person entitled to such income or his representative.

The leading case in this context is **Estate Dempers vs SIR**<sup>21</sup> which dealt with the question whether the exercise of a discretionary power was an "event as contemplated in Section 7(5)". In this case the trust founding document *inter alia*, provided that :

---

<sup>20</sup>Supra

<sup>21</sup>1977 (3) SA 410 (A) 39 SATC 95

- a) Until the donor's death, the annual income may be used by the trustee in their discretion in making charitable donations and/or for the benefit of the donee and ... any income not paid out during that year.
  
- b) After the donor's death, the annual income was to be used by the trustees in their discretion for the benefit of the donee and the balance, if any, was to accumulate in the trust.

In the application of second condition under Section 7(5), namely that but for the stipulation or condition the income would have been received by or has accrued to the beneficiaries, it was held that a vested right was not a *sine qua non*, although if the beneficiaries have vested rights this would be a strong, possibly decisive factor, leading to the conclusion that, but for the stipulation or condition withholding the income, it would have been received by them.

On scrutinising the trust deed the Court found that the donee had a vested right to the income but such right was encumbered by the fact that, amongst other things, the power conferred upon the trustees to benefit charitable institutions. It was on this basis that the Court held that Section 7(5) applied and thus the donor

was taxable on the income derived by that subsection to be his.

**Silke, Divaris and Steyn**<sup>22</sup> argue that the exercise of such discretionary powers does not constitute an "event" as contemplated by Section 7(5). Two analogies that might arise as a result of the decision in this case are :

- i) Where income accrued to a trust during the year is derived to be that of the donor even if on the last day of the year the trustee exercised his discretion and paid the whole amount to the beneficiaries yet the purpose of Section 7(5) is to tax the income of the trust in the hands of the donor when it is not received by the beneficiaries.
  
- ii) If the exercise of such discretion was an event, once the trustee exercised his discretion the liability of the donor would cease, whether the effect of the discretion exercised was to distribute the income to the beneficiaries or to retain it in the trust. It thus appears that the event encompassed in that section is one that vests the income in the beneficiaries.

In ITC 673 it was held that Section 7(5) contemplates firstly, a hypothesis - the existence of a stipulation or condition that the beneficiary must not receive the income under the deed until the happening of an event.

Secondly, the subsection provides what is deemed to be the devolution until the event takes place. That devolution is back to the donor if apart from the stipulation it would be received by or accrue to the beneficiary concerned.

Unfortunately, this decision, as it is not binding precedence, can not be relied upon heavily as what is legally right.

The issue was raised in CIR vs Berold<sup>23</sup> where the line of argument by the taxpayer was that the exercise of discretion by the trustees was not an 'event' within the meaning of the section, but the 'event' contemplated was one that altered the incidence of tax.

A similar argument was raised and rejected in ITC 1035<sup>24</sup>, the Court holding that the word 'event' is one of wide significance and that its ambit is increased by the addition of the words "whether fixed or

---

<sup>23</sup>1962 (3) SA 748 (A), 39 SATC 729

<sup>24</sup>(1959) 26 SATC 73

---

contingent". The issue was somewhat crystallised in **SIR vs Sidley**<sup>25</sup>, in which the trust deed contained a provision calling for the nett income of the trust to be devoted to the maintenance, support, education and reasonably pleasures of the beneficiary unless the trustees, in the exercise of a discretion granted to them, decide to withhold the income in whole or in part. The Court came to the conclusion that this provision was merely an administrative provision determining the way in which the income was to be dealt with.

The ultimate termination of the trust upon death of the donor and his wife and the attainment by the beneficiary of a specified age was considered to be the true event upon which the beneficiary would receive the withheld income. But for this stipulation, the income would have been received by or accrued to the beneficiary thus Section 7(5) applied. In practice Revenue applies Section 7(5) whenever there is a withholding of income in terms of the trust deed, no matter whether the beneficiaries have a vested right to the income or merely a contingent right or whether their right to income is dependent upon the exercise of the trustee's discretion. On the other hand, where the trustee exercised his discretion distributing the

---

<sup>25</sup>1977 (4) SA 913 (A), 39 SATCH 153

income to the beneficiaries, it is practice to subject the beneficiaries to tax on that income and to apply Section 7(5) to the undistributed income, thereby subjecting the donor to tax on such income.

In concurrence with Revenue's practice it is submitted by **Silke et al** that for the purpose of Section 7(5) it makes no difference whether or not the beneficiary has a vested right to the income accumulated in a trust. A contrary view was expressed in the decision reached in **ITC 1328**<sup>26</sup> in which the Special Court held that if the beneficiaries had a vested right to income it was taxed in their hands in terms of Section 7(1).

The introduction of Section 25B(1) seems to have cleared the misconception surrounding this issue as it specifically deems income to be that of the beneficiary where such beneficiary has a vested right to a trust. And Section 25B(2) deals with the position where the vested right to income is acquired by the beneficiary by virtue of the trustee exercising his discretion and such income to be that of the beneficiary.

---

<sup>26</sup>43 SATC 56, Taxpayer 86

---

### 5.3 INCOME TAXABLE IN THE HANDS OF THE BENEFICIARIES

Where the beneficiaries are ascertained and have a vested right to income, the accrual of the income is to the extent to which the will directs. Each beneficiary is taxable on the share accruing to him or her.

In the decision laid down in ITC 1328<sup>27</sup> where income is taxable in the hands of the beneficiary when such beneficiary has a vested right, irrespective of whether that income is distributed or not. This the special Court reached by merely invoking the provisions of Section 7(1). It follows from this that, where the beneficiary has a contingent right there can be no accrual to them and the income is taxable in the hands of the trustee as a representative taxpayer. Whether the beneficiary has a contingent or vested right to the income is a matter of construction of the will.

In *Estate Munro vs CIR*<sup>28</sup> the problem facing the Court was one where the beneficiaries had no vested right but the trustees had the discretion to pay for the maintenance and education of such trust income for the ultimate division among these beneficiaries. It was held that in respect of the income utilised for the

---

<sup>27</sup>IBID

<sup>28</sup>1925 TPD 693, SATC 163

benefit of the beneficiaries tax will be payable by them on the amounts spent for their benefit. The income accumulated was taxable in the hands of the trustee.

Another situation that may arise is where income is payable to a parent to be used by him for the support or maintenance of his children. Such income remains the income of the parent since he is not accountable to his children for the expenditure of the income or any surplus remaining, and consequently there is an accrual to him. This was said in *ITC 417*<sup>29</sup>. But if the income is received by the parent in his capacity as guardian of his minor children and therefore taxable in their hands and not in the parent's hands as in *ITC 919*<sup>30</sup>.

Income distributed to beneficiaries does not lose its identity by virtue of having gone through the hands of the trustee. This was initially decided in the case of *Armstrong vs CIR*<sup>31</sup> and later confirmed in *Rosen's case*<sup>32</sup>. Thus where an amount is taxable owing to the fact that it is from a source within or deemed to be within the Republic remains as such even on receipt by

---

<sup>29</sup>10 SATC 264

<sup>30</sup>1961 Taxpayer 19, 24 SATC 2361

<sup>31</sup>Supra

<sup>32</sup>Supra

a beneficiary. Similarly, whether the income is or is not exempt from tax must be determined in relation to the beneficiary and not in relation to the trustee. Where such income is apportionable among several beneficiaries, each kind of income must be apportioned among them, unless the testator or donor has directed what income must go to whom.

As regards expenditure, deductions allowable under the Act are deductible against the income of the trust and by so doing are allowable in the hands of the beneficiaries (Section 25B(3) even provides for the deduction of allowances).

#### 5.4 INCOME TAXABLE IN THE TRUST

For income to be taxable in the trust, it has to be retained in such trust and as proposed in the above discussion, it should not be affected by the deeming provisions of Section 7. Legal precedence in this regard has little to offer but confusion surrounding the issue of the basis of the taxation of trusts as pointed out earlier in the text, is now crystallised by the decision reached in Phillip Frame's case. To reinforce the mood of such decision a reaction by the Legislature was warranted, hence the amendment, as

discussed above relating to the issue of the trust. The issue of the trust being taxable and the way the Courts have gone about has been dealt with in the previous parts of this paper.

It should be noted however that, it is not on the donation or settlement that the income tax is paid or is payable. It is on the income guaranteed by the donated assets or the employment thereof that the tax is levied. The donation will be subjected to either donations tax or estate duty tax depending on whether the donor is alive or not. The question of 'source' of trust income is also important in considering the taxation of trusts, especially where taxability of a receipt or accrual depends upon the ordinary residence of the taxpayer. Since income distributed by the trust retains its identity, it is imperative to look at the source of such income before it can be taxed in the Republic.

In the case *Nathan Estate vs CIR*<sup>33</sup> where the par estate was under administration, it was held that the estate had a residence in Natal, because "the administrators are resident in this province and it is from this province that the particular fund is administered." In

---

<sup>33</sup>1948 (3) SA 866 (N), 15 SATC 328

ITC 826<sup>34</sup> the Court held that the source of an accruity paid by an estate is influenced by the debtor's residence before such accruity is paid. In this particular case the administrators of the trust were personae resident in the union and the *fons et origo* of the debt was a formal act performed in the union.

These cases give two contrasting views on the issue but Meyerowitz and Spiro submit that the residence of an Estate is not determined by the situation of the assets nor the place of execution of the will but by the residence of the executors or more probably, where the central management and control of the estate abides, the latter is the test of residence. In the case of companies, which fall under the category of artificial persons, and it appears reasonable to apply the source criterion in determining the residence of any other artificial person including a trust.

---

<sup>34</sup>1928 AC 217

---

## CHAPTER 6

### TAX AVOIDANCE OPPORTUNITIES

In the case of *Levene vs IRC*<sup>35</sup> Viscount Sumner at 227 stated "it is trite law that His Majesty's subjects are free, if they can, to make their own arrangements so that their cases may fall outside the scope of the Taxing Acts. They incur no legal penalties and, strictly speaking, no moral censure if having considered the lines drawn by the Legislature for the imposition of taxes, they make it their business to walk outside them". As opposed to fraudulent tax evasion, this is the essence of tax avoidance. Taxpayers can in many instances make tax avoidance arrangements legitimately and legally through the use of trusts.

The trust institution may be used in this connection either to avoid the burdensome effects or to take advantage of such provisions of the Act as Sections 41 and 42 on their Residential Shareholders tax, Section 22(1) on shares as trading stock, and Section 20(1) and (2A) on assessed losses. Let us look at each of these as well as some illustration in the form of examples.

---

<sup>35</sup>[1928] AC 217, 13 TC 486

---

## 6.1 NON-RESIDENT SHAREHOLDERS TAX

In terms of Section 42(1) non-resident shareholder's tax or dividends is payable in respect of dividends payable to a person not ordinarily resident nor carrying on business in the Republic, a deceased estate of such person, a company which is not a South African Company. These provisions make possible the avoidance of non-residence shareholders tax as shown below.

**Example :** Suppose Taxpayer is a non-resident and is not carrying on business in the Republic. Suppose also that he is in receipt of, or is due to receive, R100 000 dividend from a South African company. The position will be as follows :

DIVIDEND -	R100 000
WITHHOLDING TAX 15% (545) -	R 15 000
BALANCE DUE TO TAXPAYER -	R 85 000

If, however, taxpayer forms a discretionary trust in the Republic which becomes the shareholder and recipient of the dividend, and the trustee distributes the dividends to T being after the end of the tax year, there will be a tax saving

as follows :

- 1.1 The dividend will not vest in T immediately it is declared and paid into the trust. So T will not be liable to non-residence shareholders tax.
- 1.2 The trust is not a non-resident person because it was formed in the Republic. Therefore it will not be liable to non-residence shareholders tax on the dividend accruing to it.
- 1.3 It will also not be liable to income tax as dividends are exempt in terms of Section 10(1)(K).
- 1.4 The result will be a saving of R15 000.

## 6.2 SHARES AS TRADING STOCK

Section 22(1) provides that, except for shares held by a company as trading stock, the amount which shall be

taken into account in respect of the value of any trading stock held and not disposed of shall be the cost price or nett realisable value of such trading stock.

**Example :** Suppose there are two share dealing taxpayers, Company C and Trust T. Suppose also that during year 1, their first year of trading, they each purchase a stock of shares for R100 000 and that they each sell 50% of their shares for R100 00. Assume further that at the end of the tax year the remaining shares have become worthless. The effect of Section 22(1) on their respective tax positions will be as follows :

Year 1	Company	Trust
Opening Stock	-	-
Purchases	(100 000)	100 000
Sales	100 000	100 000
Closing Stock	50 000	
Taxable income	50 000	NIL
 Year 2		
Opening Stock	50 000	-

The advantage of a trust is obvious in this example. At the end of Year 1 the company will be taxed on R50 000 while the trust will be taxed on nothing. The advantage of the trust remains even if "disadvantageous" closing stock of R50 000 of Year 1 of the company will be the "advantageous" of opening stock of R50 000 in Year 2. In terms of Section 22(2)(a), for a rand in the hand is worth more than a rand in the future taking into account inflation and present value and interest considerations. It must be noted however that the same result could be achieved with an individual taxpayer or a partnership with a trust.

### 6.3 ASSESSED LOSSES

Section 20(1) provides for set-off against income from trade of any balance of assessed loss from any previous year and any assessed loss incurred during the same year in carrying on any other trade.

The provisions for set-off of any balance of assessed loss against income from trade has been interpreted as

---

applying only if there has been trading during the tax year.

In **SA Bazaars (Pty) Ltd vs CIR**<sup>36</sup> at 245 Eentlivers J stated "a deduction or set-off is admissible only against income derived from carrying on a trade. As the Appellant carried on no trade during the year under consideration it was not competent for it to set-off in its income tax return for that year the balance assessed less incurred by it in previous years".

It must be noted, however, that apart from the requirement of continuity of operations as required by the **SA Bazaars** decision the "trade concerned must fall within the definition of Section 1, which does not for instance include the earning of interest hence the importance of subsection 2A(a) of Section 20 in respect of Non-company taxpayers.

Subsection (2A)(a) and (b) provide that in the case of a taxpayer other than a company, subsection (1) of Section 20 will apply in determining the taxable income derived otherwise than by carrying on a trade, and that such non-company taxpayer shall not be prevented from carrying forward a balance of assessed loss merely by reason of the fact that he was not derived any income

---

<sup>36</sup>1952 (4) SA 505A, SATC 240

during the year of assessment.

In short, to obviate the problem created by Section 20(1) in the case of the SA Bazaar's decision, and to take advantage of the opportunities created by Section 2A, one would be well advised to form a trust which would be able to do the following :

- i) To carry forward assessed losses from previous years even if it did not trade during the year.
  
- ii) To set-off trade losses against non-trade income.

## CHAPTER 7

### ANTI-AVOIDANCE PROVISIONS

It is often desirable for a taxpayer who is taxed at a high marginal rate to divest himself of certain sources of income by divesting such income into the hands of his wife and children.

The benefit being that this income would be taxed at a lower marginal rate<sup>37</sup>.

It is exactly this type of avoidance that the provisions of Section 7 and Section 103(1) seek to prevent.

#### 1) Section 7

The provisions of Section 7 override the provisions of Section 25B where the applicable circumstances are present save for the more general provisions contained in Section 7(1) the remaining six sub-sections of Section 7 seek to tax income which has arisen "by reason of" or "in consequence of" a donation, settlement or other disposition, in the hands of the maker of such donation, settlement or other

---

<sup>37</sup>Walpolem, Income Tax Splitting (1991) 5 Tax Planning 89

disposition, hereinafter referred to as the "donor".

i) Section 7(1)

This section states that income shall be deemed to have accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalised or otherwise dealt with in his name or on his behalf and that a complete statement of all such income shall be included by any person in returns rendered by him in terms of the Act<sup>38</sup>. It would appear that the purpose of Section 7(1) is to prevent an accrual as being regarded as postponed by reason of the income being dealt with in the ways set out above.<sup>39</sup>

In *CIR vs People's Choice*<sup>40</sup> the Court held that the purpose of Section 7(1) was not clear in that it merely listed a number of situations in which an accrual would be affected but that there would have been an accrual in any event in terms of the Gross Income Definitions.

---

<sup>38</sup>Meyerowitz and Spiro on Income Tax at 157

<sup>39</sup>IBID

<sup>40</sup>1990 (2) SA 353 at 365

---

Both **Silke**<sup>41</sup> and **Meyerowitz**<sup>42</sup> contend that because the section achieves no more than the "Gross Income Definitions" it would appear to be superfluous. **Silke**<sup>43</sup> highlights a problem which may occur where income has vested in a beneficiary. This income may be deemed to be income of the beneficiary in terms of the provisions of Section 7(1), or in terms of Section 25(B)(1). Should the income be deemed to be the beneficiary's in terms of Section 7(1) such beneficiaries could be prejudiced in that he/she would not qualify for attribution of deductions or allowances provided for in Section 25(B)(3). **Silke** holds that in these circumstances Section 7(1) should be disregarded.

In Section 7(1) it is submitted and merely repeats what is contained in the Gross Income Definition but together they prevent the taxpayer from arguing that he is not liable for tax on income which has accrued to him but which he has not actually received.

---

<sup>41</sup>**Divaris C., Steyn M.L., : Silke on South African in Tax at 12 21A**

<sup>42</sup>OP CIT

<sup>43</sup>OP CIT

ii) Section 7(2)

This section is intended to prevent income splitting between husband and wife to take advantage of the separate taxation of spouses.

For the purpose of this paper I will limit my discussion to the provisions of Section 7(2)(a).

Section 7(2)(a) which applies to "donations" made or "schemes" entered into on or after 20 March 1991 deems any income received by or accruing to a spouse (recipient) whether married in or out of community of property to be the income accrued to his or her spouse if such income was derived by the recipient

a) in consequence

i) of a donation, settlement or other disposition;

ii) of a transaction, operation or scheme entered into or carried out by the donor on or after that date; and

- b)
  - i) the sole or main purpose of such donation or such scheme was the reduction, postponement or avoidance of the donor's liability for any levy or duty;
  - ii) which but for such donation or scheme would become payable by the donor under the Income Tax Act or any other Act administered by the Commissioner.

In the context of the taxation of trust income Section 7(2)(a) will apply where for example, a husband has donated assets to an inter vivos trust and where his wife is the income beneficiary of that trust.<sup>44</sup> However, the ambit of the section goes beyond the requirements of gratuitousness or generosity between spouses and can even be applied where the property has been transferred into the trust by means of a loan at full market rates or where the property is sold at market value to the trust subject always to the provision that the "donor" spouse's sole or main purpose was to avoid or postpone any tax

---

<sup>44</sup>Urquhart and Davis : Estate Planning at 1211

administered by the Commissioner of Inland Revenue including Income Tax, Estate Duty, Vat, Stamp Duty and Marketable Securities Tax.<sup>45</sup>

iii) Section 7(3)

Section 7(3) prevents parents avoiding tax by diverting part of their income to their minor children, who would usually be taxable at a lower marginal rate.

This section provides that income is deemed to have been received by the parent of a minor child if by reason of donation, settlement or other disposition by the parent of that child if

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

Meyerowitz holds that a minor child is any unmarried individual under the age of 21 or

---

<sup>45</sup>Meyerowitz and Spiro on Income *supra* at 1064

married person irrespective of age. A married person who is divorced or widowed before the age of 21 will not revert to the status of a minor for the purpose of the Income Tax Act.<sup>46</sup>

The operation of Section 7(3) (as well as 7(2)(a), 7(4), 7(6) and 7(7) is restricted to circumstances where the recipient of the income (in this case, the minor child) receives the income by reason of or in consequence of a donation settlement or other disposition. The terms donation and settlement have never caused problems in that they are clear and unambiguous. The phrase that has some problems is

a) "other disposition"

The uncertainty as to the precise meaning of this phrase has its origins in the judgment of *Barnet vs COT*<sup>47</sup> where it was held that a disposition did not only mean a gratuitous disposition but also included transfer, transaction, plan, scheme or arrangement not in the form of a gift or donation. This principle was

---

<sup>46</sup>IBID at 1100

<sup>47</sup>1959 (2) SA 713

disconcerting in that it meant that virtually all forms of transferring ownership (including sale for full value) of an asset would fall within the ambit of this section. This uncertainty has fortunately been resolved by two judgments dealing with what has been referred as the "critical phrase".

In *Joss vs CIR*<sup>48</sup> a decision on Section 7(3) of the Act, Coetzee J held that "I think a thing which is absolutely certain is that the words "other disposition" in the context cannot possibly mean every disposition which in law is recognised as such. This would lead to startling results." The Court continued "I think that the *ejusdem generis* rule is of application and, that transactions for full value in money or money's worth are excluded from "other disposition" and that where consideration was given it would be necessary to determine whether it is triflingly inadequate. If so, full value did not pass and Section 7 would come into

---

<sup>48</sup>1990 (1) TPD 674 at 679B

play.

In *Ovenstone vs SIR*<sup>49</sup> the Appeal Court interpreted the words "other disposition" as follows :

"Since "disposition", the general word that rounds off the critical phrase, was not intended to have its wide unrestricted meaning I think that this is an appropriate situation in which to circumscribe its scope by extending that common element of gratuitousness to it too by the *ejusdem generis* or *noscitur a sociis* rules. The critical phrase should in other words be read as any donations, settlement or other similar disposition."

Finally the Court held that the phrase "other disposition" would include a disposition made for some consideration but where there was still an "appreciable element of gratuitousness and liberality or generosity".

---

<sup>49</sup>1990 (2) SA 721 (AA) of 737

b) "by reason of"

An important point raised in both the above decisions is that the words "by reason of" indicated that there must be a casual connection between the receipt of the income and donation, settlement, or other disposition, and that once this has been determined an apportionment of income must in appropriate circumstances be made.

Coetzee J in Joss' case<sup>50</sup> held it was "logically imperative to separate the interest free loan from the transfer of shares to determine the casual connection between the receipt of the income and that of the disposition. This flows from the words "by reason of" in the section. Hence once an amount received by way of dividend is clearly attributable as to part thereof to such a disposition, then an allocation must be made for tax purposes of the amount which was received "by reason of" the donation, settlement or other disposition".

---

<sup>50</sup>Supra

The Court held that on the facts that there had been two dispositions of which only one being in the form of an interest free loan fell within the ambit of Section 7(3) and which had affected the quantum of the dividend received by the taxpayer's daughter and the trust. As a result the Court ordered the Secretary for Inland Revenue to amend the relevant assessment to reflect the position that "only the interest free loan in respect of the purchase price of the shares is deemed to be a disposition within the meaning of Section 7(3) to the extent that the aggregate of interest that should have been charged on the price of the shares from inception of the scheme would have exceeded the aggregate of profits available for distribution by way of dividend."<sup>51</sup>

An important point made by Joss' case is that where a disposition is partly gratuitous and partly for value the income which is received or accrued by reason thereof must be apportioned between the

---

<sup>51</sup>at page 683

two elements and not simply be taxed in full in the donor's hands because of the disposition.

This idea of apportionment found support in *Ovenstone's case*<sup>52</sup> where the Appellate Division by Trollip JA held "I wish to add this observation about the last kind of composite disposal, one that a partly gratuitous and partly for consideration. If the consideration is merely illusory simulated or minimal, the disposal will, of course, be regarded as wholly gratuitous. On the other hand, merely because the settlement or disposition contains some element of bounty or gratuitousness, that is insufficient to render Section 7(3) applicable, such element must be appreciable for that to happen. To this extent the approach is somewhat less strict or rigid that may be suggested by the words "no element of bounty" used in the English cases referred to above. Then where the consideration while not being due consideration is nevertheless appreciable, it will mean

---

<sup>52</sup>OP CIT

that the income in question under Section 7(3) will usually have accrued or been received "by reason of" both elements of gratuitousness and consideration. I see no reason why in these circumstances the income should not then be apportioned between two elements. The words, "by reason of", themselves suggest accrual or receipt of the income. If such apportionment is not possible, or if insufficient evidence is adduced to enable the Court to effect it (the burden of proof being on the taxpayer under Section 8(2)) the composite disposal will usually, because of its appreciable element of bounty, be then simply, treated as a gratuitous settlement or disposition, as the case may be, that falls within the scope of the critical phrase.

c) Income on Income - "the meaning of by reason of"

It is often difficult to ascertain whether income has been received by a minor "by reason of" a donation, settlement or other disposition made by the parent of a minor.

In *Kohler vs CIR*<sup>53</sup> the Court accepted the taxpayers construction of the words "by reason of" as requiring a direct and immediate casual connection between the income and donation but that the words did not refer to cases where the donation was merely the *causa sine qua non* but rather where it was proximate cause and not too remote a cause. Where the income was received by or accrued to the minor and had been capitalised its subsequent income upon income could be attributed to the employment of the minor's new capital.

This decision was not followed in *CIR vs Widan*<sup>54</sup> where the Court held that it was unlikely that the Legislature intended when it used the words "by reason of", that Section 9(5) (the equivalent of 7(3) that it should have such a narrow application. The Court held that in applying the words "by reason of" one had to ascertain that the proximate cause but then added "when one seeks the "proximate cause" of a certain result, it does not

---

<sup>53</sup>1949 (4) SA 1022 (T)

<sup>54</sup>1955 (1) SA 226 (A)

necessarily follow that a cause, nearest in point of time is the proximate cause.<sup>55</sup>

In establishing whether such a casual relationship exists the Court held that one must look to the real efficient cause of the income being received which must be ascertained on the facts of each case. If it is found that the effective cause of the income was the donation made by the parent then the income would be deemed to be that of the parent.

iv) Section 7(4)

It is submitted that this section is an anti-avoidance provision enacted to avoid circumvention of Section 7(3) by way of reciprocal schemes. The section deems the income of a minor to be his/her parents income if that parent has made a donation, settlement or other disposition or given some other consideration to some other person or that person's family in return for a donation, settlement or other disposition by that person

---

<sup>55</sup>IBID at page 683

to the parent's minor child.

In order for this section to apply there must be a casual connection between the donation on the one hand and the consideration given by the parent of the donee on the other, i.e the considerations must be reciprocal.<sup>56</sup>

v) Section 7(5)

This section's general aim as was said in *Estate Dempers vs SIR*<sup>57</sup> is to prevent the avoidance of tax liability where so long as the settler does not permit the beneficiary of the gift to enjoy immediately the income derived therefrom, by deeming the income in question to be that of the settler.

In *Estate Dempers*<sup>58</sup> it was held that Section 7(5) contemplates a hypothesis consisting of two elements both of which had to be met in order for the section to apply.

The elements of the hypothesis being :

---

<sup>56</sup>Meyerowitz and Spiro at 1112

<sup>57</sup>1977 (3) SA 410 AD

<sup>58</sup>IBID

- a) There must be a stipulation or condition, the effect of which is that the beneficiaries shall not receive the income until the happening of an event, and
- b) but for the stipulation the income would be received by or accrued to the beneficiaries.

Once both elements of the hypothesis have been met, any person who has made a donation, settlement or other disposition to the trust will be taxed on the income irrespective of who made the stipulation or who founded the trust.

1) The event

An important element of Section 7(5) is that the stipulation or condition must relate to the happening of an event which may be fixed or a contingent question which has been left unanswered in two Appeal Court decisions is whether the exercise of a trustee's discretion to distribute income or not, would constitute an event for the purpose of Section 7(5).

The Appellant in *Estate Dempers*<sup>59</sup> argued that Section 7(5) did not apply because the exercise of a trustee's discretion was not an "event" falling within the scope of the section.

- i) because the trustee could distribute the income there was no stipulation to the effect that the donee should not receive the income until the happening of an event, and
  
- ii) that the kind of event contemplated by the subsection was a "single once-and-for all occurrence until the happening of which the beneficiary did not receive the income and after which he did". These arguments were based on the premise that "if the exercise of such a discretion were to be regarded as an "event" it would mean that, once the trustee exercises his discretion either against or in favour of the

---

<sup>59</sup>The Taxpayer September; 1977 p 56

beneficiaries, the tax liability of the donor would cease, because the question is not whether the occurrence of the event in fact resulted in the beneficiaries receiving income but whether the event before the occurrence of which they were not entitled to receive income had in fact occurred"<sup>60</sup>

Thus it was argued that the event contemplated by the section was one which would finally vest the income in the beneficiaries.

The Court held that there was undoubtedly some force in these arguments but did not pronounce on them or consider their correctness because there were other occurrences stipulated in the trust deed which in themselves constituted events in terms of Section 7(5).

---

<sup>60</sup>Huxham K. and Haupt P. 1995 : Notes on South African Income Tax, p 465

In *SIR vs Sidley*<sup>61</sup> the facts were similar to those of *Estate Dempers* except that the income was distributable unless the trustee in exercising his discretion withheld the income. The Court however again found it unnecessary to pronounce on this issue.

vi) Section 7(6)

This section provides that "if any deed of donation, settlement or other disposition contains any stipulation that the right to receive any income thereby conferred may under the 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.

It would appear that the purpose of this section, is to prevent a person from directing

---

<sup>61</sup>197 (4) SA 913 AD : The Taxpayer December 1977 p 226

his income to others while still retaining the right to determine who should receive income.

In ITC 673<sup>62</sup> it was held that this section contemplates an express provision as opposed to implied powers to revoke the right to receive income. It should seldom be necessary for the donor to reserve the type of power referred to in Section 7(6) because the discretion conferred upon a trustee as to vesting and distributing income could serve the same purpose.<sup>63</sup>

vii) Section 7(7)

Section 7(7) was inserted into the Income Tax Act in 1983, primarily to overcome the situation in which the taxpayer donated to a charity his rights to dividends for a period of four years and thus avoided the accrual and taxation of such dividends in his hands.<sup>64</sup>

As a result Section 7(7) was introduced into the Act and in terms of which, income which has been received by or accrued to or for the benefit of

---

<sup>62</sup>16 SATC 230

<sup>63</sup>The Taxpayer (June 1994) p 114

<sup>64</sup>Urquhart and Davis : Estate Planning A 1257

some other person, on or after 1 July 1985 is deemed to have been received by or accrued to the donor where the following circumstances are present :

- a) There must be a donation, settlement or disposition made by the taxpayer.
  
- b) By reason of the donation, settlement or other disposition, the taxpayer's right
  - i) to receive or have paid to him or for his benefit any amount by way of rent, dividend, interest, royalty or similar income in respect of any movable or immovable property; or
  
  - ii) in respect of the use of, or the grant of permission to use such property is ceded or otherwise made over to any other person or to a third party (e.g. a trustee) for the benefit of that other person.
  
- 2) the cession or making over is in such

manner that :

- i) the taxpayer remains the owner of or retains an interest in the property; or
  - ii) if the property or interest is transferred, delivered or made over to the other or third party (e.g. a trustee) for the other person's benefit, the taxpayer is or will at a fixed or determinable time be entitled to regain his ownership or interest.
- c) Alternatively to (b), by reason of the donation, settlement or other disposition, the taxpayer's right to receive or have paid to him for his benefit any income that is or may become due to him by any other person acting in a fiduciary capacity (e.g. income from a trust) is ceded or otherwise made over to any person or to a third party (e.g. a trustee) for that other person's benefit in such a manner that the taxpayer is or will at a fixed or determinable time be entitled to

regain that right.

- d) But for the donation, settlement or other disposition any such rent, dividends, interest, royalty or income received by or accruing to the other person or for his benefit (including any income which would have been exempt in his hands) would otherwise have been received by or accrued to or for the benefit of the taxpayer.<sup>65</sup>

viii) Section 103(1)

This section is a general anti-avoidance provision which gives the Commissioner a remedy to determine tax liability as if the scheme had not been entered into or carried out. The Commissioner may only invoke Section 103(1) if all the requirements for the operation of the section have been met.<sup>66</sup>

The Commissioner must be satisfied that :

- a) there must be a transaction, operation or scheme;

---

<sup>65</sup>OP CIT at 1256

<sup>66</sup>SIR vs Geustyn, Forsyth and Joubert 1971 (3) SA 567 (A)

- b) which has the effect of avoiding or postponing liability for any tax, duty or levy imposed by the Income Tax Act (i.e. Income Tax, Donations, TAX STC and MRST);
  
- c) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out if :
  - i) it was entered into by abominable means or in an abominable way or;
  
  - ii) has created rights and obligations not normal in an armslength transaction.
  
- d) and was entered into solely or mainly for the purpose of avoiding or reducing or postponing any tax administered by the Commissioner (e.g. Income Tax, Estate Duty, MRST, VAT, stamp duty).

Where income is taxed in the hands of the "planner" in terms of the provisions of Section 103(1) he will not have had, had the income been deemed to be his or in terms of the provisions of Section 7(3) to 7(7) where a trust has been

set up in terms of an Estate pegging scheme it may be preferable for the income to be taxed in terms of Section 103(1) so that no right of recovery is available. In so doing the planner can avoid a further build up of income in his Estate.

---

## CHAPTER 8

### INCOME OF TRUSTS PER SE

Trust income which does not or is not deemed to accrue to the beneficiary or to the settlor (in the case of an inter vivos trust), will be taxable as income of the trust as such. A trust is taxed at the rates applicable to unmarried persons, but is not entitled to a primary rebate with effect from the 1992 year of assessment.

In terms of the definition in Section 1, the obligation to pay the tax falls on the trustee as a representative taxpayer in respect of income the subject of any trust. Prior to the recent amendment defining a trust, it was held in *Estate Smith vs CIR*<sup>67</sup> that the definition of a representative taxpayer, which appears to contemplate a narrow concept of a trustee in the Act, in effect limiting the meaning of the latter definition in the context of representative taxpayer.

Thus the trustee as defined qualifies as a representative taxpayer only if the income in question is income the subject of a trust. The Courts have interpreted the words "income the subject of a trust" narrowly, giving "trust" its common law (strict) meaning and distinguishing between the trustee of a

---

<sup>67</sup>1960 (3) SA 375 (A) at 379

---

deceased estate, a guardian or a curator on the other.<sup>68</sup>

It is submitted that, although there is no inherent limitation in the definition of a trust, all three definitions must be read together and the fact that executors, guardians and curators are enumerated separately from trustees in the definition of a representative taxpayer implies that the narrower interpretation of the Courts is appropriate in this context. Therefore the income of a discretionary testamentary trust is not treated in the same way as the income of a deceased estate which is administered by an administrator, although there are clear similarities.<sup>69</sup> In addition, income accrued to or received by a trustee in an insolvent estate cannot be characterised as income subject to a trust even though it will be used for the benefit of creditors.<sup>70</sup>

**Meyerowitz and Spiro** consider that where the trust income vests in a beneficiary or is deemed to accrue to him, the trustee is not a representative taxpayer in respect of such income because it is no longer income of a trust (unless he is appointed by the Commissioner as an agent in terms of Section 99).<sup>71</sup> However, Honóre states that the trustee may be compelled to pay the tax due on income of the donor or

---

<sup>68</sup>OP CIT 380-1

<sup>69</sup>**Davis and Urquhart**, para 1265

<sup>70</sup>**Thorne and Ano N.N.O vs Receiver of Revenue 1976 SA 50 (C); Estate Smith vs CIR** (See note 69 supra)

<sup>71</sup>**Meyerowitz and Spiro**, para 2004

beneficiary who he represents, but may recover the amount from the.<sup>72</sup>

Trust income which has accrued during the year of assessment and is deemed to be that of the donor or of the trust itself, does not become taxable as income in the hands of a beneficiary when it is subsequently distributed to that beneficiary.<sup>73</sup>

#### 8.1 Margo Commission

The Margo Commission has recommended that where the trustees have the power to distribute income, whatever income remains undistributed at the end of the tax year and has not accrued to any particular beneficiary, should be taxed in the hands of the trustee at the maximum marginal rate applicable to individuals. The Commission appeared to rely on the somewhat dubious contention that income not distributed to beneficiaries was therefore not need by them.<sup>74</sup>

The recommendation also seems to imply that income which accrues to a non-business trust will be taxed either in the hands of the beneficiary or in the hands

---

<sup>72</sup>Honore's South African Law of Trusts, para 271

<sup>73</sup>Estate Dempers (supra)

<sup>74</sup>Honore's South African Law of Trusts, para 276

of the trustee. This would not allow for the application of Section 7(3) to tax the parent who has donated assets to a trust on income which has accrued to a minor beneficiary.<sup>75</sup>

In addition, the concept of accrual means that the trustees may retain income in the trust but accumulate it for the benefit of a beneficiary to be taxed on the accrued income possibly at lower than the maximum marginal rate, while allowing the income to remain in the trust under the control of the trustees.<sup>76</sup>

## 8.2 Business Trusts

The Commission suggested that a business trust be defined as one which, in the opinion of the Commissioner, is used for carrying on business for profit, including the owning and letting of property for profit. A trust which simply protect and conserve assets would fall outside this definition. A trust should be deemed to be a business trust where :

- a) the interests of a beneficiary are transferable,
- or

---

<sup>75</sup>Trusts and the Margo Commission (1988) The Taxpayer

<sup>76</sup>IBID

- b) the beneficiaries and trustees establish their association by voluntary, consensual or contractual means, excluding the mere acceptance of benefits stipulated between a donor and trustee.

The main advantages of using a trust for business purposes other than the investment or administration functions usually associated with trusts can be summarised as follows :

- ease of formation;
- lack of formalities with respect to formation and management;
- limited liability of beneficiaries;
- limited liability of trustees if properly arranged, particularly if the trustees operate through a company;
- perpetual succession, if properly drafted.<sup>77</sup>

In effect, many of the advantages of a company may be enjoyed through the use of a trust without compliance with the provisions of the Companies Act. There is also an advantage over a Close Corporation in that its members may be personally liable in some circumstances. As a trustee acting in his capacity as such is only

---

<sup>77</sup>Davis and Urquhart (supra)

liable to the extent of the trust assets, the form of limited liability independent of the Companies Act which is available to a business carried on by trustees.

It may be perceived as having potentially dangerous consequences. Limited liability is obtained without "essential protection" for creditors viz. the maintenance of capital in company law and the solvency and liquidity requirements in Close Corporation law. Unwary "beneficiaries" may also be prejudiced by a lack of clear rules for their protection. A further advantage of a business trust in terms of income tax is the difference in tax rates between a company and individuals. In addition, income distributed by a trust to a beneficiary retains its character in terms of the Conduit Pipe principle, subject to the anti-avoidance measures in Section 7 and Section 103.

A trust is also a flexible vehicle, with the rules applicable to it largely determined by the contents of a trust deed.

The definition proposed by the Commission has been described as both illogical and discriminatory in terms of distinguishing business trusts from Estate-planning

or common law trusts.<sup>78</sup>

Many estate-planning trusts do more than simply preserve assets, but rather manage them so as to obtain a profit, although their primary purpose would be to peg the asset's value for estate duty purposes. Depending on the extent of their activities such trusts could well fall within the definition. The criteria of transferability of the beneficiary's interest, and establishment of association among trustees and beneficiaries by consensual means, could apply to any trust "designed to protect and conserve assets" which carries on a business such as letting property.

Bearing in mind the perceived "mischief" that such a definition would be designed to remedy, i.e. the tax benefits of a trust which has attributes of a company, it is difficult to conceive a definition which will not result in inequity. Motions such as conducting business operations as opposed to investment, or profit as opposed to conserving and protecting property, do not take the matter further. In view of the limited potential for additional revenue of such a measure it may not be a worthwhile exercise.

---

<sup>78</sup>Taxation of Business Trusts : 1992 The Taxpayer 48 at

## CHAPTER 9

### EXEMPTION FROM TAX OF CERTAIN TRUSTS

Certain trusts are exempt from tax. These comprise :

- i) Certain pension funds and other benefit schemes.
  - ii) Non-profit making and non-proprietary clubs.
  - iii) Charitable institutions.
- i) Under the Act receipts and accruals, including receipts and accruals from investment, of any terminating building society, pension fund, provident fund, retirement annuity fund, benefit fund or any institution which in the opinion of the Commissioner is a mutual savings bank, mutual loan association, a fidelity or indemnity fund, a trade union, a chamber or association of chamber of commerce or industry, a local publicity association or a non-proprietary stock exchange, are exempt from tax.<sup>79</sup> The assets of such bodies are often vested in trustees and where this is so the trust is itself exempt from tax.

---

<sup>79</sup>ACT 58 of 1962 510 (1) (D) as substituted by Act 85 of 1974

ii) Exemption is also granted in respect of the receipts and accruals of any company, society or other association of persons whether or not registered under any law with certain exceptions, the profit or gains of which, other than receipts and accruals from investments, are derived solely from transactions with or on behalf of its individual members, and the constitution of which does not admit of any distribution of its profits or gains to any person other than the members with or on whose behalf the transaction takes place, and does not confer on any person any benefits other than the benefits accruing to that person from transaction with or on behalf of that person.

Amateur sporting associations, housing associations, political parties, research institutions set up by law and a variety of associations for the purpose of research, conservation, culture, recreation and business or occupational interests on a non-profit making basis are exempt. Investment income from these non-proprietary clubs and sporting associations is exempt from tax also. Usually the assets of such clubs are vested in trustees and the trust itself is exempt from tax in such cases.

iii) The receipts and accruals of all ecclesiastical,

charitable and educational institutions of a public character, whether or not supported wholly or partly by gifts from the public revenue are exempt from tax. It must be stressed however that charitable trusts are not as such exempt from tax, for a trust may be charitable without constituting a charitable institution.

An "institution" is said to be the object called into existence to translate the purpose as conceived in the mind of the founder into a living and active principle.

In order that a body may be an exempt institution it must actually be carrying out ecclesiastical, charitable or educational functions. It is not enough that it is bound by trust to do so at some future date, or that it distributes money to institutions which themselves perform charitable functions. For this reason trustees who hold assets upon trusts for charitable purposes and receive income from them may nevertheless be assessable to income tax as representing the trust.

The question whether a trust is an ecclesiastical, charitable or educational institution is one of degree. Such factors as the permanence of the trust, its complexity and whether immovable property is purchased or leased directly for trust purposes and not merely as

an investment all bear on the decision. When the trustees are directed to pay the income to charitable institutions the trust is not itself usually regarded as a charitable institution.<sup>80</sup>

Hence the trustees may be assessable as representative taxpayers at least as regards undistributed income.<sup>81</sup>

A trust which fails to qualify as a charitable institution may be entitled to exemption under (iv) below, which formalises a practice that the Inland Revenue would not tax trustees who distributed at least 75 percent of the nett income in any tax year to ecclesiastical, charitable or educational institutions.

- iv) The receipts and accruals of any fund approved by the Commissioner which has been established by a will or written instrument requiring it to distribute so much of its nett revenue as the Commissioner directs to an institution falling under (iii) above. The Commissioner may impose conditions to ensure that benefits are allocated by the fund only for ecclesiastical, charitable and educational purposes. He may revoke his approval if the conditions are

---

<sup>80</sup>Manchester vs Adam (1896) 3 Tax Cases 491, 497 [1986] AC 500 at 511

<sup>81</sup>ITC 239 (1952) 6 SATC 358

broken, or if the fund fails to make a sufficient distribution. This exemption gives effect to a long-standing practice. It makes it less crucial for the trust to establish that it is an ecclesiastical, charitable or educational institution provided the trustees can show that the written constitution or instrument requires them to distribute a sufficient proportion of their nett income to such institutions.

## CHAPTER 10

### CONCLUSION

The notion of a trust, while not recognised in Roman Dutch Law, has become a part of our legal system through usage. Trusts are extensively used for estate planning and tax purposes and as a vehicle for conducting business operations, although the Legislature has reduced their potential tax advantages by means of anti-avoidance measures in the Income Tax Act, with fairly comprehensive specific provisions in Section 7 and the general provisions of Section 103.

It will be noted that the problem that could not be given a solution, the taxation in the hands of a trustee which forms the crux of the discussion and is calling for attention of the Legislature.

Although it will not always be clear under what circumstances income that is the subject of a trust is to be taxed in the hands of a trustee as representative taxpayer and in what circumstances the beneficiaries will be liable for tax, both the wording of 525B and the case law that preceded it support the same generalisation.

I submit that since the trustee is a mere conduit-pipe and the

income of the trust does not accrue to him but to the beneficiary then the trustee should not be liable for tax in this case and a trust be taxed in the hands of the beneficiary when it vests. Because of these uncertainties of whose hands a trust should be taxed and case law emanating for it, this part of our law is crying for legislation on exactly the taxation the trust that has not vested. In the past trusts have been used to avoid tax.

The Margo Commission sounded several warnings about the use of trusts. Its recommendation concerning the application of the maximum marginal tax rate for individuals to undistributed trust income, and the taxation of so-called business trusts at company tax rates will have a major impact if implemented. Similarly, with regard to the use of trusts in estate planning, the Commission recommended that generation skipping devices such as trusts should be subject to a capital transfer tax after the lapse of a fixed period of time. These possibilities must obviously be borne in mind when the use of a trust is contemplated.

Finally, the scope of interpretation of a taxing statute always provides opportunities for the taxpayer to structure his affairs creatively to his best advantage. Having considered the lines drawn by the Legislature for the imposition of taxes, he will, as always, strive to make it his business to walk outside them.

## BIBLIOGRAPHY

1. DAVIS D.M. AND URQUHART G.A. :  
1989, ESTATE PLANNING, BUTTERWORTHS
2. EMSLIE T.S., DAVIS D.M., HUTTON S.J. :  
INCOME TAX CASES AND MATERIALS, BUTTERWORTHS
3. HONORÉ T. AND CAMERON E :  
HONORÉ'S SOUTH AFRICAN LAW OF TRUSTS : 4TH  
EDITION, JUTA
4. HUXHAM K. AND HAUPT P :  
1995 : NOTES ON SOUTH AFRICAN INCOME TAX,  
H AND H PUBLICATIONS
5. KOURIE M.A. AND OOSTHUISEN J. :  
TAX AND TRUSTS EASIGUIDE
6. MEYEROWITZ D :  
MEYEROWITZ ON INCOME TAX, 1995
7. STEYN M.L., DIVARIS C. :  
SILKE ON SOUTH AFRICAN INCOME TAX, 1989, JUTA