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**TAXATION**

**OF**

**TRUSTS**

**IN**

**SOUTH AFRICA:**

**A COMPARISON**

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**THE TAXATION OF TRUSTS IN SOUTH AFRICA**  
**A COMPARISON**

**DISSERTATION PRESENTED TO THE**  
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**BONGO TAMSANQA QINA**

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## INTRODUCTION

There are a number of reasons why people would want to form a trust. For example, a business person who has minor children can decide to set up a trust in order that experienced people could act as trustees and run his or her businesses on behalf of those minor children. The reasons for forming such a trust could be varied: (i) As minors, the children will not be, legally, in a position to enter into ~~BINDING~~ contracts, or (ii) even when they reach majority the parent (business person) may think that, because of their lack of experience in running a business, they may ruin it, or (iii) they may squander all the wealth he has accumulated after his or her death. There are other reasons for forming trusts - some people always support one cause or another, e.g. religious, political or social causes. In order to support a cause that calls for continuous management rather than a once-for-all disposition, a person would need to create a trust. A trust could also be created for the purpose of concealing ownership of assets or when a person wants to put some or all of his assets out of the reach of creditors or family.<sup>1</sup>

Whatever purpose one uses trusts for, the common feature in trusts is that they tend to reduce and/or postpone the incidence of taxation. That there are often tax advantages in the creation of trusts is confirmed by the observation of the late

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<sup>1</sup>.Honoré and Cameron

Stanley Surrey who said: 'The tax structure favours the family that adds a trustee to the family dinner.'

This provides a vast terrain to explore. I intend exploring how taxpayers are taxed on trust income, how they try to avoid the long arm of the taxman, how the taxman and the legislation try to close the gaps. On the excursion into this territory I will also venture into some foreign lands, i.e. I will compare the South African tax system vis-a-vis trust with that of countries like the United Kingdom, Australia and, to a limited extent, Canada.

My reasons for this choice are quite simple. The United Kingdom 'exported' the concept of trust to the countries that it, in one form or another, colonised. The direct 'beneficiaries' thereof are Australia and South Africa (and with adjustments here and there Canada also adopted the English version of trusts). Therefore I felt that for this discussion to be balanced, as well as to know what advances, if any, the South African tax law has made to keep on par with other countries, I had to make such a comparison. Thus by the end of this journey I hope I would have succeeded in not only explaining how South Africa taxes trusts but also why it does - and part of the latter explanation lies with the understanding of how other tax systems operate.

## CHAPTER I

### The Foreign Influence

The origin of trusts is in English law. It dates as far back as the 11th century when the practice of granting land to a feoffee, i.e. transferee, ad opus and in usum of the beneficiary started. This kind of transaction was then known as 'use'.<sup>2</sup>

In a recorded case a man known as Robert was off to the Holy Land and decided to leave all his land to his brother to keep for the use of his sons. However, later the brother refused to hand the land over after the death of Robert and as a result the issue was brought to court. The court came to the decision that all had an equal claim to the land and therefore it ruled that the land be divided amongst the parties. This decision, I dare say, is the origin of the latter day equitable interest. This is so because the court recognised the rights of Robert's sons to the land.

The use of trusts can also be traced to the practice of Franciscan friars, who arrived in England as missionaries, of conveying houses they were staying in to the borough community 'to the use of' the friars. This arrangement was the result of the friars' vows of poverty which also excluded them from

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<sup>2</sup>.Corbett

ownership of property. So the borough community held the property in the trust for the friars.

It was not until the 15th century that the beneficiaries' interest were recognised as a form of equitable or beneficial ownership. The implication of this was that legal ownership was severed from equitable ownership.<sup>3</sup>

In contrast, the Roman or Roman-Dutch law had no such thing as trust. According to these two forms of law the understanding of trust relations was based on the concept of a fiduciary and a fideicommissary under the institute of fideicommissum.<sup>4</sup>

This is the system South Africa adopted, the reason being that that was the law known to the Dutch settlers who established themselves in South Africa in the 15th century.

Under the South African law trusts were divided between the testamentary trust, which was regarded as fideicommissum mortis causa, and the inter vivos trust, which was construed as stipulatio alteri, i.e. a contract for the benefit of a third party.<sup>5</sup>

With the arrival in the 19th century of the British settlers in the cape and Natal, the English institution of trusts was

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<sup>3</sup>. Shrand

<sup>4</sup>. Frere - Smith

<sup>5</sup>. Shrand

introduced in South Africa. These settlers used trusts widely in various transactions such as wills, antenuptial contracts as well deeds of gift. Despite the popularity of trusts amongst the British settlers South African law still did not recognised them. This is best expressed in the judgement of the Estate Kemp v MacDonald's Trustee case: 'The English law of trusts forms, of course, no portion of our jurisprudence, nor ..... have our courts adopted it, but it does not follow that testamentary dispositions couched in the form of trusts cannot be given full effect to in terms of our own law.'<sup>6</sup>

The interpretation of this statement, I think, is that South African law could be bent and twisted in order to accommodate the English law of trusts. Indeed, the law was made flexible enough to adopt some aspects of the English law of trusts. Because of this fact not all rules of South African trust law are derived from, nor identical with those of English law. Any reception of English trust law in South Africa has only been partial. Therefore the rules of South African trust law are a mixture of English, Roman-Dutch and distinctively South African rules.<sup>7</sup> These South African rules are continuing to grow both in use

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<sup>6</sup>.1915 AD 941

<sup>7</sup>.Honoré and Cameron

and importance, hence Hahlo's observation that:

"When it comes to trusts in our law, even the most elementary propositions cannot be regarded as settled. It will take the work of several generations of judges and text-writers before our law of trusts reaches maturity".

This statement is confirmed by the fact that it was only in 1991 that the legislation ultimately settled the question of the taxation of trusts.<sup>8</sup>

#### Definition of a trust

To understand the taxation of trusts one has to know what a trust is.

The Income Tax Act does not provide any definition of 'trust'. However, it is accepted that a trust arises where property is transferred by a person to trustees to be managed for the benefit of beneficiaries or for a charitable purpose. Usually, the transfer is by way of gift but it may be pursuant to a contract.<sup>9</sup> This does not define a trust; it merely explains the transactions, and consequences thereof, that form part of a trust.

Perhaps the definition provided by the Trust Property Control Act 57 of 1988 could shed light here. Trusts are defined thus:

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<sup>8</sup>.Income Tax Act Section 25B

<sup>9</sup>.Hayton and Marshall

'The arrangement through which the ownership of property of one person is by virtue of a trust instrument made over or bequeathed to another person, the trustee, to be administered for the benefit of another, the beneficiary, but does not

include the case where the property of another is to be administered by any person as executor, tutor or curator or in terms of the provisions of the Administration of Estates Act 1965'.

(My own emphasis).

By the terms 'made over or bequeathed' the Act is attempting to differentiate between two forms of trusts. The Hague Convention on the Law Applicable to Trusts and their Recognition is in conformity with this definition. It defines 'trust' as referring to the legal relationship created inter vivos or on death by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or a specified purpose.

(It should be pointed out that South Africa is not a signatory to this Convention.) The similarity between the two definitions is that they both refer to the inter vivos (made over) and 'on death' or bequeathed forms of trusts. The latter is referring to the testamentary trust. The significance of these two trusts will shortly be apparent.

Trusts may also be classified according to how they come into existence. They may be divided into four heads, viz:

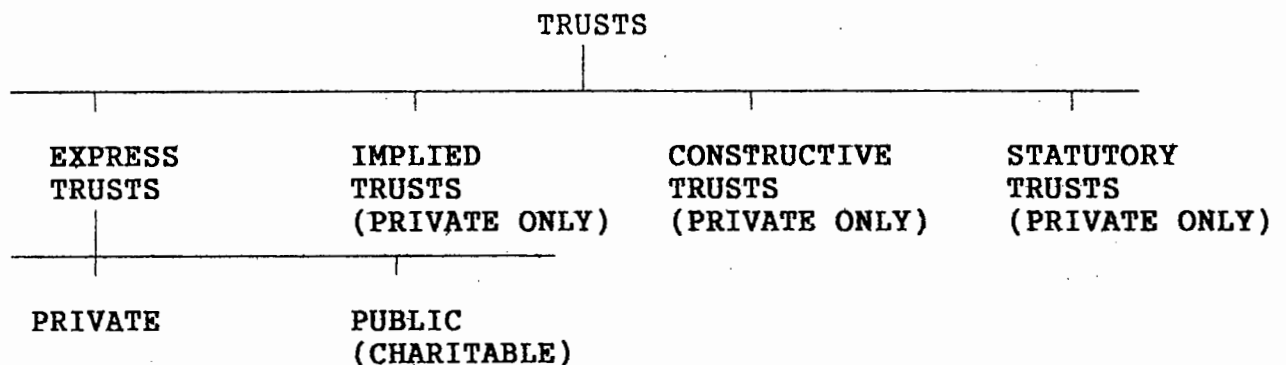
Express trusts

Implied trusts

Constructive trusts

Statutory trusts

They may further be classified according to whether their object is to benefit private individuals - these being private trusts, or certain public purposes (public trusts).<sup>10</sup> The latter are alternatively called charitable trusts. Since a public or charitable trust can arise only as a result of the express intention of the settlor, the classification of private and public can be regarded as a sub-classification of express trusts.<sup>11</sup> Implied, constructive and statutory trusts exist as private trusts only. This classification can be presented as follows:



The other means of classification is the sub-division of express private trusts into discretionary and non-discretionary

<sup>10</sup>. Riddall

<sup>11</sup>. Ibid.

trusts. To illustrate the point, let us suppose that a testator leaves certain property to trustees on trust "for my sons A,B and C". In this case the trustees are not required to exercise any discretion as to which beneficiary should receive the property. Nor do they have a choice as to what share each beneficiary should have: Each is entitled to one third.

A contrast is where S leaves property to trustees on trust for such of his sons A,B and C, and in such shares, as the trustees should decide. This is a discretionary trust. The tax implications of these arrangements form the basis of this discussion.

I am going to deal with the taxation of inter vivos and testamentary trusts after giving a brief overview of how trusts came to be taxed and on what capacity they are so taxed.

#### The trust as a 'person'

It was not until 1991, when the Income Tax Act was amended to include trusts in the list of taxable entities, that trusts were taxed. Before 1991 the Act (S5) did not regard the trust as a taxable entity, i.e. a legal persona. The word 'person' is not defined in the Act and the Interpretation Act 33 of 1957 does not provide any solution either.

On a number of occasions the tax legislation has had to deal with the meaning of the term 'person', especially where trusts

and deceased estates are involved. For example, in Estate Smith v CIR<sup>12</sup> and CIR v Emary NO<sup>13</sup> the issue was whether a deceased estate was a 'person' (taxable entity) for income tax purposes.

In CIR v MacNeillies' Estate<sup>14</sup>, re Phillip Frame Will Trust v CIR<sup>15</sup> and, on appeal, CIR v Friedman and Others NNO<sup>16</sup>

the question was whether a 'trust' was a 'person' for, respectively, estate duty and income tax purposes. In all of these cases judgement was given against the fiscus. Joubert JA, in Friedman, unequivocally held that a trust was neither a taxable entity nor a legal persona: 'There is also no basis for a submission that because the statutory definition of "person" in section 1 of 1962 Act was extended to include a deceased estate, it should by analogy be further extended to include a trust. The conclusion is inescapable that a trust is not a 'person' within the meaning of that word in the 1962 Act.'

He further remarked that:

'A "taxable entity" in the sense of a taxable being (as an

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<sup>12</sup>.1960 (3) SA 375 A

<sup>13</sup>.1961 (2) SA 621 (A)

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

<sup>15</sup>.1991 (2) SA 340 (W)

<sup>16</sup>.1993 (1) SA 353 (A)

abstract notion) other than a natural person or legal persona would seem to be, juridically speaking, an extremely loose concept which would be of very little use in fiscal legislation. It is accordingly by no means surprising to find that the Legislature does not avail itself of the expression "taxable entity" in the 1962 [Income Tax] Act. A "taxable entity" can only be construed as such if it can be brought within the ambit of S5 (1) as the charging section'.

This non-taxability of trusts extended to the trustees: Trustees could not be regarded as representative taxpayers because they are not representing a 'person' (because a trust is not a 'person').

However, after the Friedman case the Income Tax Act 58 of 1962 and the Value Added Tax Act 89 of 1991 were amended to include a trust within the definition of 'person' for purposes of these respective Acts.

Section 1 was amended to include the trust as a 'person'. The section defines a 'trust' as 'any fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person'.

Section 25B(1) was inserted but I will not dwell on this section in this chapter.

A trust is, therefore, a 'person' for income tax (and other taxes) purposes.

But this is not the case in the United Kingdom, Australia or Canada. That is, a trust is not ordinarily regarded as a legal entity under the laws of these countries. This does not, by any means, mean trusts are not taxable. On the contrary, they are taxed, but they are taxed as trusts and not as a 'person'

or 'tax entity'. Thus they are treated as separate from their trustees as far as tax is concerned.

It would have been teoretically possible for a trust to have been treated as a notional corporation, but this has never been the case in English law nor in other countries using similar legal systems.

Instead the general rule has been that, to the extent that a trust's income is not currently distributable to a beneficiary, it is subject to tax in the hands of the trust under the laws of these three countries, as though it were an individual.

But, on the other hand, it will not enjoy benefits that an individual does in that it is not entitled to personal allowance or some such reliefs: Just as is the case with trusts in South Africa; they are also not entitled to such benefits, which are enjoyed by other 'persons'.

## CHAPTER II

### Inter Vivos Trusts

As mentioned earlier, trusts in South Africa are distinguished as inter vivos trusts and testamentary trusts. This distinction is quite vital when determining who bears the tax burden on trust income.

An inter vivos trust is a trust that is created and operates during the lifetime of the settlor or donor of such trust. In some books it has been described as referring to a trust that has been created during the lifetime of the settlor. My submission is that most trusts are created during the lifetime of the settlor, testamentary trusts included. As a result, this definition is not complete.

An inter vivos trust may be discretionary or non-discretionary. There are three persons who are affected by tax in an inter vivos and this will also depend on whether such trust is discretionary or not.

The three persons are:

- i. The settlor,
- ii. the beneficiary or
- iii. (through trustees) the trust.

Who pays the tax will also be determined by the form of tax that applies, i.e. whether it is income tax, donations tax or

estate duty (these are to be dealt with separately). In this instance we will deal with trust taxation under the Income Tax Act.

**A. TAXATION OF THE BENEFICIARY: S 7(1) S 25B**

A beneficiary will be assessed for tax if the income is received by or accrues to him under a trust deed. For such income to be taxed in the hands of the beneficiary, he has to have a right to receive it, whether presently or in the future, i.e. it must have vested in him on the year of account, whether or not the income is actually paid to him in that year.<sup>17</sup>

The argument that, in order to accrue, the income must be claimable forthwith has been rejected by the Appellate Division in CIR v People's Stores.<sup>18</sup> Hefer JA held: '..... any right (of a non-capital nature) acquired by the taxpayer during the year of assessment and to which a money value can be attached forms part of the "gross income" irrespective of whether it is immediately enforceable or not, but that its value is affected if it is not immediately enforceable'. S 7(1) of the Act says that income is deemed to have accrued to a person notwithstanding that it has been

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<sup>17</sup>.Lategan v CIR 1926 CPD 203

<sup>18</sup>.1990 2 SA 353 (A)

invested, accumulated or otherwise capitalized by him or that it has not been actually paid over to him but remains due and payable to him or has been credited to his account or reinvested or accumulated or capitalized or otherwise dealt with in his name and on his behalf.

Thus, where a father donates money to a trust to be accumulated or invested on behalf and for the benefit of his daughters the income from such accumulation or investment shall accrue to the beneficiaries and not to the father, the donor.

Actually, in CIR v Polonsky<sup>19</sup> and ITC 22<sup>20</sup> the income was held taxable in the hands of the beneficiary when, though there was a direction to the trustees to accumulate unexpended income, the beneficiaries had a vested right to the capital, so that they or their representatives were bound to receive the income at a future date.

#### B. VESTED TRUSTS

The key word here seems to be 'vested'. What does it mean and what are its implications? 'Vested' seems to refer to two things, viz:

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<sup>19</sup>.1942 TPD 249

<sup>20</sup>.1924 1 SATC 208

- a. It is possible for property to vest in a person without that person being an owner or having any enjoyment of it. The appropriate example would be that of trustees in whom the property vests, yet all the benefits will be enjoyed by the beneficiaries, and
- b. there is a situation where a beneficiary would be entitled to become, i.e. would have a real right as opposed to contingent right. With regard to the latter the trustee or donor still has a say on whether the beneficiary will receive any income. South African law recognises a vested right as a right vested in interest even if not vested in possession or enjoyment (*dies cedit, sed nondum venit*). The implication of this is that a beneficiary with a vested right to income can pass such right to his estate on his death, even if the income is payable only at the termination of the trust.<sup>21</sup> It is not necessary that he receives the income now - the use of the word 'vested' in S 25B is intended merely to distinguish such a right from a conditional right. In *Goliath v Estate Goliath*<sup>22</sup> it was held that a vested right means the acquisition by the beneficiary of an immediate right, although the enjoyment of it may be postponed.

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<sup>21</sup>.The Taxpayer 1990 Vol. 40

<sup>22</sup>.1937 CPD

by the beneficiary of an immediate right, although the enjoyment of it may be postponed.

At this point I would like to draw an analogy of our law on vested interest to that of the U.K, Australia and Canada.

In the U.K a beneficiary entitled to the income of the trust of a particular year of assessment, or to a share of such income other than by way of annuity or annual payment is liable to tax on such income, or his share of it, whether he receives it in that year or not, both at the basic and additional rates (if it has not borne tax in the hands of the trustees) and at the higher rates, subject to a deduction for expenses properly incurred and paid by the trustees out of the trust income.<sup>22.1</sup>

But for this principle to apply the beneficiary must be entitled to the income as, and when, it arises; if such income is retained by the trustee and the beneficiary's claim to it is liable to be divested on some later event, then such income is not that of the beneficiary, but that of the trustees. An example of where this usually arises is with the income of a minor which is accumulated by the trustees during his minority; if

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<sup>22.1</sup> Whiteman and Wheatcroft

such minor has an absolute right to the income and it is not paid to him only because of his age, then the income is treated as his.

But if the minor's right to the income depends upon some contingency (e.g. attaining majority), and if that contingency does not occur the income passes to others, then it is not his income. A test that is applied in deciding whether a beneficiary is entitled or not is whether his personal representative would be entitled to it in the event of him dying after the income arose.

(This is quite similar to our concept of 'vested' rights.)

On the other hand, in Australia, 'where any beneficiary is presently entitled to his share of income of the trust estate and is not under any legal disability, his assessable income shall include that share of the net income of the trust estate'.

Although Australia has several states that all have different laws, it seems all the states refer to a beneficiary's 'present entitlement' as the basis for his taxation on trust income. The concept of 'present entitlement' of a beneficiary to a share in trust income is therefore fundamental to the taxation of the trust

income (according to Income Tax Assessment Act of 1936 S 97 (1) ). The meaning of 'present entitlement' was given in the case of FCT & Whiting.<sup>23</sup> This case concerned a trust that was established under the testator's will in respect of the carrying on of a rubber business on the testator's properties. Under the will, the residue of the income of the estate, after payment of debts, was to be divided amongst the testator's widow and children. In the relevant year of income, 1940, over 10 years after the testator's death, the finalisation of the discharge of the estate's liabilities was not completed but the trustees were in a position to credit in the estate's books of account certain amounts of income for the beneficiaries.

The High Court held that the beneficiaries were not 'presently entitled'. The Whiting estate had not reached the stage where beneficiaries were entitled to call upon the trustee to make payment of the residue as the debts had not been finally ascertained and paid. Thus, the legal right to call for income determined whether a beneficiary was presently entitled, which in this case he was not. The fundamental role of trusts is that a beneficiary who is sui juris, with a vested interest, may at any time put an end to the trust and require the trustee to transfer trust property to him -

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<sup>23</sup>.1943 68 CLR 199; AITR 421.

(see *Saunders v Vautier*).<sup>24</sup>

So from the comparison of the two (South African and Australian) tax laws it seems 'vested' and 'present entitlement' are interchangeable.

The Canadian trust taxation is also quite similar to these two countries' taxing method. Section 104 (13) of the Income Tax Act 1970 provides that 'such part of the amount that would be the income of a trust for a taxation year .... as was payable' in the year to a beneficiary shall .... be included in computing the income of the person to whom it so becomes payable whether or not it was paid to him in that year and shall not be included in computing his income for a subsequent year in which it was paid'. Accordingly, where trust income is payable as of right to an income beneficiary is a minor whose right to receive income from the trust has vested, but the income is not payable to him in the year simply because he is a minor, such income is considered to have been payable to him in the year.<sup>25</sup> To illustrate the application of this provision let us say, for example, the income is payable to the beneficiary contingently upon his attaining majority; before he reaches majority the income is not regarded as vested

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<sup>24</sup>. (1841) 4 Bear 115

<sup>25</sup>. Youdan

and as such it is not deductible from the trust's income nor is it includable in the beneficiary's income.

In the South African law, in terms of section 25B(2), where a beneficiary has acquired a vested right to any income of a trust as a result of the exercise by a trustee of a discretion vested in him in terms of the deed or similar instrument establishing the trust, such income is deemed to have been derived for the benefit of the beneficiary.<sup>26</sup> This means that where a trustee under a discretionary trust receives R2 000, and during the year of assessment he, in accordance with his discretion, decides to distribute the R2 000 to the beneficiary or vest such beneficiary with a right to that R2 000, then the beneficiary and not the trust is taxable on the R2 000.

An example in summary:

Vested or present entitlement - Taxpayer A donates R30 000 to a trust he has formed to be invested or accumulated for his major sons X, Y and Z. Let us say the money is invested in shares in a company and the company pays out dividends of R15 000.

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<sup>26</sup>.The Taxpayer Vol. 40

Simply, the position would be:

Trust Capital	-	R30 000
Trust Income	-	R15 000
Income distributed to X	-	R5 000
	Y	- R5 000
	Z	- R5 000

Each would have had a vested right to the R5 000 that he received and would therefore be assessable to income tax on that amount (subject to Section 10(1)(k) ).

Consider the same scenario but where the trustees have a discretion on whether to pay out the income to the beneficiaries. If in 1997 the trustees decide to pay out the income to the beneficiaries, what is the position on the 1996 income from the money that had been invested in 1995?

	<u>1995</u>	<u>1996</u>	<u>1997</u>
Trust Capital	R30 000		
Trust Income		R15 000	R15000

The 1996 income had not yet vested in the beneficiaries and they (beneficiaries) only received the 1997 income when the trustees exercised their discretion. Would that mean the income, in terms of Section 25B(2), suffers double taxation where the trustees had received income on behalf of the trust in 1996, invested it and paid it out in 1997? Meaning, is the income first taxed

in the hands of the trust in terms of section 25B(1) in year one because then the beneficiaries had no vested rights to the income, and then as a result of having acquired vested rights in terms of sub-section (2), would they then be taxed on the same income in the following year?

The answer is provided by the case of *Estate Dempers v SIR*<sup>27</sup>, which held that if the income is taxed in the hands of the trust it may not then be taxed in the second year in the hands of the beneficiary. Simply, it has accrued to the trust which has since become a person and its distribution in a subsequent year renders it tax free in the hands of the beneficiaries.

Section 25B(3) provides that any deduction or allowance which may be made in terms of the Act in the determination of the taxable income derived by the trust shall, to the extent to which such income is deemed to have accrued to the beneficiary or to the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income of such beneficiary or trust fund as the case may be. However, this section is not easy to apply because of the problem of finding the true and correct meaning of 'income' as it is used in S 25B. But the discussion of this section is not in the scope of

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<sup>27</sup>.1977 (3) SA 410 (A)

this dissertation

We have so far discussed the position of major beneficiaries vis-a-vis taxation. What about minor beneficiaries? Before dealing with the question of minors I should point out that Section 25B is subject to section 7. I intend discussing section 7 separately in another chapter. However, to answer the question I have to refer to the section briefly.

A beneficiary will be taxed where:

- \* assets have been donated to the trust; he will be taxed under section 25B on income he has actually received, unless
  - he is a minor, in which case sub-sections 7(3) and (4) would apply if the assets were donated by his parent;
  - the provisions of sub-sections 7(6) or (7) apply, in which case the donor will be taxed on income actually received by a beneficiary as well as income accrued to him;
- \* assets have been donated to the trust; the beneficiary will be taxed on income accruing to him from the trust where he has a vested right to income, unless
  - he is a minor, or sub-sections 7 (6) or (7) apply.

In cases where a donor who had donated assets to the trust has died the beneficiary will be taxed on income he has actually received and on income accruing to the trust in which he has a

vested right. The provisions on sub-sections 7(3) to 7 (7) fall away once the donor dies. The beneficiary will be taxed, or not only on income that has actually been paid out to him, i.e. actually received, but also on income which has been accumulated or capitalized or otherwise dealt with in the beneficiary's name or on his behalf - S 7(1).

#### TAXATION OF SETTLOR (DONOR)

One of the differences between an inter vivos trust and a testamentary trust lies in the question of taxation of a donor. In a testamentary trust, as the term implies, the trust is formed in terms of a will and that also implies that the donor would be dead when the trust comes into existence. Since a dead person is not a 'person' anymore for income tax purposes, such a donor can no longer be taxed. But in an inter vivos trust the donor may be one of the trustees or even the only trustee. He may arrange the affairs of the trust in such a way that he receives all the income from the trust, or he would be in control of how and who receives trust income amongst the beneficiaries. The provisions of S7(3) to (7), which are deeming provision, ensure that a donor does not escape tax where he personally benefits through manipulation of trusts.

For example, section 7(3) is concerned with a 'donation, settlement or other disposition' made by the parent to his/her minor child(ren) - such donation etc. is deemed to have been received by the parent. If this provision had not been there,

such donation etc. would have only been taxable in the hands of the trust, which is at a lower rate than that of a normal person, because a minor is not taxable. That means most, if not all, parents would have donated large chunks of their wealth or income to their children in order to escape or avoid higher taxes.

Before embarking on a discussion on how the donor is taxed under S 7(3) to (7), it is important to first dispose of the meaning of the phrase "and donation, settlement or other disposition".

'Donation' is not very difficult to understand - it simply means that the disposition must be gratuitous, i.e. it must be made out of the generosity of the settlor. A disposition which is wholly commercial - that is where parties are dealing with each other as business people do, at arm's length, is excluded from the provisions of the section. But in a case where the income is attributable to part commercial transaction and part generosity, such transaction can still be subjected to the provisions of the section.

The part that is due to generosity will be taxed as 'donation or settlement' and the commercial part of it will be seen as such.

An example, in an attempt to illustrate the point, would be

that of a father who donates to a trust a block of flats (worth R100 000) for his minor son to rent out, with an agreement that the son will pay the father R60 000 in consideration for the flats. In this case there is an element of generosity, which is the R40 000 difference between the value of the flats and the consideration, R60 000, the son is paying for them.

It was held in *Ovenstone v SIR*<sup>28</sup> that "where the consideration, while not being due consideration, was nevertheless appreciable, it would mean that income would usually have accrued or been received 'by reason of' both elements of gratuitousness and consideration. There was no reason why in those circumstances the income should not then be apportioned between the two elements. Indeed, the words 'by reason of' themselves suggested some apportionment in order to give proper effect to the real cause of the accrual or receipt of the income".

The other word that has caused confusion in the interpretation of the section is 'other disposition'. In the *Ovenstone* case Trollop JA held that the phrase 'donation, settlement or other disposition' covered both a gratuitous disposition for some consideration in which there was an appreciable element of gratuitousness liberality or generosity. The phrase should be interpreted eiusdem generis, and should be read as 'donation, settlement or other similar disposition'.

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<sup>28</sup>.1980 (2) SA 721 (A), 42 SATC 55

While I concur with this interpretation, I cannot help but wonder why the legislation decided to omit 'similar' if the section was meant to be limited in its application. My point here is that the section could have been meant to be wider if including other dispositions which do not necessarily or strictly fall within the mode of donations or settlement. However, I must submit, it is a question of semantics.

Another term that seems to permeate through sub-sections 7(3) to (7) is 'by reason' which is also used as 'in consequence of' a donation, settlement or other disposition. Using the earlier example of a donation of a block of flats - the questions would be: Is the income that section 7(3) refers to the R100 000 which is the value of the flats, by which the son is enriched, or is it income in the form of rent which is the result of the donation? Or does it refer to the income that would be generated by the investment of the rent money?

In *Kohler v CIR*<sup>29</sup> the court came to the conclusion that once income had been capitalised, its subsequent earning or product was to be attributed not to the source from which the original income was derived, but to the advantageous employment of the minor's new capital. In this respect the 'income upon income' in issue stood on the same footing as income derived by the minor from the employment of other capital of his, borrowed,

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<sup>29</sup>.1949 (4) SA 1022 (T), 16 SATC 312

earned or bequeathed.<sup>30</sup>

The court went on and held that although the original donation may have been a causa sine qua non it was, nevertheless, not the causa 'by reason of which' income was derived by the minors. If this decision were to stand this would mean that in our example of the block of flats the income to the beneficiary in the form of rent would have been regarded as income derived by the advantageous employment of the beneficiary's new capital.

But Kohler's reasoning was not accepted in CIR v Widan<sup>31</sup> where it was held that 'by reason of' implied that there had to be some causal relation between the donation and the income in question. However, the decision in Widan merely narrowed the application of this section rather than overrule Kohler's decision. It held that 'income upon income' was the result of the original donation, but Centlivres CJ ruled that ".... Every case must be derived on its own facts and if in any particular case it appears that, apart from proof of any specific intention on the part of the parent, the effective cause of income accruing to a minor child was the donation made by the parent, then such income is deemed under S 9(3) to have been received by the parent".

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<sup>30</sup>. Emslie Davis Hutton

<sup>31</sup>. 1955 (7) SA 226 (KD); 19 SATC 341

So according to Widan the parent would be taxed for the rent received by the beneficiary from the letting of the block of flats because such income is the direct result of the donation. In simple terms, without the donation of the block of flats there would have been no income.

Therefore section 7(3) and (4) provides that where a parent has made a donation, settlement or other disposition to a minor child or where any other person has made a donation to his minor child in return for a donation, settlement or other disposition or some other consideration given directly or indirectly by the parent to the other person or his family, the parent will be taxed on the income arising from the asset donated.<sup>32</sup> Section 7(4) was meant to deal with what I'd call 'donation swap'. It may seem far fetched, but the section envisaged a situation where parents would swap donations to their respective minor children - thus parent A donates R100 000 to parent B's minor child and in return parent B donates a block of flats to parent A's minor child - which would otherwise have escaped the provisions of sub-section 7(3) because none of the parents had made any donation to his minor child although the end result is that their respective children have received donations or settlements.

This is one of the anti-avoidance measures that have been put in place to prevent any exploitation of tax gaps that may

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<sup>32</sup>.Stack

exist. Anti-avoidance is the subject of Chapter IV of this paper. At this stage, suffice to say that parents will find it difficult to escape tax for donations, settlements or other dispositions in favour of their minor children.

**C. DISCRETIONARY TRUSTS**

The donor may also be taxed under S 7(5) when a donation, settlement or other disposition is subject to a stipulation or condition whereby income is withheld from a beneficiary until the happening of a fixed or contingent event. The 'event' contemplated in section 7 (5) may consist of various eventualities, such as reaching a stipulated age, or death. Up to this point, I have been avoiding quoting any section word for word, but because of the many and varied issues raised by section 7 (5) I think it is only appropriate that I cite the whole section. It reads:

'If any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or disposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of any income as would, but for such stipulation or condition, in consequence of the donation, settlement or

other disposition be received by or accrue to or in favour of the beneficiaries, shall, until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person'

(My own emphasis.)

The section refers to 'any person' who makes a donation which is 'subject to a stipulation' whether imposed by such person or anybody else. A scenario that comes to the fore is that of a grandfather who decides to donate property or capital to his minor grandson's trust. Let us assume that the trust deed drawn up by the father has a stipulation that the trust income would not be distributed to the minor beneficiary until he attains the age of 30.

If we follow section 7(5) the grandfather would be taxed on any income that is derived from his donation. This is despite the fact that he was unaware of such a stipulation or condition. Granted, this section may be attempting to prevent people avoiding tax by simply donating their assets to others, but to expect every donor to first find out if a trust is subject to a stipulation or condition before making any donation is taking things rather too far.

It is my submission that rather than taxing the income from such a donation in the hands of the grandfather, it should be taxed in the trust because it would still be onerous to tax it in the hands of a person who created the trust and the stipulation thereof.

Another issue that has not yet been settled on the application of S 7(5) is whether exercising discretion constitutes an 'event' as envisaged by the section. Corbett JA in *Estate Dempers v SIR*<sup>33</sup>, while saying that there was undoubtedly some force in the argument that the exercise of a trustee's discretion is not an event, found it unnecessary to decide the question.<sup>34</sup>

At this point I think it would be helpful to come with some examples of stipulation one is likely to come across in a trust. The first example is of a trust deed that provides that the income from the trust accrues to the beneficiaries, but the trustees have a discretion as to whether to pay that income to them or to invest on behalf of the beneficiaries.

The second example is of a deed of trust which provides that the beneficiary would only receive income from the trust when he attains the age of 30.

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<sup>33</sup>.1977 (3) SA 410 (A)

<sup>34</sup>.Taxpayer

The third trust deed has a stipulation that it is entirely to the discretion of the trustees to decide whether or not to pay the income to the beneficiaries or to somebody else.

In the first example the beneficiaries have a vested right to the income. However, the enjoyment can be postponed if the trustees decide to invest the income. The second example is that of a trust that is burdened with a condition. Until such a condition is fulfilled, i.e. the beneficiary turns 30, he has no claim to the trust income. The event is the attainment of the age of 30. The third involves a right contingent upon the trustees' decision. They may or may not pay the beneficiaries any income and should they decide to pay out that should not constitute any event; they are merely exercising the powers conferred on them by the trust deed.

So, the position in terms of section 7(5) is that any person who has donated income to a trust that is subject to stipulation will be liable for income tax. Under S 7(6) a donor who retains the powers of deciding who or whether the beneficiary receive the income, will be taxable on any income that is subject to that stipulation.

To turn to the countries that feature in this dissertation: We have to look at the United Kingdom first. Discretionary trusts are subjected to heavier taxation in the United Kingdom. If the trustees have a discretion as to the identity of the beneficiary or a power to accumulate income, an additional rate tax is imposed, which is currently at 18 percent on such income, in addition to the basic rate, which at the moment is 27 percent.<sup>35</sup> This means that when the trustee with such a discretion decides to exercise it, he would pay 45 percent tax on the income he pays to the beneficiary and pay the remaining 55 percent to such beneficiary.

In Canada the end result is substantially the same, but the method by which it is arrived at is different.<sup>36</sup> The procedure is quite complicated but in Canada, if a discretionary trust is established, any accumulating income will be taxed in the hands of the trust as a separate taxpayer, different from the beneficiaries. In Australia, as in Canada, that part of the net income of the trust in which no beneficiary has a vested indefeasible interest is taxed in the hands of the trust.

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<sup>35</sup>. Youdan

<sup>36</sup>. Ibid

## TAXATION OF TRUSTS

Trust income which escapes tax in the hands of either the beneficiaries or the founder (donor) of the trust will be taxed in the hands of the trust, in terms of S 25B, at the rates of normal tax applying to an unmarried person.

Section 25B(1) provides:

'Any income received by or accrued to or in favour of any person in his capacity as the trustee of a trust referred to in the definition of "person" in section 7, 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 is not so derived, be deemed to be income which has accrued to such trust.'

Any income to which the beneficiary has no vested right or has not been derived for the benefit of such beneficiary is taxed as the income that has accrued to the trust. Ample example of such income have been given in the previous pages, e.g. in a discretionary trust in which income does not accrue to the beneficiary, it would accrue to the trust.

Deductions will be allowed for expenditure incurred in producing trust income, including administration charges, the trustee's remuneration or interest paid to the donor or founder.

## II. TESTAMENTARY TRUSTS

Testamentary trusts come into existence on the testator's death and are incorporated in his testament or will. In such trusts the income received may be taxed either:

- \* In the hands of the beneficiaries, or
- \* in the hands of the trust.

As is the case with inter vivos trusts, the income in testamentary trusts may be vested or discretionary. Where the income accrues to ascertainable beneficiaries who have a vested right to such income, they will be taxed on all amounts received by the trust to which they have a right. On the other hand, a will may only confer a contingent right on a beneficiary, for example, it could stipulate that a beneficiary would not receive any income from the trust until he reaches a certain age. As long as that condition has not been satisfied a beneficiary has no claim to the income. In ITC 76<sup>37</sup> the Special Court, in distinguishing the two types of interest, explained it in this way:

"A vested right was something substantial; something which could be measured in money; something which had

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<sup>37</sup>. (1927) 3 SATC 68

a present value and could be attached. A contingent interest was merely as spes -an expectation which might be never be realised. From its very nature it could not have a definite present value. In the income tax sense, therefore, a vested right was an accrued right".

Therefore, where a beneficiary only has a contingent interest, rather than a vested right, the income will be taxed in the hands of the trustee, in his representative capacity, on behalf of the trust. This is in terms of section 90 of the Act.<sup>38</sup>

#### SUMMARY

To summarize taxation of trust income, there are four possible ways in which it can be done. Factors that are decisive in this matter are, for example, is the trust inter vivos or testamentary, i.e. is the donor alive or dead, is the beneficiary major or minor, does the minor have a vested or discretionary interest, is the income accumulated in the trust or paid out?

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<sup>38</sup>.Stack

This can be illustrated in a form of table:

(A) DEEMED	(B) ACCUMULATED	(C) DISCRETIONARY	(D) VESTED
In inter vivos income from gratuitous transaction deemed to be the donor's under S 7(3), (4), (5) or (6)	Any income held or accumulated on behalf of beneficiary is deemed to be his and taxed under S 7(1)	Where trusts have discretion, whether inter vivos or testamentary, income taxed in the hands of trust	Income to which beneficiary have vested interest, whether inter vivos or testamentary, taxed in beneficiary S 25B(1)

#### THE CONDUIT PRINCIPLE

In discretionary trusts it happens that income which has been earned in one financial year is not paid over to the beneficiaries in that same year but in the following financial year.

The significance of this will be better understood when the role of a trustee or trust is considered. In the case of *Armstrong v CIR*<sup>39</sup> the taxpayer received an annual sum from a trust, the income of which consisted of dividends and other

<sup>39</sup>.1938 AD 343

the then Act. The question, then, was: Is such income taxable in the hands of the beneficiary?

The Appellate Division held that the trustee was a mere conduit pipe and that, as the income payed to the beneficiary included dividends, such dividends were also exempt form tax in his hands. This simply means that the trust income which is taxable in the hands of a beneficiary does not lose its identity because it passes through the trust first. This statement, however, must be qualified, because such income may lose its identity if, as indicated in the first paragraph, it is not paid over to the beneficiaries in the same financial year as it was earned.

According to Emslie, the investing of the income and paying it out the following year have an effect of switching off or plugging the conduit pipe. For example, if the trust had earned income in the form of dividends, which are still exempt from tax, and that income is used in buying a block of flats from which rent is earned, and which is paid out to the beneficiaries as their income, the beneficiaries will be taxed on that income because rent is not exempt from tax. If the trustee also decides to pay out the dividend income in the form of annuity, the beneficiaries would also be taxed on each payment they (beneficiaries) receive; the fact that such payments come form dividends will not count.

## CHAPTER III

### DONATIONS TAX

We have just dealt with the taxation of trust income under the Income Tax Act and now we turn to how donations tax affects trusts. Let me add that the provisions of donation tax appear in the Income Tax Act, but while the latter taxes the income from the trust, the former is a tax on capital.

As has become apparent by now, the formation of a trust involves the donation of assets, property or capital from one party, the settlor or donor, to another, the trustee, for the benefit of a third person, the beneficiary. Donations tax, therefore, is payable when a property is disposed of, whether directly or indirectly and whether in trust or not, under donations which take effect on or after 16 March 1988 - section 54.

Section 55(1) defines 'donation' as any gratuitous disposal of property, including any gratuitous waiver or renunciation of a right. It further defines a 'donee' as referring to any beneficiary under a donation and includes, where property has been disposed of under a donation to any trustee to be administered by him for the benefit of any beneficiary, such trustee.

This means that a transfer of property to a trustee in trust for the benefit of a beneficiary is treated as a donation to the trustee. Thus the trustee is bound to pay the donations

tax if the donor does not.<sup>40</sup> It is the donor who is supposed to pay the tax, within three months from the date upon which the donation takes effect - sections 59 and 60(1).

Even where property has been disposed of for a consideration it shall be subject to donations tax if, in the opinion of the Commissioner, the consideration is not adequate. In such a case the part that is deemed to be gratuitous will be taxed and the other part will be regarded as fair consideration of the property. This is in terms of section 58. For example, if X sells his house to Y for R50 000 and the Commissioner is of the opinion that the value of the house is R100 000, the Commissioner will not tax the R50 000 paid by Y but will tax X on the R50 000 he considers to be gratuitous.

Meyerowitz<sup>41</sup> contends that "this deeming provision in effect renders the definition of donations as being a 'gratuitous' disposal of little practical value, since even if the disposal is for a consideration and therefore not gratuitous, it may nevertheless be deemed to be a donation". His contention is based on the argument that by its definition, in a donation there must clearly be an intention to donate, and that intention should also be implied in the deeming provision; that is, the provision should operate on the basis that the transaction was entered into animo donandi.

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<sup>40</sup>.Honore

<sup>41</sup>.Meyerowitz and Spiro

While I do agree with the initial objection to the deeming provision as substantiated meyerowitz, with due respect, I submit the provision was not intended to tax donors who have genuine intention to donate. In his introduction on donations tax the author, Meyerowitz, gives an explanation for the introduction of this tax, which as far as the ministerial budget speech was concerned, was to prevent tax payers, by making donations, "reducing the value of their estates for estate duty purposes or reducing the incidence of income tax by spreading their incomes over a number of taxpayers".

Surely a taxpayer whose intention is to avoid paying the donations tax would use any loophole the legislation provides to do so. If any element of consideration would have an effect of cancelling out gratuitous intentions of the donor, taxpayers would have continued reducing the value of their estates despite any attempts of preventing that.

R2 million worth of assets would have been disposed of for R200, or even less, and still that would not have attracted donations tax because of the consideration that was paid. I submit that the section provides the Commissioner with unfettered powers to which there is no appeal, of deciding whether the consideration given is adequate to warrant a transaction to be deemed a donation. This makes his opinion decisive.

However, in practice it is expected that the Commissioner will concentrate on those cases that seem suspicious, taking into

consideration the circumstances surrounding a transaction, such as the relationship of the parties, the value of the property in relation to the consideration, etc.

One of the features of a donation is disposal of property. Where a person promises another person that he is going to donate property to that other person, could one say that there has been a disposal? Or must there be an actual delivery or transfer of the property from the 'promisor' to the 'promisee' before there is a disposal of property?

I submit, a mere promise would not suffice unless it is legally binding. It would be legally binding if such promise is in the form of an executory contract of donation whose terms are embodied in a written document signed by the donor. If this has not been done, the donation will take effect only on delivery of movable or registration of immovable property in the land register, or the cession of incorporeal movables.<sup>42</sup>

There are a number of donations that are exempt from donations tax.

I will not enumerate those, with the exception of a donation made by a natural person - a donation of up to R20 000 per annum may be made by a natural person during the year of assessment without it attracting donations tax. This

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<sup>42</sup>.Honeré

exemption applies to donations taking effect on or after 16 March 1988 (S 56(2)(b)). Thus a donor who wishes to donate to his four children will pay out R5 000 to each or if he has five he will give each R4 000 per annum.

The tax for donations taking effect on or after 16 March 1988 is at a flat rate of 15 %. Previously, the rate was cumulative and varied from 3 percent on amounts not exceeding R8 000 to 25 percent on amounts exceeding R90 000.

#### ESTATE DUTY

The Estate Duty Act of 1955, which came into effect on 1 April 1955, replaces the Death Duties Act of 1922 which charged death and succession duties on the estate of every person who dies. The new Act levies an estate duty in respect of every person who dies and was ordinarily resident in the Republic at the date of his death. That is, the assets which belonged to a person ordinarily resident in the Republic at the date of his death, form part of his estate, no matter where in the world such assets are situated.<sup>43</sup>

Estate duty is charged on the 'dutiabale amount' of the estate of a deceased person. This is arrived at:

- (i) By deducting from the gross amount of property of the estate the deductions allowed in terms of section 4 of the Estate Duty Act to obtain the

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<sup>43</sup>.Huxham and Haupt

net value and

- (ii) by deducting from the net value the sum of R1 million in terms of section 4A of the Act.

To illustrate this formula, let us say the deceased died leaving a farm worth R1 150 000, a deemed interest in a trust valued at R220 000 and bank savings of R150 000. the deceased in his will left a sum of R120 000 to the University of Cape Town Law Department. To calculate dutiable estate we follow these steps:

Property	:	(i) Farm	R1 150 000
		(ii) Savings	R 150 000
Deemed Property	:	Trust	<u>R 220 000</u>
Net value of estate			R1 530 000
Deductions	:	Gift to UCT(S4)	R 120 000
		4A deduction	<u>R1 000 000</u>
Dutiable value			R 410 000

So far, nothing connects Estate Duty to trusts, but this changes when we look at the definition of 'property'. For the purpose of the Act, it means any right in or to property, movable or immovable, corporeal or incorporeal, including

- (a) any fiduciary, usufructuary or other like interest in property held by the deceased immediately prior to his

death

- (b) any right to an annuity (other than an annuity charged upon any property) enjoyed by the deceased immediately prior to his death which accrued to some other person on his death

The interest of a beneficiary under a trust is usually in the form of a fiduciary, usufructuary or other like interest in property or an annuity charged on property. The interest of a deceased under a trust will fall within or outside the ambit of the Estate Duty depending on whether his interest was vested or merely contingent. If the deceased had no vested right to the interest, i.e. his interest is in a discretionary trust where trustees may or may not pay out income, the deceased cannot be said for this purpose to have held a limited interest at the date of his death. So, the deceased has no 'property' for the purposes of this provision.

On the other hand, the interest need not amount to a real right in the property; a personal right suffices and this is all that a trust beneficiary is entitled to.

The section also regards some interest and rights to certain categories of property to be deemed property of the deceased. Such deemed property includes amounts payable on the life of the deceased under domestic insurance policies, as well as pension funds. Of relevance to this discussion is the

property which the deceased was competent to dispose of. The old Death Duties Act provided that property in the 'control, order or disposition' of the deceased was deemed to be his property. Under the Estate Duty Act the deceased is deemed to have been competent to dispose of property:

- (i) If he had such power as would have enabled him, if he were sui iuris, to appropriate or dispose of the property as he saw fit by will, power of appointment or in any other manner;
- (ii) if he retained the power under any deed of donation settlement, trust or other disposition made by him to revoke or vary the provisions of the disposition relating to the property.<sup>44</sup>

Honoré argues that, as far as the first criterion is concerned, the mere possession of a power of appointment over property will not cause it to be deemed the property of the donee of the power, since the donee cannot exercise the power for his own benefit or the benefit of his estate.

On the second point he contends that if the founder of a trust retains a right to vary or revoke it, he will be held to retain the competence to dispose of the trust fund. This is easy to understand, because even in section 7(5) and (6) the trust income that is burdened with a stipulation or condition

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<sup>44</sup>.Honoré

is deemed not to have vested to the beneficiary but to accrue to the person who has the right to decide whether the beneficiary receives income or not.

How do donors acquire the power to revoke or vary the provisions of trusts? Can they compel the trustees to agree to variation? Theoretically, trustees are independent and cannot be and should not be influenced by the settlor in their decisions. With that in mind, it is doubtful whether the power to remove and substitute trustees is sufficient to give the founder the competence to dispose of the trust property.

In such a case he would not have a power to revoke the trust, only the consent of the trustees to the revocation obtained by the use of threat to remove them.

So a power to remove or appoint trustees is not the same as the power to revoke the trust - with the former the deceased would not have been competent to dispose of any property in a trust, because he only has power over the trustees and not the trust, whereas in the latter case he controls the trust property.

Under the old Death Duties Act, in the case of *Creighton Trust v CIR*, it was held that if the beneficiaries acquired no vested right until the donor's death the donor, even if he has transferred property to the trustees, still remains for his own benefit the control and disposition of the property.

This was, however, rejected in CIR v Estate Merensky. It does not follow that, if the 'beneficial interest' in the trust fund does not belong to the beneficiary, it then belongs to the donor. The Creighton Trust case was not overruled because on its facts the decision was correct.

Two persons are liable for the duty when it is levied:

- (a) In regard to any fiduciary, usufructuary or other like interest in property and to any annuity held or enjoyed by the deceased immediately prior to death, the person to whom any advantage accrues by the death of the deceased;
- (b) as to any other property, the executor.

The duty in (a) is payable by the person who acquires a beneficial interest in the property on the death of the deceased. Usually such a person is the reversionary beneficiary. If the trust interest had not vested in the beneficiary at the time of the deceased's death, then I presume the trust would be dutiable because it is to itself that advantage accrues as a result of the death.

But it seems the Act deemed only natural 'persons' to be liable, unless one extends the meaning of 'person' to include trusts. What is certain is that the person need not be ascertainable at the death of the deceased, following the decision of CIR v Estate MacNeillie where the founder of the

trust left income to his wife for her life and on her death to be conferred on his son if he attained the age of 35 after his mother's death.

Honoré, however, asserts that MacNeillie is no longer a sound guide.

I submit that for a duty to arise, in terms of the Act, the person must have taken over from the deceased after his death, though not necessarily immediately after the death.

It would not serve the purpose of the Act to wait for the day for the sons of a beneficiary to get their share of the trust property before they are dutiable on it, and it would be onerous on them to levy a duty for an advantage that would accrue to them when for instance, they reached a certain age.

In conclusion, I have to mention that the Estate Duty would affect only those trusts or estates that have a net value of more than R1 million because of the section 4A deduction. Due to this deduction most estates will pay no duty.

#### **TRANSFER DUTY**

Section 2(7) of the Transfer Duty Act 40 of 1949 reads as follows:

'Where any person acting in a fiduciary capacity acquires any property or where the value of any property held by any person acting in a fiduciary capacity is enhanced as a result of the renunciation of own interest in or a restriction upon the use

or disposal of that property as contemplated in subsection (1), such person shall, for the purposes of this section -

- a. if the property is in terms of the provisions of a will or other instrument so acquired or so held solely for the benefit of a natural person (whether directly or indirectly), be deemed to be a natural person;
- b. if the property is so acquired or so held otherwise than contemplated in paragraph (a), be deemed to be a person other than a natural person.'

The Act imposes a duty on the acquisition of fixed property in the Republic, no matter how it was acquired, with the result that to escape from its wide scope one has to look at the definition of 'property' in order to determine whether it has or has not been 'acquired' or whether the acquisition is made in circumstances which attract one of the exemptions from duty.<sup>45</sup>

Before dwelling on that, it is important that I point out that before the section 2(7) which I have just recited above, the rates of transfer duty used to differ according to whether the person acquiring the property was a natural person or not - in other words whether the beneficiary was a natural person or not. If the person acquiring the property (in other words,

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<sup>45</sup>.Joubert

the beneficiary) was not a natural person, the rate was 7 % (currently it is 10 %). If the beneficiary was a natural person the rate on the first R50 000 was 1 % and on the balance it was 5 % . However, this was repealed after it became clear that there was a misuse of trusts for transfer duty purposes. In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 1995 it was explained that:

'It has come to light that the provisions of [section 2(7)] are being abused in that many trust deeds which are submitted to the relevant Receivers of Revenue have in essence not been established solely for the benefit of a natural person. In order to enjoy the benefit of the rate applicable to a natural person. In order to enjoy the benefit of the rate applicable to a natural person, the trust deed is amended in such a way that the sole beneficiaries are natural persons at the time of acquisition of the property and when the deed is submitted to the relevant Receiver of Revenue. However, once the lower rate has been enjoyed, the trust deed may be amended to its original form after registration of transfer of the property. Furthermore, it has become clear that the trusts are being used more and more as a tool in estate planning to peg the value of the growth of the underlying assets of such a trust.'

The result of this Bill was the repealing of section 2 (7) by the Taxation Laws Amendment Act 37 of 1995, with the intended result of taxing all acquisitions by trusts at the uniform 10 % rate applicable to persons other than natural persons.

The amendment went as far as removing the requirement of submitting trust deeds to the Revenue (which was required before in order that the Receivers of Revenue could scrutinise them to establish the applicable transfer duty rate).

However, in a recent Revenue Practice Note (date 10 October 1995) the Commissioner for Inland Revenue concedes that 'the repeal did not achieve the desired effect, since in the case of trusts, property vests in the trustees and not in the trust.' He, therefore, withdrew the repeal. In paragraph 3 of the Practice Note it is stated: Until an appropriate amendment can be introduced, it must be accepted that where a trustee who is a natural person acquires property in a fiduciary capacity for the benefit of beneficiaries, transfer duty is payable at the rate applicable to natural persons. The requirement of calling for trust deeds in such cases must, therefore, continue. The note went on to commit the Revenue to refund those who had paid a higher rate in respect of acquisitions by a trustee on or after 19 July 1995.

All in all, things are back to where they started - the higher rate of 10 % is still applicable to persons other than natural persons and lower rates are used for natural persons. The question one is left asking is: If the Commissioner has realised that the repeal had not achieved the desired effect of counteracting the misuse of trusts for transfer duty, what other measure has been effected to achieve this? It seems

that the old method of scrutinizing the trust deeds is still the only weapon the Revenue is using to combat transfer duty avoidance.

Now to go back to section 2(7) - the definition of 'property' is not confined only to land and fixtures on it but is expanded to include related concepts, e.g. a real right in land; a right to minerals; a lease or sublease of a lot or stand registrable under the mining laws and other such rights. to 'acquire' property as used in the section does not mean the acquisition of the dominium in the property transferred. 'It is a duty imposed on the consideration given by the person acquiring the fixed property for the right conferred on him to acquire the ownership of the property at the time stipulated in the transaction'<sup>46</sup>

What is acquired is a ius in personam ad rem acquirendam - the rest being the ownership of the fixed property to be transferred. Thus the term 'acquire' is loosely used meaning 'becoming entitled to' and liability to pay the duty has arisen from the transaction, whether or not transfer of ownership in fact ensues. This makes, as has been remarked by some academics, the calling of the tax imposed by this statute a transfer duty a misnomer.

The section states that transfer duty is payable 'by any

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<sup>46</sup>.Joubert

person' acquiring property. It distinguishes between a 'natural person' and 'persons other than natural persons'. A trustee is a natural person and at common law a trust is not a juristic person. But the Act deems a person who, acting in a fiduciary capacity, acquires property or benefits from a renunciation to be a natural person only if in terms of the will or other instrument he acquires or holds the property solely for the benefit of a natural person or persons, whether directly or indirectly. If, on the other hand, the property is held for a juristic person or for both natural and juristic persons, the trustee is deemed not to be a natural person. This could lead to confusion.

For example, if X, a trustee acting on behalf of beneficiaries Y and Z, receives a donation of a house for use by the beneficiaries, then for the purposes of transfer duty he would be deemed to be natural person and taxable at a lower rate. Now let us say X is a trustee for World Wildlife Fund and receives a donation of R50 000 for the purpose of building a cage for Zoomy the bear.

At what rate would X be taxed in terms of transfer duty this time? Because he acquired the property for the benefit of a person other than a natural person (assuming the WWF is deemed a juristic person), X would pay 10 % applicable to 'person' or, specifically, a 'person other than a natural person'? The former has a narrow meaning, it refers to individuals. The

problematic one is the 'person other than a natural person'. It is apparent that the definition includes 'juristic person' but it ought to be wider than that, because then the legislature would have just stated so.

Our Income Tax Act does not provide any definition for the term 'person'. It is on this point that Riël Franzsen<sup>47</sup> argues that '[I]n the absence of a definition of "person" or "person other than a natural person", there are, apart from S 9(4), no other direct or indirect indications in the Act that an acquisition by a trust is indeed taxable.' He maintains that because the charging section (S2) is unclear on the acquisition by the trust(ee), this causes doubt as to whether trustees are taxable under the section. Where there is doubt the in dubio contra fiscum rule should apply. In the end Franzsen himself humbly admits that it would be risky, if not unwise, to use his argument in any long term tax planning. We will let the matter rest there.

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<sup>47</sup>.De Rebus

## CHAPTER IV

## ANTI-AVOIDANCE

Lord Denning MR (then) once observed that: 'The avoidance of tax may be lawful, but it is not yet a virtue'.<sup>48</sup>

He was expressing the sentiments of the time because avoiding tax has definitely become a virtue nowadays. This is borne by what Viscount Sumner said: 'It is trite law that His Majesty's subjects are free, if they can, to make their own arrangements, so that their cases may fall outside the scope of the taxing acts. They incur no legal penalties and, strictly speaking, no moral censure if, having considered the lines drawn by the legislature for the imposition of taxes, they make it their business to walk outside them.'<sup>49</sup>

There is a world of difference between tax evasion and tax avoidance. The former involves non-payment of taxes, which one is under a legal duty to pay, through fraudulent means. This is strictly illegal and may result in criminal proceedings. Tax avoidance, on the other hand, is the arrangement of one's financial affairs so that no liability or a reduced liability to tax accrues. This is perfectly legal. Though there are still judicial dicta which do not, to say the

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<sup>48</sup>.Re Weston's Settlements (1968) 3 AER 388 at 342

<sup>49</sup>.Levene v IRC (1928) AC 217 at 227

least, approve of these tax avoiding schemes, there are many more judgements recognising the right of individuals to dispose of their capital and income in such a way that they pay the least in tax. And if there is one area where the ground is fertile for tax avoiding schemes it is that of trusts. By their very nature trusts tend to reduce or postpone incidents of tax, hence their popularity, especially with the wealthy. This is proved in statistics where it is found by Pechman<sup>50</sup> that in the 1940's and 1950's more than three out of every five U.S. millionaires transferred at least some of their property in trust. Transfers in trust accounted for at least one third of non-charitable giving in that period. There was also indications from the data that trusts were used primarily by wealthy people. People with smaller estates passed their property and estates outright.

The studies also showed that in 1981 in the United Kingdom an estimated £21 billion was a capital in discretionary trusts.

Is it a wonder, then, that laws governing taxation of trusts have been tightened in these countries in order to curb the use of trusts for the purpose of avoiding tax? I do not intend repeating what has already been said in the previous chapters, but I wish to briefly compare the measures used in South Africa with those taken by the United Kingdom, Australia

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<sup>50</sup>.J.A. Pechman, *The Rich, the Poor and the Taxed They Pay* (1986) at 120

and Canada. I intend confining myself to those measures that concern trusts.

### SECTION 103

In the Income Tax Act section 103(1) is the general anti-avoidance provision which is aimed at an anticipated liability for tax, not an existing liability. One can call it a catch-all section, because its tentacles are wider than other anti-avoidance sections and covers every form of transaction. It comes into operation whenever any transaction has these four elements:

- An avoidance, reduction or postponement of a liability to pay tax levied in terms of the Income Tax Act;
- the avoidance must be as a result of a transaction, operation or scheme;
- there is an abnormality;
- the scheme was solely or mainly intended to avoid any levy administered by the Commissioner.

All four elements must be proved for S 103(7) to apply.

Trusts can be caught in the web of this section. There are transactions, operations or schemes in any trust, e.g. a donation entails transferring property or right to property from one person, the donor/settlor, to another, the trustee. This constitutes a transaction. A transaction can be

abnormal, for instance, where two trustees exchange donations for the benefit of each other's minor children, if the Commissioner is of the opinion that the parties were not

dealing at arm's length or the rights created are not normal in an arm's length transactions.

An example would be that of a father who sells property at one third of its real value to his son's trust (in an attempt to avoid donations tax, assuming there was no section 58, the deeming provision). The Commissioner would have found that the transaction, another element of S 103(7), has been entered into with the consequence of avoiding liability to pay (donations) tax. He will then look at the contract in totality, taking into consideration the relationship between the parties, whether they were dealing at arms length or not and the consideration paid for the property. Then the intention of the parties (especially the buyer) will also be considered.

In *Hicklin v SIR*<sup>51</sup> Trollop JA advised that ... when considering the normality of the rights or obligations so created or of the means or manner so employed, due regard had to be paid to the surrounding circumstances ..... Thus, what might be normal because of the presence of circumstances surrounding the entering into or carrying out of

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<sup>51</sup>.1980 (1) SA 481 (A), 41 SATC 179

an agreement in one case, might be abnormal in an agreement of the same nature in another case because of the absence of such circumstances.'

So the normality or abnormality of the transaction will depend entirely on the facts of the case. If the court fails to prove any of the four requirements section 103 will not apply. Let us say the father denies that he had any intention of avoiding any tax or levy administered by the Commissioner. If he insists that he genuinely did not know what the value of the house is - all that he knows is that it cost him £3 000 to buy it after the WWII in 1946 and he was told by his son that it was now worth R25 000.

If the court is satisfied with that explanation, on that ground alone the father would escape scot-free from S 103. I refer to SIR v Geustyn, Forsyth and Joubert where the transaction was held to be normal and that the avoidance of tax was not the sole or one of the main purposes of the transaction, and therefore S 103 was not applicable.

#### SECTION 7

However, S 103, as said earlier, is a general avoidance provision. The section that is devised to curb avoidance of tax on trusts is section 7, to which section 25B is subject. Section 7 is therefore a deeming provision and it is on this basis that I would attempt to match it up with the same in

Britain, Australia and Canada referred to as 'attribution rules'.

a. Section 7(2)

For instance, section 7(2) provides that income received by or accrued to one spouse (recipient) is deemed to be the other spouse's income if the income was derived in consequence of a donation, settlement or other disposition made by the donor on or after 20 March 1991. In the U.K. the investment income of a married woman is usually taxed as her husband's income; although she is entitled to be taxed separately on this income, it will still be taxed at her husband's marginal rate - in accordance with section 37(1) of the Income and Corporations Taxes Act of 1970. The result of this provision is that any diversion of investment income by one spouse to another does not result in minimization of tax.

Section 74.1(1) of the Income Tax Act of Canada also levies a capital gains tax on a person who has transferred or loaned property, including money, directly or indirectly, by means of a trust or otherwise, to or for the benefit of his spouse, as long as the transferor or lender is resident in Canada and they are married to each other. Once more there is no way one spouse can avoid tax or minimise it by transferring his or her property to the other spouse.

## b. Section 7(3)

The provisions of this section seek to tax income received by or accrued to children (minor) of the taxpayer from a trust set up with funds donated by him.

'Income shall be deemed to have been received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child -

- (i) it has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child; or
- (ii) it has been accumulated for the benefit of that child.'

This section is meant to prevent parents transferring their taxable income or assets to their minor children who are not taxable (being minors), thereby avoiding tax.

In Canada where an individual has transferred or loaned property by means of a trust, to or for the benefit of a person who was under 18 years of age and who did not deal with the transferor at arm's length, the income is deemed to be the income or loss of the transferor or lender, and not of the minor. This is conditional on the transferor being a resident of Canada and the minor not attaining the

age of 18 before the end of the year.<sup>52</sup>

The Canadian section is similar to the U.K.'s S 437<sup>53</sup>, which provides that where trust income is paid to or for the benefit of a child of the settlor 'who at the time of payment is unmarried and under eighteen years of age' the income is deemed to be the settlor's.

Australia has a slightly different system from the other countries. It provides that where a person has created a trust whose income is payable to or accumulated for the benefit of a child of that person who is under the age of 21 and unmarried, the Commissioner may assess the trustee for tax on the trust income at the rate applicable to the top slice of the settlors's income, in terms of S 102(1) of the Income Tax Assessment Act 27 of 1936.

But the case law has held that the provision does not apply where the minor's entitlement is not vested. If the trustee has a discretion and has not exercised that discretion, it does not apply, because it requires that the income is payable to the 'applicable' beneficiary.<sup>54</sup> In 1980 Australian Tax legislation introduced a minimum tax on all property income earned by children, whether

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<sup>52</sup>.S 74.1(2) ITA

<sup>53</sup>.Income and Corporations Taxes Act

<sup>54</sup>.Youdan

directly or through a trust, at a fairly substantial, but not at the highest marginal tax rate. This was in response to the frustration of tax authorities by the lack of success in combating tax minimization through attribution rules dealing with infants. The 1980 enactment restricted the advantages of income splitting with children to taxpayers in the highest marginal rate brackets.

c. Section 7(4)

This subsection provides: 'Any income received by or accrued to or in favour of any minor child of any person, by reason of any donation, settlement or other disposition made by any other person, shall be deemed to be the income of the parent of such minor child, if such parent or his spouse has made a donation, settlement or other disposition or given some other consideration in favour directly or indirectly of the said other person or his family.'

As an example, say taxpayer A who has minor child B enters into an agreement with D, a father to minor son E, whereby A donates R150 000 into DE trust and D in return donates a house (valued at R150 000) into the AB trust. This transaction would not have been taxable under section 7(3), because the donations to the respective trusts were not made by the respective parents, though each trust

benefitted to the same amount as it would have done if each parent had donated the property and money directly into the trust of his minor child.

In the U.K. this 'reciprocal' scheme is also provided for. Section 437 of ICTA applies not only to income paid to infant beneficiaries, but also in a case where a reciprocal arrangement has been entered into between parents agreeing to make settlements on each other's children. But it will not apply where the income is for the benefit of 'children of others' or for grandchildren.

d. Section 7(5)

This sub-section applies to discretionary trusts - where the income of the beneficiaries can be withheld until the happening of a certain event, e.g. attaining the age of 30, or getting married, income from such trust will be taxed as if it is the donor's. Discretionary trusts delay the date when the beneficiary receives the trust income and such income does not accrue to the beneficiary until the stipulated event happens. The effect is that the liability for income tax on the beneficiaries is also postponed.

In the U.K., if the terms of the trust allow any person either to revoke or to otherwise determine the settlement or to decrease any sums which are paid or are payable to

the beneficiaries, the sum payable or the amount of the reduction is treated for all tax purposes as the settlor's income.<sup>55</sup> However, there is an exception to this provision where the power (discretion) is not exercisable of six years after the first payment or three years where the beneficiary is a charity. When the power is subsequently exercised this provision will operate. Although the settlor is taxed, he can recover the tax paid from the trustees.

The difference with the Australian tax law is that the Commissioner assesses the trustee for tax on the trust income, not the settlor. But the amount of tax payable is the amount by which the tax on the settlor's own income is less than it would have been if he had received such income, in addition to his other income.

In Canada, section 75(2) (ITA 1970-71-72) is applicable to a trust where the trust property may pass to persons determined, after the trust has been created, by the person from whom the property was received. For example, if X, a trustee of certain property, has a discretion to determine who of his issues may receive the property, the trust income and capital gains, whether accumulated or distributable, would be taxed in his hands. The subsection will also apply where property is held on

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<sup>55</sup>.S 445(1) of ICTA (U.K.)

condition that during the lifetime of the donor (settlor) the property shall not be disposed of except with his consent or in accordance with his direction.

e. Section 7(6)

this subsection is quite similar to the one above dealing with donors who have right to decide how the property is disposed of. That is, it is meant to tax those donors who try to avoid tax by setting up a trust with a deed giving him power to vary beneficiaries at will. Such donor can achieve this by choosing a beneficiary who has the lowest marginal rate of tax and directing income accruing to the trust towards that beneficiary.

This is different from a case where the donor retains only the power to vary trustees, because the trustee's decision would not be influenced by the fact that the donor can get rid of him. If he has power to vary beneficiaries then he still has complete and total control over the trust and therefore he is still enjoying the right of ownership.

In Australia, the trustee is liable for tax on income from such a trust. In the U.K., if any person has the power to revoke or otherwise determine a settlement or to diminish any property comprised in the settlement prior to six years from the time the property was settled, and on the exercise of that power the settlor or the settlor's spouse

will or may become entitled to the property, that part of the interest that he may revoke is attributed to him, whether or not this power is exercised.<sup>56</sup>

Canada - where a trust is revocable or where the trust property may revert to the person from whom it was received, the income or loss derived from such property, as well as taxable capital gains or allowable capital losses in respect of that property, are treated as that person's income or loss or taxable capital gains or allowable capital losses, as long as he is alive and is a Canadian resident - S 248(5)<sup>57</sup>

these anti-avoidance measures are quite similar in all four of the countries referred to in this discussion. In almost all of them the donor (settlor) will be directly or indirectly taxed for any attempt to avoid tax by using trusts.

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<sup>56</sup>. Ibid. S 446

<sup>57</sup>. ITA

## CONCLUSION

As conclusion I would like to point at the similarities in taxation of trusts in the four countries that are compared in this dissertation.

This similarity can be seen in the use of trusts and the anti-avoidance laws of these countries. This is a testimony to the influence English trust law has in the other three countries' trust laws. South African law of trust has since discarded the attitude that '...English law of trusts forms, of course, no portion of our jurisprudence nor ... have our courts adopted it ...', as per *Estate Kemp v MacDonald's Trustee* case.

However, this is not difficult to understand given the ties these countries have historically shared. When trusts were introduced in South Africa they were used mainly by the English settlers. Through the years, however, their popularity grew to such an extent that English influence was unavoidable if trust laws were to be formulated and enforced.

It is my hope that this discussion has managed to highlight the fact that our trust law, though it is still in a state of flux, has managed to keep abreast with that of other developed countries. The South African trust law compares favourably with that of the other three countries, namely U.K., Australia and Canada.

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