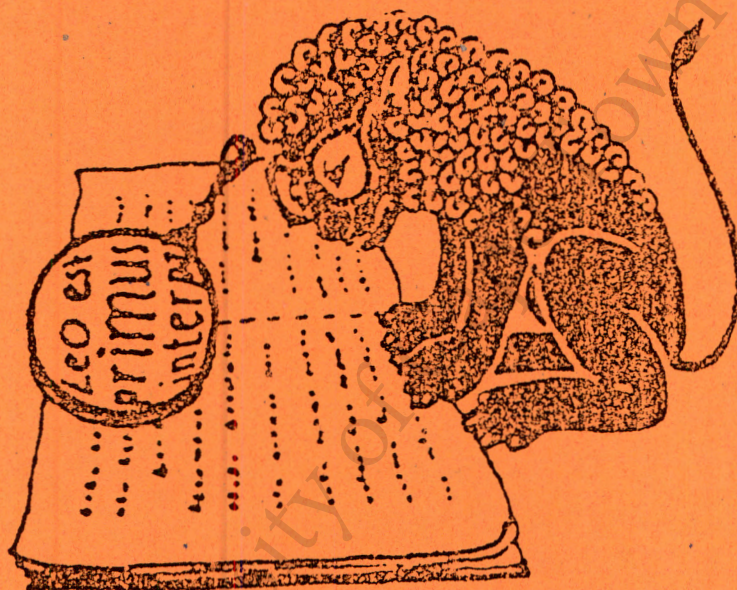


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**DATE:** JANUARY 1998  
**COURSE:** CML 609W - TAX LAW I

## THE TAXATION OF TRUSTS IN SOUTH AFRICA



**MASTER OF LAWS: MINOR DISSERTATION - [20 000 words]**

*Research dissertation presented for the approval of the Senate in fulfilment of part of the requirements of the degree of Master of Laws in approved courses and minor dissertation. The other part of the requirement for this degree, namely, in the instant case, the completion of one full course and two half courses, has been fulfilled.*

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## A. INTRODUCTION:

Trusts are extensively used, primarily for estate and tax planning and more recently for business purposes. Frequently being the recipients of large amounts of income, trusts are often used as vehicles to minimize or avoid the incidence or levying of tax, rendering the taxation of trust income an issue of great significance.

Depending upon the circumstances, trust income, in terms of the *Income Tax Act No. 58 of 1962* [as amended and hereinafter referred to as "the Act"], may be taxable in the hands of the trust and/or the beneficiary and or the donor. The aforesaid possibilities have in the past generated several uncertainties with regard to ultimate tax liability for trust income and have also been the source of various tax avoidance stratagems, so much so that the Act has, in an attempt to remove same, over the years, with a relative degree of success, been amended.

This dissertation, which concerns the taxation of Trusts in South Africa, will be focused on the income tax treatment of trusts as opposed to the various other types of trust taxation such as donations tax, estate and transfer duty, which exist. The taxation of trust income in general will be traversed with specific emphasis being placed on past and current important and in some instances, rather controversial, issues relating thereto. They include *inter alia*, the following:

- [i] Whether the effect of *section 25 B* of the Act is that trust income, received by or accrued to a trust in year one and thereafter, in year two, distributed to or vested in a beneficiary, is in fact taxed twice, first in the hands of the trust and thereafter in the hands of the beneficiary;

- [ii] Whether, when deductions and allowances available under the Act, exceed the gross income attributable to the beneficiary, such beneficiary can, in terms of section 25B(3), set off the aforesaid "loss' against his/ her other income.
  
- [iii] The conduit pipe principle and certain consequences thereof;
  
- [iv] Whether, in the case of a discretionary trust, the exercise by the trustee of a discretionary decision as to whether to distribute income to a trust beneficiary is an '*event*' within the meaning of section 7 (5) of the Act.

**B. THE CONCEPT OF A TRUST AND OTHER DEFINITIONS RELEVANT TO THE TAXATION OF INCOME ARISING THEREFROM:**

**1. THE CONCEPT AND NATURE OF A TRUST:**

**1.1 *Judicial Definitions:***

Various judicial definitions relating to the concept of a trust exist. In *Thorne and Molenaar NNO v Receiver of Revenue, Cape Town 1976 (2) SA 50 (C), 38 SATC 1* it was stated that in a trust, a person (the settlor, or sometimes the "donor" if he donates property), transfers certain property to a trustee on terms which oblige the latter to administer the property for the benefit of a third person (the beneficiary) who has the right against the trustee to enforce the trustee's obligations. More specifically, Van Winsen J<sup>1</sup> described a trust as follows:

"...in general a trust is created by contract, very often by a contract of donation or in virtue of an antenuptial contract or by way of will. It is created in respect of defined property transferred to a trustee, who is burdened with the obligation to administer the property for the benefit of a third person, the latter being accorded a right against the trustee to enforce the trustee's compliance with his obligations towards the beneficiary concerned. Generally trusts contemplate an extended continuation of the administration of the trust property in favour of the beneficiary until terminated upon the happening of some specified future event. A trust can also be created by statute.

The characteristics and consequences of a trust as above stated are not intended to be exhaustive. They may vary in certain respects without detracting from the essential concept of a trust. But I think it is clear that a trust in the above sense does not, in proper parlance, have reference to the situation where, for example, a curator is administering the property of a mentally defective patient. Although it may well be regarded as creating a situation analogous to one consequent upon a trust, it is not a trust in the accepted sense of the word. Moreover, a creditor in insolvency, while occupying a position in relation to the trustee analogous to that of a beneficiary in a trust

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At SATC 6

properly so-called, is not in the same position as such beneficiary. His only interest is to receive from the trustee as much of the original debt owing to him by the insolvent as the circumstances will permit."

In *Estate Kemp v McDonald's Trustee 1915 AD at 491*, the underlying concept of a trust, was held to be that while the legal *dominium* is vested in trustees, they have no beneficial interest, but are bound to hold and apply the property for the benefit of some person or persons or for the accomplishment of some special purpose.

Finally, in *Braun v Blann and Botha NNO and Another 1984(2) SA 850 at 859*, Joubert J stated the following in respect of the trust:

"In its strictly technical sense the trust is a legal institution "*sui generis*"...

The English conception of an equitable ownership distinct from, but co-existing with, the legal ownership is foreign to our law. Our courts have evolved and are still in the process of evolving our own law of trusts by adapting the trust idea to the principles of our own law."

Although none of the foregoing judicial pronouncements are intended to be comprehensive, it is evident that the descriptions introduce the elements of donation of property to trustees, administration for the benefit of third parties, independence and public control<sup>2</sup>.

It is further evident that trusts are generally speaking, created by contract, during the life of the settlor, very often by contract of donation, by virtue of an ante-nuptial contract [ an *inter vivos* trust] or by way of a will [a testamentary trust], but may also be created by statute. They contemplate an extended continuation of the administration of the trust property in favour of the beneficiary until terminated by the happening of a specified future event.<sup>3</sup>

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<sup>2</sup> De Koker and Urquhart - *Income Tax in South Africa* - Page 17 - 18

<sup>3</sup> LAWSA - Vol.:22; Part 1; Paragraph 740; Page 449

### 1.2 *Discretionary and fixed trusts:*

A trust may be a *discretionary* or a *fixed* trust. In a *fixed* trust, the beneficiaries have a vested right to all or part of the income and/or capital of the trust, while in a *discretionary* trust the distribution of income and capital is in the discretion of the trustees. Furthermore, in a *discretionary* trust, a beneficiary obtains no vested rights to trust income, unless and until the trustee exercises his discretion to distribute income to him; and only thereupon does the beneficiary obtain a vested right and become liable to income tax on the amount.<sup>4</sup>

### 1.3 *Testamentary trusts and trusts inter vivos:*

A trust may be created by a will, in which case it comes into being after the death of the testator or it may be created during the lifetime of the donor, in which case it is constituted under a deed *inter vivos*.

A *testamentary trust* is created by a will wherein the testator stipulates that the corpus of his estate or a particular asset, instead of being distributed among beneficiaries, is to be administered or managed by administrators (or trustees) for the benefit of beneficiaries nominated by the testator. The testator further specifies in the said will, the powers of the administrators, the division of the income and capital among the beneficiaries and further provides for matters such as the termination of the trust. The taxation of this trust income is regulated by section 25B of the Act which is discussed hereinbelow. Briefly the beneficiaries may be ascertained and have a vested right to the income, in which instance each beneficiary will be taxed in respect of his or

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her portion of the income. The beneficiaries may alternatively have no vested right in which instance the income will be taxed in the hands of the trustee as representative taxpayer.<sup>5</sup>

*Trusts inter vivos*, which will be elaborated upon hereinbelow, are essentially created by a contract, which usually contains a stipulation in favour of the beneficiary (*stipulatio alteri*) who, by accepting same, acquires an indefeasible right under the trust. A donation is usually involved in the formation of a trust *inter vivos* and in terms of the contract, the donor agrees to transfer property to trustees for the benefit of third parties.<sup>6</sup> The principles with regard to the taxation of testamentary trusts, as set out in sect 25B of the Act apply equally to trust *inter vivos*, except that in certain circumstances the provisions of section 7 of the Act will be applicable, in which circumstances, the income of a trust *inter vivos* will be taxed in the hands of the founder of the trust.<sup>7</sup>

The document setting out the terms of the trust (i.e. the 'trust deed', which, in the case of a testamentary trust, is incorporated in the will) stipulates the assets to be held in trust, the name of the trustee(s) and the beneficiaries, the powers of the trustees or administrators (the two terms often being used as synonyms), the rights of the respective beneficiaries to the income and capital of the trust and the circumstances in which the trust will terminate.<sup>8</sup>

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<sup>5</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-20

<sup>6</sup> The points of comparison between the aforesaid donation and an outright or common law donation include *inter alia* the following:

[i] Legal ownership of the property donated vests in the trustees in their capacities as same and not in the beneficiaries;

[ii] The trustees are in terms of the deed, appointed by the donor and are responsible to conserve and administer the trust property in accordance with their powers and duties as specified in the trust deed. They are obliged to distribute the income and capital according to the provisions of the trust deed.

De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-22

<sup>7</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-22 - 17- 23

<sup>8</sup> Williams RC - *Income Tax in South Africa: Law & Practice*, Page 410

#### 1.4 Statutory definitions:

In addition to the aforesaid judicial pronouncements, various statutory definitions for the term "trust" exist. They include *inter alia* the following:

In terms of *section 1* of the Act, the word 'trust' has been defined as follows:-

**'trust' means any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of the deceased person;**

*[Definition of "trust" inserted by section 2(i) of Act 141 of 1992.]"*

The *Trust Property Control Act No. 57 of 1988*, to which the operation of trusts are subject, has in *section 1*, defined a trust as follows:

**The arrangement through which the ownership in the property of one person is by virtue of a trust instrument made over or bequeathed -**

- (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or**
- (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument, but does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act 1965;**

In determining the liability for tax in respect of trust income, careful attention must be given to the trust deed, the appropriate provisions of the Income Tax Act and the legal principles pertaining to the vesting of rights. Depending on these factors, the income of the trust may be taxable in the hands of the trust, or partly in the hands of the beneficiaries and partly in the hands of the trust, or in the case of a trust *inter vivos*, in the hands of the founder of the trust.<sup>9</sup>

## **2. THE TRUSTEE - A REPRESENTATIVE TAXPAYER:**

The representative taxpayer in respect of income of any trust is, in terms of paragraph (c) of the definition of a "representative taxpayer" in *section 1* of the Act, the trustee or any other person entitled to the receipt, management, disposal or control of such income.<sup>10</sup>

*Section 1* of the Act, in respect of the two aforesaid concepts, reads as follows:

**'representative taxpayer' means -**

- (a) in respect of the income of a company, the public officer thereof;**
- (b) in respect of the income under his management, disposition or control, the agent of any person, including an agent appointed as such under the provisions of section *ninety-nine*, and for the purposes of this paragraph the term "agent" includes every person in the Republic having the receipt, management or control of income on behalf of any person permanently or temporarily absent from the Republic or remitting or paying income to or receiving moneys for such person;**
- (c) in respect of income the subject of any trust or in respect of any minor or mentally disordered or defective person, or any other person under legal disability, the trustee, guardian, curator or other person entitled to the receipt, management, disposal or control of such income or remitting**

<sup>9</sup> De Koker and Urquhart - *Income Tax in South Africa* - Page 17 - 18

<sup>10</sup> Pace RP & Van der Westhuizen WM - *Wills and Trusts* Page 53

- payment to or receiving moneys on behalf of such person under disability;
- (d) in respect of income paid under the decree or order of any court or judge to any receiver or other person, such receiver or person, whoever may be entitled to the benefit of such income, and whether or not it accrues to any person on a contingency or an uncertain event;
  - (e) in respect of the income received by or accrued to any deceased person during his lifetime and the income received by or accrued to the estate of any deceased person, the executor or administrator of the estate of such deceased person,
- but nothing in this definition shall be construed as relieving any person from any liability, responsibility or duty imposed upon him by this Act;

'trustee', in addition to every person appointed or constituted as such by act of the parties, by will, by order of declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, *fideicommissum* or other limited interests or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability;

It has been held in *Estate Smith v CIR (3) SA (AD) at 379* that the aforesaid two definitions, which contains some duplication, should be read together. A trustee as defined, qualifies as a representative taxpayer only if the requirement of paragraph (c) above of the definition of "representative tax payer" is present, namely, that there is income subject to a trust. Only if there is income subject to a trust, does the trust need to be registered as a taxpayer, which in most cases

will be as a provisional taxpayer, <sup>11</sup>in terms of Practice Note 21<sup>12</sup>, as confirmed by the Commissioner for Inland Revenue, at the office of the Receiver of Revenue in whose area the office of the trustees is situated.<sup>13</sup>

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<sup>11</sup> ie if the rules for provisional taxpayers in terms schedule 4 of the Act apply.

<sup>12</sup> Entitled 'Income Tax: Registration of Inter Vivos Trusts' - dated 1 June 1994; GN574 GG 15782 of 10 June 1994 - Divaris, C and Stein, ML SILKE ON SOUTH AFRICAN INCOME TAX - Vol 2 - Page 12 - 23

<sup>13</sup> Pace RP & Van der Westhuizen WM - Wills and Trusts Page 53

**C. LIABILITY FOR TAX:**

In *Trustees of the Philip Frame Will Trust v CIR (1991) 53 SATC 166*, affirmed by the Appellate Division in *CIR v Friedman & Other NNO 1993 (1) SA 353 (A), 55 SATC 39, 1993 Taxpayer 12*, it was held that a trust was **not** a legal *persona* and hence not a taxable entity liable for tax in respect of undistributed trust income of the trust. It was further held that for a trustee to be a representative taxpayer, there had to be an ascertained 'person', whom he represented, failing which, trustees are not liable for tax on income which has not and is not deemed to have accrued to any person, such as, for instance, the undistributed trust income to which the deeming provisions of section 7 do not apply.<sup>14</sup> Accordingly, until the amendments to the Act referred to below, income tax could be levied neither on a trust, nor upon the trustees, as representative taxpayers in respect of undistributed income of the trust.

The aforesaid finding and loophole was speedily reversed and blocked via the following amendments to the Act:

- [i] The enactment of section 25B of the Act, which was operative with effect from 1 March 1986 and which provided for the taxation of trust income via the extension of the statutory definition of 'person' to include 'trust'; and,
- [ii] The adding a of " trust" to the definition of "person" in section 1 of the Act, in terms of the 1991 Amending Act which was backdated to 1 March 1986.<sup>15</sup>

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<sup>14</sup> Williams *Income Tax in South Africa: Law and Practice* - Page 411

<sup>15</sup> Williams *Income Tax in South Africa: Law and Practice* - Page 411

Accordingly, now, in terms of section 1 of the Act:-

**'person' includes the estate of a deceased person and any trust;**

*[Definition of "person" substituted by section 2 (1) (b) of Act 129 of 1991 and by section 2(f) of Act 141 of 1992.]*

As a result of the aforesaid amendments, trustees became "representative taxpayers" and the apparent lacuna was closed. A trust is therefore now a taxable entity for the purposes of the Act and in respect of any undistributed income an assessment is raised upon the trustee or administrator as representative taxpayer.<sup>16</sup>

In the circumstances, depending on factors such as:

- (a) The nature of the transaction (ie a donation or a sale or a loan with or without interest);
- (b) The provisions of the trust deed with regard to the type of rights of beneficiaries and the discretionary powers given to trustees;
- (c) Whether income is distributed or whether it is retained in the trust;
- (d) The minority or the majority of the beneficiaries;

any one or more of the following parties to a trust can be liable for income tax namely:

- (i) The founder of the trust;

- (ii) The donor (other than the founder) of the trust;
- (iii) The trustees as representative taxpayers on behalf of the trust;
- (iv) The beneficiaries in terms of the trust deed.

The aforesaid liability will be determined *inter alia* by sections 1 "person" and "trust", 25B, 7(1), 7(2), 7(3), 7(4), 7(5), 7(6) and 7(7) of the Act, which sections either have been and / or will be traversed hereinbelow.<sup>17</sup>

A trust is taxed, via an assessment upon the trustee as representative taxpayer of the trust at the rates of normal tax applicable to an unmarried person. Confinement of the application of section 6(1) and (2) of the Act to natural persons has the effect that the trust cannot qualify for any of the personal rebates. It is however, due to its inclusion in the definition of "person" in section 1, liable for the transition levy. A trustee is furthermore, entitled to claim any deductions for which it qualifies in terms of the Act, in the determination of income subject to taxation in his hands as trustee, which include *inter alia*, the following: administration charges, such as the trustees remuneration and the premium on a fidelity bond, as are deductible in terms of section 11(a) of the Act.<sup>18</sup> It has been held in *ITC 1562 1994, Taxpayer 16, 55 SATC 310* that separate trusts (and therefore separate *personae*) can be created in the same trust instrument.<sup>19</sup>

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<sup>17</sup> Van der Westhuizen WM - Wills and Trusts - Page 54

<sup>18</sup> Divaris, C and Stein, ML SILKE ON SOUTH AFRICAN INCOME TAX - Vol 2 - Page 12 - 23

<sup>19</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16131 Page 16-45

### 1.1 *Exemption from tax of certain trusts:*

It should be noted that in terms of section 10 (1) of the Act, various possibilities exist to create trusts which are entirely exempt from income tax.<sup>20</sup> They include the following categories:

- [a] In terms of section 10(1)(d) of the Act, certain pension funds and other benefit schemes;
- [b] In terms of section 10 (1) (cA) to 10 (1) (cF) of the Act, non - profit - making and non-proprietary clubs;
- [c] In terms of section 10 (1) (f) of the Act, charitable institutions.<sup>21</sup>

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<sup>20</sup> Van der Westhuizen WM - Wills and Trusts - Page 61

<sup>21</sup> Honore T & Cameron E, Honore's South African Law of Trusts - Page 373

**D. THE GENERAL RULE PERTAINING TO THE TAXATION OF TRUSTS AND BENEFICIARIES - SECTION 25 B**

Section 25 B, subject to the provisions of section 7 of the Act, governs and contains the general principles relating to the taxation of trust income. It reads as follows:

**Income of trusts and the beneficiaries of trusts**

**25B (1)** 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 1, shall, subject to the provisions of section 7, to the extent to which such income has been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, be deemed to be income which has accrued to such beneficiary, and to the extent which such income is not so derived, be deemed to be income which has accrued to the trust.

**(2)** Where a beneficiary has acquired a vested right to any income referred to in subsection 1 in consequence of the exercise by the trustee of a discretion vested in him in terms of the relevant deed of trust, agreement or will of a deceased person, such income shall for the purposes of that subsection be deemed to have been derived for the benefit of the beneficiary.

**(3)** Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of income referred to in subsection (1) shall, to the extent to which such income is under the provisions of that subsection deemed to be the income which has accrued to the beneficiary or to the trust, be deemed to be a deduction or allowance which may be made in the determination of taxable income derived by such beneficiary or trust, as the case may be.

*[S25B inserted by section 27(1) of Act 129 of 1991 and amended by section 22 of Act 141 of 1992.]*

## 1. SECTION 25B(1) OF THE ACT:

It is evident from the above, that subject to the provisions section 7 of the Act, which relate to the taxation of trust income other than in the hands of the trust or the beneficiaries of the trust, where the trust is an *inter vivos trust*, and certain required circumstances are present, which will be elaborated upon hereinbelow, the general rule as set out in section 25B(1) of the Act provides that any income<sup>22</sup> received by or accrued to a trustee, whether testamentary of *inter vivos*, shall:

- [i] To the extent to which it has been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to such income, be deemed to have accrued to the beneficiary<sup>23</sup>; and
- [ii] To the extent that it is not so derived for the immediate or future benefit of an ascertained beneficiary with a vested right to it, be deemed to have accrued to the trust itself.

### 1.1 *Ascertained beneficiary with vested right:*

A beneficiary must be ascertained by the end of the year of assessment and hence must be a

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<sup>22</sup> It is considered that the word "income" as used in the context means "income" as defined in section 1 of the Act, that is, gross income, less exempt income. See: Divaris, C and Stein, ML SILKE ON SOUTH AFRICAN INCOME TAX - Vol 2 - Page 12 - 25

<sup>23</sup> If and ascertained beneficiary has a vested right, the income vested in him must as a matter of course be for his immediate or future benefit.  
Meyerowitz [SC], D - Meyerowitz on Income Tax - 16134 Page 16-44

known or determined person by then. He may be a natural person or a juristic person, including a deceased estate or a trust fund.<sup>24</sup>

In *Jewish Colonial Trust Ltd v Estate Nathan 1940 AD 163 at 175*, it was held that a beneficiary has a vested right to income if he has a right which cannot be defeated and passes to his cessionaries (ie if he is permitted, by the terms of the trust, to do so) or his estate on his death even if the income is payable at some future date after its accrual, eg at the termination of the trust (*dies cedit sed nondum venit*).<sup>25</sup>

In terms of the aforesaid, if the terms of the trust deed are such that the trustee is required or obliged to pay any income to a particular beneficiary, that income accrues to the beneficiary in terms of section 25B and it is he and not the trustee as representative taxpayer, who will be taxed on the income.<sup>26</sup>

So long as the income vests in the beneficiaries name in terms of the trust deed, the aforesaid outcome would ensue, even if the income is not actually paid directly to the beneficiary, but is required to be expended by the trustees for his benefit or is accumulated<sup>27</sup> or capitalized or otherwise dealt with in the beneficiaries name<sup>28</sup>. More specifically in the aforesaid regard:

In *Estate Munro v CIR, 1925 TPD 693, 1 SATC 163*, it was held that even if income from a trust is not paid directly to the beneficiary but is expended by the trustee for the beneficiary's benefit,

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<sup>24</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16136 Page 16-46

<sup>25</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16134 Page 16-44

<sup>26</sup> De Koker & Urquhart - Income Tax in South Africa [ Vol.1]; Page 17-22 - 17- 23

<sup>27</sup> ITC 1484(1990) 52 SATC 312

<sup>28</sup> Divaris, C and Stein, ML SILKE ON SOUTH AFRICAN INCOME TAX - Vol 2 - Page 12 - 27

the income will be taxed in the hands of the beneficiary.<sup>29</sup>

The aforesaid rule also applies where the income is accumulated or capitalized or otherwise dealt with in the beneficiaries name, as was the case in *CIR v Polonsky 1942 TPD 249, 12 SATC*, where income, which was derived from investing the capital of a trust which accumulated and reinvested for the benefit of a beneficiary until she attained the age of 30, was held to have accrued to her under the equivalent of section 7(1).<sup>30</sup>

In *Hilda Holt Will Trust v CIR (1993) 55 SATC at 8 - 9* it was held that the fact that trust assets are not static and may grow or diminish in specie or in value does not render a beneficiary's entitlement conditional or create uncertainty as to the existence of the right. In the circumstances, it is possible for an uncertain but ascertainable amount *in futuro* to vest immediately, and where a will clearly contemplates that there will be a residue for distribution to ultimate beneficiaries, the intention to postpone vesting is not present. Furthermore, the usual condition of survivorship found in a true *fideicommissary* bequest is not present where the ultimate beneficiary is a charity with an apparently indefinite future existence and there can be an immediate vesting of capital, including income which is surplus to the amount necessary to pay the stipulated annuity.<sup>31</sup>

Finally, in *ITC 1552(1993)55 SATC 82*, it was held that where an intermediate right is of a usufructary nature, the natural inference is that there is an immediate vesting of heirs. Similarly, the mere postponement of payment to a beneficiary does not prevent vesting from taking place.<sup>32</sup>

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<sup>29</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-22 - 17- 24

<sup>30</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-22 - 17- 24

<sup>31</sup> Emslie, Davis, Hutton - *Income Tax Cases and Materials* - Page 1020

<sup>32</sup> Williams *Income Tax in South Africa: Law and Practice* - Page 411

The general principle of taxing the beneficiary and not the trustee will be applicable only when it is clear that the beneficiary has a vested right to such income, that is that he has the right to claim that income. In the circumstances, if he has no vested right but merely a contingent right, it cannot be said that the income has accrued to him.

The Special Court has described the distinction between a vested and contingent right as follows<sup>33</sup>:

ITC 76  
 "Vesting implied the transfer of *dominium*, and the children had clearly not in the year under review acquired *dominium* of the trust income or any portion thereof. A vested right was something substantial; something which could be measured in money; something which had a present value and could be attached. A contingent interest was merely a *spes* - an expectation which might never be realized. 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."

In *Jewish Colonial Trust Ltd v Estate Nathan* 1940 AD 16, Watermeyer J, at 175 - 176 stated that:

NEW  
 "The word ['vested'] is also used ...to draw distinction between what is certain and what is conditional, a vested right as distinguished from a contingent or conditional right. When the word "vested" is used, in this sense Austin (Jurisprudence, vol 2, lect 53), points out that in reality a right of one class is not distinguished from a right of another class but that a right is being distinguished from a chance or a possibility of a right, but it is convenient to use the well-known expressions vested and conditional or contingent right."

In *Lategan v CIR* 1926 CPD 203,2 SATC 16, it was held that trust income does not accrue to a beneficiary while the latter's right thereto is conditional or where the beneficiaries interest in the income is merely a *spes*. The word 'condition' in the aforesaid context is used in its legal sense as referring to an entitlement which is dependant on the occurrence of a future uncertain event, that is to say, something which may or may not happen.<sup>34</sup>

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Per G J Maritz, President of the Special Court for Hearing Income Tax Appeals, in ITC 76 (1927) 3 SATC 68 at 70

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Williams *Income Tax in South Africa: Law and Practice* - Page 411

## 2. SECTION 25B(2) OF THE ACT:

Section 25B(2) deals with discretionary trust which involves the situation where the beneficiary has no vested right in terms of the trust deed, will or settlement, but the trustee has a discretion to vest any income in a beneficiary. In these circumstances, there can be no accrual of an ascertained amount of income to a beneficiary until the trustee exercises his power of discretion and distributes the income to the beneficiary, when he becomes assessable on the amount distributed. The reason for the aforesaid is that is that until the discretion of the trustee has been exercised, the beneficiary has no more than a contingent right and it is only on the exercise of this discretion by the trustee that the right to the income vests in the beneficiary and he becomes taxable thereon.<sup>35</sup>

Where such aforesaid beneficiary, in consequence of the exercise by a trustee of a discretion vested in him in terms of the trust, acquires a vested right to any of the aforesaid income, section 25B(2) deems such income to have been derived for the benefit of such beneficiary. Such vesting in terms of section 25B(2) may take the form of an actual distribution or a credit in account and payment withheld until some future date.<sup>36</sup>

In order to vest any income derived by the trust fund during its year of assessment in a beneficiary in consequence of the exercise of his discretion, the trustee should do so, it is considered, before the year end. It should however, be noted that in *ITC 1033 1964 Taxpayer 30, 26 SATC 73*, the Special Income Tax Court took the view in relation to section 7(5) that it

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<sup>35</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-22 - 17- 25

<sup>36</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16136 Page 16-46

would be sufficient to affect the incidence of tax if the discretion were exercised within a reasonable period after the close of the year, which the court thought was up to the time when a return had to be submitted.<sup>37</sup>

Section 25B(2) is silent on the important issue of whether, if income accrued to, or is received by a trust in year 1, which is thereafter, in year 2, distributed to or vested in a beneficiary, the effect of section 25B(2) of the Act is that an amount is taxed twice, first in the hands of the trust and secondly in the hands of the beneficiary.<sup>38</sup>

It is considered that section 25B(2) does not result in double taxation of the income in that if the income is taxed in the hands of the trust in year 1 and the beneficiary acquires a vested right thereto only upon distribution in a subsequent year, the beneficiary will not be taxed on the same income. The reason for the aforesaid is that apart from the presumption against double taxation, there is authority in *Estate Dempers v SIR 1977(3) SA 410 at 424F, 1977 Taxpayer at 157, 39 SATC 95*, to the effect that if any income has been taxed in the hands of the trust, it may not be taxed in a subsequent year of assessment in the hands of a beneficiary. In short, it has accrued to the trust which is a legal persona and its distribution in subsequent years has no tax consequences.<sup>39</sup>

### 3. SECTION 25B(3) OF THE ACT:

Section 25B(3) decrees that any deduction or allowance available under the Act and taken into

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<sup>37</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16136 Page 16-46

<sup>38</sup> Williams Income Tax in South Africa: Law and Practice - Page 412

<sup>39</sup> De Koker & Urquhart - Income Tax in South Africa [ Vol.1]; Page 17.22 - 17. 19  
Meyerowitz [SC], D - Meyerowitz on Income Tax - 16139 Page 16-47  
Pace RP and Van der Westhuizen WM Wills and Trusts Page 54

account in determining 'taxable income', shall, to the extent to which such income is deemed under section 25B(1) to be income of the beneficiary or the trust, be deemed to be a deduction or allowance which can be taken into account in determining the taxable income of the beneficiary or the trust, as the case may be. The aforesaid means, it would seem, that allowances and deductions are to be apportioned or 'matched' on a *pro rata* basis against gross income or more precisely, gross income, other than exempt income, as per the definition of 'income' in section 1 of the Act, which is deemed to accrue to the trust and to the beneficiaries, respectively, with the result that such allowances and deductions are claimable by the trust and the beneficiaries, respectively.<sup>40</sup> Thus, if income is deemed to be the income of the beneficiary in terms of section 25B(1) and there are allowances which relate to the earning thereof, the beneficiary will be allowed the benefit of such allowances in the calculation of his taxable income in addition to the deduction of expenditure which has been incurred by the trust in the production of such income.<sup>41</sup>

Although Section 25B(3) clarifies, at least partly, the uncertainty and controversy which has in the past prevailed on the aforesaid point, a problem however still arises, in that should a trust instrument provide for the vesting of the whole or portion of the net income (including the exempt income) of the trust, ie after payment of all of the expenses, there would in consequence, be a portion of the trust's income which would not vest in the beneficiary entitled to income only. Meyerowitz submits that a construction of 25B(3) along the aforesaid line would, particularly in the case of a discretionary trust, frustrate what the draftsman had in mind and

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<sup>40</sup> Williams Income Tax in South Africa: Law and Practice - Page 412

<sup>41</sup> De Koker & Urquhart - Income Tax in South Africa [ Vol.1]; Page 17-20

suggests, in an attempt to overcome the aforesaid problem, that apportionment<sup>42</sup> to a beneficiary of deductions and allowances under section 25B(3) should be based on the ratio that the net income of the trust vesting in him bears to the total net income of the trust.<sup>43</sup>

### 3.1 Losses:

**De Koker & Urquhart**<sup>44</sup> and **Williams**<sup>45</sup> are of the opinion that, where the amount of deductions or allowances apportioned to a beneficiary, exceed the gross income attributed to him, the beneficiary can deduct such 'loss' from any other income accruing to him. The aforesaid is in line with the reasoning of Melamet J in *ITC 1483 (52 SATC 306)*, where he held (*obiter*) that if the profits of a trust vested in the beneficiaries, this should also include the losses.

**Meyerowitz** is however of the opinion that unless a trust instrument provides that a beneficiary entitled to income only, shall be responsible to make good expenditure incurred by a trust, there cannot be an apportionment of a loss occasioned by an excess of expenditure over income as there would in the circumstances be no net income to vest. An income beneficiary would

<sup>42</sup> Example of proposed apportionment of deductions and allowances based on the ratio that the net income of the trust vesting in the beneficiary bears to the total net income of the trust:

Gross income of trust:					100
Less exempt income:					<u>10</u>
Income:					90
Less: expenses:	15				
allowance:	<u>5</u>				<u>20</u>
Taxable Income:					<u>70</u>
<b>Net income of trust:</b>	<b>100 - 15 = 85</b>				
Taxable income apportioned as follows:					
	<u>20</u>				
Beneficiary:	85	of	70	=	16,47
	<u>65</u>				
Trust:	85	of	70	=	53,53

<sup>43</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16140; Page 16-47  
See further: 1992 *Taxpayer* 227

<sup>44</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-25

<sup>45</sup> Williams *Income Tax in South Africa: Law and Practice* - Page 412.

however still be able to claim a loss for tax purposes arising from an allowance, since an allowance does not affect the net income of the trust. On the other hand where a beneficiary has a vested right to both the income and the capital, it could be said that where a trust suffers a loss, it is at the expense of the beneficiary and that because of the aforesaid, he is entitled to deduct the loss, although there is no net income for distribution.<sup>46</sup>

A beneficiary who enjoys a vested right to both the capital and income of a trust is liable to tax on not only the income actually received by him from the trust, but also on any inadmissible expenditure laid out by the trust. In the aforesaid circumstances, the gross income of the trust accrues to the beneficiary, the inadmissible expenditure is disbursed on his behalf, and the taxable income or assessed loss is derived or incurred by him and not the trust. **De Koker & Urquhart** submit that when only the net income of the trust passes to the beneficiary and it is clear from the terms of the deed that the beneficiary has no vested right to the capital, but is entitled to receive only a share of the income, he is not liable to tax on any inadmissible expenditure incurred by the trustees. The trust would in these circumstances be liable to tax on the income laid out on such inadmissible expenditure.<sup>47</sup>

The Commissioner for Inland Revenue, as a result of the measure of doubt which appeared to exist with regard to the intention of the Legislature in respect of the deduction of a loss in terms of section 25B(3), has issued the following rather helpful Practice Note 23<sup>48</sup>, which sets out the interpretation of section 25B and reads as follows:

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<sup>46</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.140; Page 16-48

<sup>47</sup> De Koker & Urquhart - Income Tax in South Africa [ Vol.1]; Page 17-25

<sup>48</sup> Entitled 'Income Tax: Taxation of Trusts and trust beneficiaries in Terms of Section 25B of the Income Tax Act, 1962' and dated 17 June 1994; GN 633 GG 15805 of 24 June 1994.

"Practice Note: No. 23

17 June 1994

INCOME TAX: TAXATION OF TRUSTS AND TRUST BENEFICIARIES IN TERMS OF SECTION 25B OF THE INCOME TAX ACT, 1962

1. As a result of the judgement handed down by the Witwatersrand Local Division of the Supreme Court in the case of *Trustees of the Philip Frame Will Trust v CIR* (53 SATC 166) the definition of 'person; in section 1 of the Income Tax Act (the Act) was amended to include a trust. Concurrent with the amendment, section 25B of the Act was introduced with a view of governing the assessment of trusts and trust beneficiaries, thereby *confirming the conduit principle* without affecting the Commissioner's taxing rights in terms of section 7 of the Act.
2. A measure of doubt exists as to whether it was the intention of the legislature to grant losses to trusts and trust beneficiaries in terms of section 25B(3) of the Act. In certain instances, the view was apparently held that the wording of section 25B(3) of the Act has a 'ring-fencing' effect i.e. that this section limits the allowable deductions and allowances to income (as defined) in the hands of the trust and the trust beneficiaries.
3. Section 25B(1) provides (subject to the provisions of section 7) that the income received by or accrued to a trust is deemed to accrue to a beneficiary who has a vested right to it. To the extent to which there is no vested right to such income, it is deemed to accrue to the trust. Section 25B(2) deems a vested right to arise if vesting take place in consequence of the exercise of the trustee of a discretion vested in him with regard to the distribution of income.
4. Section 25B(3) further makes provision that *'Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any income referred to in subsection (1) shall, to the extent to which such income is under the provisions of that subsection deemed to be income which has accrued to a beneficiary or to the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by such beneficiary or trust, as the case may be.'*

The wording in section 25B(3) "to the extent to which" can, therefore, not be construed as meaning that deductions and allowances be limited to the income of a trust or trust beneficiary. What it in fact means is that such deductions and allowances are to be allocated between a trust or trust beneficiary in the same proportion as the income has been allocated. Therefore, any deduction or allowance which would be available to a trust beneficiary in terms of section 25B in the determination of taxable income, will be deductible in full in the hands of the beneficiary.

[The emphasis is that of the practice note.]

**Pace and Van der Westhuizen**<sup>49</sup> are correctly of the opinion, it is submitted, that practice note 23 confirms that section 25B(3) does not have the effect that deductions are limited to the income of the trust.

The trust expenses which are not admissible because they are not revenue expenses incurred in the production of income will be ignored in the calculation of taxable income. As the duties in regard to returns etc and the obligations to pay tax in respect of the income taxable in the hands of the trust fall upon the trustee as the representative taxpayer, it is considered that the trustee must, in the first instance, determine, for the purpose of filing his return, what portion of the trust's income is taxable in the hands of the trust. He should furthermore advise the beneficiaries as to what of the trust's income, deductions and allowances is attributable to them for tax purposes, for the aforesaid information may not otherwise be patent to the beneficiaries in the accounts furnished to them by the trustee.<sup>50</sup>

#### 4. TRUST INCOME RETAINS IT'S NATURE - THE CONDUIT PIPE PRINCIPLE:

Ordinarily, the principle is that if an amount passes through the hands of several taxpayers, the character thereof must be assessed in the hands of each taxpayer.<sup>51</sup>

Trust income which is taxable in the hands of a beneficiary, subject to some statutory exceptions, does not lose its identity due to the fact that it passes through the hands of the trustee first.

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<sup>49</sup> Pace RP and Van der Westhuizen WM Wills and Trusts Page 55  
They therefore, for example submit that if a trust has income of R50 000,00 and related expenses of R55 000,00, and the R50 000,00 vests in the beneficiary, the beneficiary is allowed to claim a deduction of the full R55 000,00.

<sup>50</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.142; Page 16-49

<sup>51</sup> Williams Income Tax in South Africa: Law and Practice - Page 417

Accordingly, from an income tax point of view, a trust is a mere conduit pipe through which the income flows and the income retains its nature in the hands of the beneficiaries. The aforesaid conduit principle is well established in our case law, seems to have remained intact in section 25B of the Act and was also confirmed in Practice Note 23 *Government Gazette* 15805 24 June 1994. In *Armstrong v CIR*<sup>52</sup> it was held that<sup>53</sup>

"...in a simple case such as I am now examining, namely that a trio comprising a company, the intervening trustee and beneficiary, it is manifest that in the truest sense the beneficiary derives its income from the company and the trustee can neither increase nor diminish it, he is a mere conduit pipe."

It follows from the aforesaid general statement that in determining whether an amount in the hands of a beneficiary constitutes income from a source within or deemed to be within the Republic of South Africa, no regard must be had to the fact that it passed through the hands of a trustee. In the circumstances capital remains capital, income remains income and interest remains interest. Consequently, any exemption from tax or special tax treatment provided in the Act, applying to income accruing to a beneficiary, will be available to that beneficiary in respect of both fixed and discretionary trusts. In the circumstances, where a trust derives income in the form of dividends, it is exempt in the hands of the beneficiary since dividends received by or accrued to any person are, in terms of section 10(1)(k)<sup>54</sup> of the Act, exempt from tax.<sup>55</sup> Therefore, whether the income is exempt from tax or not must be determined in relation to the beneficiary and not in relation to the trust and where income is apportionable among several beneficiaries, each kind of income must likewise be apportioned among them, unless the trust

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<sup>52</sup> 1938 AD 343, 10 SATC 1, ITC 636(1947)15 SATC 120

<sup>53</sup> At 348, At SATC 6

<sup>54</sup> Section 10 of the Act specifically provides however, that the exemption in respect of dividends and the exemption in respect of interest do not apply to any portion of an annuity. The aforesaid will be elaborated upon in the chapter on annuities set out hereunder.

<sup>55</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-42

instrument directs or confers a discretion upon the trustee to decide, what income is to go to whom.<sup>56</sup>

In *SIR v Rosen*<sup>57</sup>, Trollop JA confirmed the aforesaid principle as follows:

"It suffices to say that the trust deed may itself 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 contradistinction to the benefit of the dividend rights in terms of the above crucial phrase. Thus, a trust deed may endow the trustee with a discretion to pass on the dividends to the beneficiary or to retain and accumulate them. If he decides on the latter, I think (but express no firm view) that the dividends might then lose their identity and character as dividends, so that, if they are subsequently paid out to the beneficiary, they might possibly no longer be dividends in his hands, for the conduit pipe had turned itself off at the relevant time. But if he decides on the former, ie to pass the dividends onto the beneficiary, the condition suspending the beneficiary's entitlement thereto is fulfilled, and they would constitute dividends in his hands in the same way as if he had been originally entitled to them unconditionally under the trust deed, ie as if the conduit pipe had always been open."

Logically, the conduit principle ought to apply where the trust in fact operates as a conduit, in other words, where the trust income is distributed in the same year as it was deprived by the trust.

It was suggested in *SIR v Rosen*<sup>58</sup> (although not firmly decided) that the trust income may lose its original character or identity if it is accumulated by the trust and distributed in a later year.

A contrary view was taken in *Estate Dempers v SIR*<sup>59</sup> and *SIR v Sidley*<sup>60</sup>, where it was held that income accumulated in a trust did not change its character as income.<sup>61</sup>

Where income is subject to tax in the hands of the trust itself and ordinary residence is a relevant factor in determining whether any such income is exempt from tax, such residence, it is

<sup>56</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.137; Page 16-46

<sup>57</sup> 1971 (1) SA 173 (A), 32 SATC 249 at 269 - 270

<sup>58</sup> at 269 - 270

<sup>59</sup> 1977 (3) SA 410 (A), 39 SATC 95

<sup>60</sup> 1977 (4) SA 913 (A), 39 SATC 153 at 159

<sup>61</sup> Williams *Income Tax in South Africa: Law and Practice* - Page 413

considered, is to be found in the country where the central and control of the trust abides and not necessarily where the trustees or the majority of them reside.<sup>62</sup>

## 5. EXEMPTIONS, DEDUCTIONS AND THE NEGATION OF THE CONDUIT PRINCIPLE IN RESPECT OF ANNUITIES:

Certain exceptions to the general rule that trust income retains its identity exist and consequently, certain exemptions afforded under the Act, which are set out hereinbelow, do not apply to an annuity derived by a beneficiary that is payable by the trustee out of dividend income or interest on government stocks.<sup>63</sup>

### 5.1 *Exemptions:*

The conduit principle is, in respect of the following exemptions granted under the Act, in terms of section 10(2)(b) thereof, negated.

Section 10(2)(b) provides that the exemptions from normal tax granted under section 10(1)(h) and 10(1)(k) in respect of interest and dividends in respect of government stocks, respectively, do not apply to any portion of an annuity. It reads as follows:

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<sup>62</sup> The trust *persona*, for tax purposes, is akin to a company whose residence, it in *Kootcher's Estate v CIR 1941 AD at 256, 11 SATC 298*, was held to be where its central management and control abides. It should be noted that a view, inconsistent to the aforesaid was however taken in *Nathan's Estate v CIR 1948 (3) SA 866 (N), 15 SATC 328*, where the Court held a trust to be resident in Natal because the trustees were resident in that province and it was from that province that the fund was administered. The *Margo Report* has, at 11.58 - 11.62 recommended that business trusts should be treated as companies for income tax purposes. Although the government accepted this recommendation in the 1988 White Paper, it has not yet been translated into law.

Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.137; Page 16-46- 16-47

<sup>63</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-33

**Exemptions**

**10(2) Notwithstanding the exemptions provided for in paragraphs (h) and (k) of subsection (1)-**

**(a) ...**

**(b) the said exemptions shall not apply in respect of any portion of an annuity.**

In the circumstances, where trust income was derived from dividends or interest on government stocks and the trustee pays an annuity out of such income to a trust beneficiary, the Act overrides the conduit principle and does not allow the annuity to retain the original character of the trust income. Similarly, the trust beneficiary, (other than a company), who is not ordinary resident or carrying on business in the Republic, and who is entitled to an annuity paid out of trust income consisting of interest on government stocks, will be liable for tax on the annuity.<sup>64</sup>

It should be noted that section 10(2)(b) makes no reference to the special classes of exempt income referred to in section 10(1)(i). It ought to follow, therefore, that the conduit principle continues to apply to all other forms of exempt income derived by a trust and paid out to a beneficiary in the same year of assessment. Inland Revenue however does not accept this interpretation in relation to categories of exempt interest listed under 10(1)(i).<sup>65</sup>

## **5.2 Deductions:**

In respect of deductions, section 19(6) of the Act further negates the conduit principle where the trust receives income and distributes it in the form of an annuity. It reads as follows:

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<sup>64</sup>

Williams *Income Tax in South Africa: Law and Practice* - Page 413- 414

<sup>65</sup>

De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-34

**Deductions and set - off from income derived from dividends**

**19(6) Income received by or accrued to any person in the form of an annuity shall, notwithstanding the fact that such income may also be in the form of dividends or be income of the nature described in subsection (5A), be deemed for the purposes of this section to be income derived otherwise than in the form of dividends.**

In the circumstances, in the hands of the beneficiary such income is deemed not to be from dividends and consequentially the percentage dividend deduction is not available.<sup>66</sup>

**E. TRUST AND STATUTORY ANTI-AVOIDANCE PROVISIONS -  
SECTION 7 - DEEMED INCOME.****1. INTER VIVOS TRUSTS:**

The principles with regard to the taxation of a testamentary trust, inclusive of but not limited to, the Conduit Pipe principle and the comments as to the nature of the trust income in the hands of beneficiaries who may be taxable thereon, discussed above in the context of section 25B, apply equally in the case of trusts *inter vivos*. An *inter vivos* trust differs from a testamentary trust in that there are a number of provisions in section 7 of the Act which may be relevant to the determination of the liability for tax in respect of income derived by a trust in circumstances not normally present in the case of a testamentary trust. The aforesaid provisions may result in income of the said trust *inter vivos* being taxed in the hands of the founder of the trust.

Thus there are three possibilities with regard to income which accrues to, or is received by a trust *inter vivos* as far as income tax liability is concerned. The income can be regarded as -

- (a) In terms of section 25B(1) of the Act, income of the beneficiary, who then becomes the taxpayer;
- (b) The income of the founder *per se*, making the trust the taxpayer; and
- (c) Subject to the provisions of section 7(2) - (7) of the Act, the income of the founder (or settlor), leading to his becoming the taxpayer.<sup>67</sup>

## 2. SECTION 7:

It is evident from the above that generally, trust income is taxable in the hands of either the trustee or the beneficiaries.

Trusts are however, frequently the vehicles of various tax avoidance stratagems whereby a taxpayer seeks to minimise his income tax liability by disposing of his income producing property to another person, usually a spouse or a child, thereby diverting income from himself.<sup>68</sup>

In the circumstances, in order to avoid income tax avoidance stratagems of the aforesaid nature, section 7 of the Act was enacted. It was directed at transactions:

"in which a taxpayer seeks to achieve tax avoidance by donating, or disposing of income producing property to or in favour of another under the...specified conditions or circumstances, thereby diverting income from himself without replacing or being able to replace it."<sup>69</sup>

Section 7 provides that in certain circumstances, income, which is the subject of a trust, will not be treated as income of the beneficiary or the trust, but will be deemed to be the income of the founder of the *inter vivos* trust. A summary of the aforesaid circumstances set out in section 7, includes the following:

Subsection 7(1) deems income to have accrued to a person, notwithstanding that it has been invested, accumulated or otherwise capitalized by him, or on his behalf etc.

Subsection 7 (2) deals *inter alia*, with a "donation", which may take the form of a "trust", by one spouse to the other, with the sole or main purpose of avoiding, postponing or reducing liability

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<sup>68</sup> Williams Income Tax in South Africa: Law and Practice - Page 414 - 415

<sup>69</sup> Per TrollipJA in *Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55 at 72

for tax.

Subsections 7(3) and 7(4) deems the income of a minor to be that of his/her parent in certain circumstances, in which circumstances a trust may be involved.

Subsection 7(5) deems the income of, *inter alia*, a trust to be the donor's to the extent that it has been withheld by a stipulation or deed.

Subsection 7(6) deems income to be the donor's where he retains certain powers in respect of a "donation", in circumstances where a trust may be involved.

Subsection 7(7) deems income to be the donor's if the asset producing income is to be returned to him at some future date, where the "donation " takes the form of a trust.<sup>70</sup>

Each of the above-referred subsections, in so far as they relate to trusts an impact on the taxation of trust income, will now be traversed and certain controversial issues relating thereto, highlighted.

### 3. SECTION 7(2):

In terms of section 7(2) of the Act, any income received by or accrued to a husband or wife is deemed to be the income of the other spouse if it was derived -

[a] In consequence of a donation, settlement or other disposition made on or after 20 March 1991, or

[b] As a result of a transaction, operation or scheme entered into or carried out after that date and the sole purpose of the transaction, operation or scheme was the reduction,

postponement or avoidance of the donor's liability for income tax or any other tax, levy or duty administered by the Commissioner.<sup>71</sup>

In the circumstances, where a spouse (the recipient) is in receipt of trust income, as a result of a donation or other disposition by the other spouse (the donor), and the required circumstances as described above are present, the income will be deemed to be that of the donor.<sup>72</sup>

#### 4. SECTION 7(3):

Section 7(3) of the Act reads as follows:

**When income is deemed to have been accrued or to have been received**

**7(3) 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 -**

- (a) 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**
- (b) it has been accumulated for the benefit of that child.**

[My emphasis.]

Section 7(3) is designed to counter income-splitting between parent and minor children. It is evident from the above that it will apply where a parent creates a trust in favour of a minor child by donating money or assets to a trustee upon terms requiring the latter to distribute the trust income to that minor child or to expend the trust income on the maintenance, education or for the benefit of that child or, to accumulate the said income for the benefit of the said child. In the aforesaid circumstances, the trust income will be deemed to have been received by or accrued

<sup>71</sup> De Koker and Urquhart - Income Tax in South Africa - Page 17 - 26

<sup>72</sup> De Koker and Urquhart - Income Tax in South Africa - Page 17 - 26

to the parent of that minor child whether or not the minor child has a vested right to the income in question.<sup>73</sup> The expressions "by reason of" and "donation, settlement or other disposition" have been the source of long controversy and have been subjected to extensive examination by our Courts. They will now be discussed in the subsections hereinbelow.

#### **4.1 The causal link between the "donation, settlement or other disposition" by a parent and the derivation of income by the minor child:**

##### **4.1.1 Income on income:**

In *Kohler v CIR 1949(4)SA 1022, 12 SATC 312*, Murray J construed the words "by reason of" in a narrow fashion, holding that they should be interpreted as referring to **the proximate cause** and not to a remote cause. Consequentially, it was held that where income received by reason of a donation is invested or employed, the "income on income" was not by reason of the original donation since the causal connection was interrupted by a *novus actus viz*, the reinvestment of the original income.<sup>74</sup>

The aforesaid reasoning, although not expressly overturned, was not accepted by the Appellate Division in the case of *CIR v Widan 1955(1) SA 226 (A)* where Centilivres JA (Greenberg JA, Schreiner JA, Van den Heever JA and Fagan concurring), felt that it was unlikely that the Legislature intended that the words "by reason of" to be construed as narrowly as in *Kohler's* case. It was rather held that there must be some causal relation between the donation and the

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As a matter of practice, Inland Revenue does not invoke Section 7(3) where a farmer, in accordance with well-established custom, makes a genuine gift of particular livestock to his minor children. Income which accrues to the minor child as a result of such donation, is in practice, taxed in the hands of the minor children.  
Williams *Income Tax in South Africa: Law and Practice* - Page 379

<sup>74</sup>

Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.54; Page 16-21

income in question and that in ascertaining whether such causal connection exists, one must look not necessarily to the cause which is the proximate cause in time, but to the **real efficient cause** of the income being received. If the real efficient cause is the donation by the parent then the section applies.<sup>75</sup>

In *Widan's* case, the real efficient cause was at 234, held to be a matter to be ascertained on all the facts and circumstances of the case and difficult cases may arise. In the aforesaid regard, the following was stated:

"Where, for instance, a father donates a sum of money to a minor child and the child buys a business to which he contributes his skill and labour and from which he earns an income, that income may be attributable to two causes, *viz* the donation and the skill and the labour of the child. In such cases it may be impossible to say which part of his income may be the result of the donation and which part the result of his skill and labour and it may be that the Commissioner would not be able to apply section 9(3) [now section 7(3)]....."

*Widan's* case concerned a series of transactions which flowed on the original donation, which the Court found to constitute an single all-embracing design. The Court pointed out that a parent may have to pay tax even in the absence of an all embracing design or in the absence of a design of providing the child with income.<sup>76</sup> It was felt at page 254 thereof that:

"Every case must be decided 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 the income accruing to a minor child was the donation made by the parent, then such income is deemed under section [7(3)] to have been received by the parent."

In the circumstances, it is submitted that it does not necessary follow that the provisions of

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<sup>75</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.54;Page 16-21

<sup>76</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.54;Page 16-21

section 7(3) do not apply to income on income.<sup>77</sup>

*CIR v Berold 1962 (3) SA 748 (A)* concerned a parent who sold shares to company A, with the purchase price remaining owing, and without interest being charged. Thereafter the said parent donated his shareholding in A and a portion of his loan account to trustees under deeds of trust for the benefit of his children. Several years later company B was formed and the donor's mother donated to the trust, shares in company B which had been allotted to her. The trustees then sold the shares in company A to company B. Subsequently, company B received dividends from company A and in turn declared dividends which were received by the trustees by virtue of their shareholding in company B. Hoexter JA, adopting a substance over form approach, held (concurring), that the dividends were to have been received by reason of the parent's donation and to be taxable in his hands in terms of section 7 (3).<sup>78</sup>

In *Barnett v COT 1959 (2) SA 713 (FC)*, a case concerning sections in the Rhodesian Act which are materially the same as sections 7(3) and 7(4), the taxpayer, in consultation with his brother-in-law, E, formed a company and sold assets to it, the price being payable on demand free interest. Ten shares at par value were donated to E who donated the shares to the taxpayer's children. Dividends that were subsequently declared by the company were held to be taxable in the hands of the taxpayer. The aforesaid conclusion was reached, by each of the three judges, for reasons of their own, with differing views existing with regard to whether "donation, settlement or other disposition" included an arrangement.<sup>79</sup>

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<sup>77</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-27

<sup>78</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.54;Page 16-21

<sup>79</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.54;Page 16-22

**De Koker and Urquhart** submit that the whole tenor of the aforesaid judgement in *Barnett's* case was that in interpreting the equivalent of section 7(3), a court must examine the very purpose of the scheme and if the court is of the opinion that the purpose of the scheme is to enable the parent to divest himself of his income in favour of his children so that, but for the provisions of section 7(3), the income would accrue to the child who would be taxed thereon, the Commissioner is entitled to apply section 7(3) and tax the parent on such income.<sup>80</sup>

**Meyerowitz** considers that section 7(3) of the Act does not extend to an arrangement or scheme, but to a single transaction constituting a donation, settlement or other disposition, more particularly because the Act contains a general provision, namely section 103, dealing with a transaction, operation or scheme for the purpose of tax avoidance.<sup>81</sup>

In the circumstances it is considered that each case will depend upon the surrounding circumstances and facts, and in order to determine whether income derived by the minor accrued by reason of any donation, settlement or other disposition made by the parent, the facts of the particular case will have to be taken into account.<sup>82</sup>

#### **4.2 *The question of whether the phrase "or other disposition" includes the transfer of property for full value:***

In *Ovenstone SIR 1980 (2) SA 721 (A), 42 SATC 55*, the Appellate Division at *SATC 72*, after long controversy, held that the phrase "or other disposition" in its unrestricted meaning, could

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<sup>80</sup> De Koker & Urquhart - *Income Tax in South Africa* - Page 17 - 29

<sup>81</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.54; Page 16-22

<sup>82</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-27

include a disposition of property under an *bona fide* commercial or arm's length contract for full value, but it was inconceivable that the legislature had intended to hamper such transactions. In the circumstances, the phrase should be read as "any donation, settlement or other *similar* disposition". So construed, "disposition" would mean any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer. The aforesaid interpretation endorses earlier cases which held that the equivalent of section 7(3) did not apply to dispositions in *bona fide* partnerships between fathers and their minor sons. It should be noted that the aforesaid interpretation contradicts the suggestion in *Barnett v COT 1959 (2) SA 713 (FC)* adopted for many years by Inland Revenue - that "disposition" in the aforesaid context could include a disposition for due consideration.<sup>83</sup>

#### 4.3 *The distinction between a "donation", "settlement" and a "disposition":*

*Ovenstone's* case<sup>84</sup> held that the distinction between a "donation", "settlement" and a "disposition", is the following:

"...in a donation the donor disposes of property gratuitously out of the liberality or generosity, the donee being thereby enriched and the donor correspondingly impoverished, so much so that, if the donee gives any consideration at all therefore, it is not a donation...

It can therefore be regarded as a unilateral contract in the sense that the donor is the only party to whom an *obligation* lies. In a "settlement" the property is usually disposed of on specific terms and conditions, set out in a deed of settlement, to or through the medium of a trustee or trustees for the benefit of some person ...As far as the beneficiaries are concerned a settlement is also generally made gratuitously out of liberality or generosity in the sense that no consideration passes from them to the settlor for the benefits conferred upon them. "Settlement" is thus usually of the

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<sup>83</sup> Williams *Income Tax in South Africa: Law and Practice* - Page 380

<sup>84</sup> 1980(42) SATC 55 at 73

same *genus* as donation ...Hence the words "donation, settlement or other disposition " all have this feature in common: they each connote the disposal of property to another otherwise than for due consideration. ...The critical phrase should thus be read as "donation, settlement or other *similar* disposition". So construed, "disposition means any disposal made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer."<sup>85</sup>

#### 4.4 The phrase "donation, settlement or other disposition" and the meaning thereof:

*Ovenstone's* case further held that the critical phrase in section 7(3) comprising of the words "settlement or other disposition" should be construed "*eiusdem generis*" with "donation", so as to exclude any disposal of property that is wholly a commercial or a business one, that is made for due consideration.

The phrase "donation, settlement or other disposition" was considered to cover:

- (i) Any disposal of property made wholly out of liberality or generosity; and also
- (ii) Any disposal of property made under settlement or other disposition for some consideration, but in which there is an appreciable element of gratuitousness and liberality or generosity.

More specifically in respect of (ii) above, Trolip JA held [concurring]<sup>86</sup> that:

"I wish to add this observation about the last kind of composite disposal - on which is partly gratuitous and partly for consideration. If the consideration is merely illusionary, simulated, or minimal, the disposal will of course be regarded as wholly gratuitous. On the other hand, merely

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Williams *Income Tax in South Africa: Law and Practice* - Page380

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*Ovenstone v SIR* 1980 (2) SA 721 (A) at 740 B - F

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 than may be suggested by the words 'no element of bounty' used in the English cases referred to above. Now where the consideration, while not being due consideration, is nevertheless appreciable, it will mean 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 those circumstances the income should not then be apportioned between the two elements. The words 'by reason of', themselves suggest some apportionment in order to give proper effect to the real cause of the accrual of income. (Cf *Joss v SIR (supra)* at 29 - 30). If such apportionment is not possible, or insufficient evidence is adduced to enable the court to effect it (burden of proof being on the taxpayer under s 82), 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."

In the circumstances, a "disposition" need not flow from a unilateral contract, nor need it be wholly gratuitous. If the consideration was illusory, simulated or minimal, the disposal would be regarded as wholly gratuitous. In situations where the disposal is partly gratuitous and partly for consideration, the income in question will usually have accrued or been received by reason of both elements of gratuitousness and consideration and may then be apportionable between those to elements. If no apportionment is possible, or if the taxpayer fails to produce sufficient evidence on that aspect, the composite disposal must be treated as a gratuitous settlement or disposal.<sup>87</sup>

#### **4.5 *Apportionment of the consequential income where the disposition was not wholly gratuitous:***

It should be specifically noted from the above, that the cases of *Ovenstone* and *Joss* established the important factor of apportionment in terms of which it can now be argued that an

apportionment of income derived from both elements of gratuitousness and consideration can be made, so as to tax only part of the income in terms of section 7(3).<sup>88</sup>

**4.6 *Is a sale of property from parent to child, on credit and interest free, a donation of the interest and hence within the scope of section 7(3)?***

Williams<sup>89</sup> submits that it is in principle, an oversimplification to say that a sale from parent to child, free of interest, entails a continuing donation of the forgone interest and necessarily brings section 7(3) into play<sup>90</sup>, although it is arguable that the courts have endorsed the aforesaid oversimplified view.

The decision in *SIR v Berold*<sup>91</sup> established that, where a parent sold assets on credit to a company, free of interest, and *the absence of interest enables identifiable income to accrue to or be accumulated for* his minor child, the necessary causal connection between the "donation" of the interest on one hand and the income on the other hand, may suffice to bring section 7(3) into effect.<sup>92</sup> The Court in *Berold's* case found that the fact that no interest was charged amounted to a continuous donation and that the dividends which were accumulated for the

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88 De Koker and Urquhart - Income Tax in South Africa - Page 17 - 31

89 Williams Income Tax in South Africa: Law and Practice - Page 381

90 Williams at the text at footnote 109 submits that if a contract stipulates that no interest is payable, then *ex hypothesi*, there is no interest component in the consideration paid. It is trite that, where assets are sold interest-free, the seller is not charged with income tax on the notional interest. It must follow that there is no "donation" of notional but non-existent interest. It is true that where credit is given interest-free, value of some kind passes between the parties; but income tax is based upon, not on economic theory, but on the terms of the Income Tax Act as interpreted by the Courts. Expressed differently, the income tax consequences of a contract arise out of the terms of the contract, not its hypothetical economic equivalent. The *dictum* in *Berold (infra)* on the to the effect that, in the credit sale therein issue, "there was a continuing donation ...of the interest on the loan" should not be read in isolation as though it were a general principle; its application must, it is submitted, be confined to the particular facts of that case, where the absence of interest enabled identifiable income to flow to the child. Also troublesome is the *dictum* in *Berold* where the Court held, apropos a taxpayer who sold goods on credit, interest-free: "In effect he lent a substantial sum of money to [the purchaser]. Williams Income Tax in South Africa: Law and Practice - Page 381

91 1962(3) SA 748 (A) at 755-B - E; 24 SATC 729

92 [Williams emphasis]

benefit of the minor children of the taxpayer accrued by reason of this donation. Although there was no direct donation or disposition in this case, it was felt that the operations of the taxpayer had the effect of a direct donation or disposition, in a sense that the disposition could only be declared due to the fact that the taxpayer did not charge interest on the loan he made to the company. The Court held that it should not allow the forms of the company law to cancel the effective causal connection between the parent's donation, that is the interest free loan, and the income (dividends) accumulated for the benefit of the minor children.<sup>93</sup> Williams is of the opinion that [for the reasons set out in footnote 90 hereinbelow] it was arguably inaccurate for the court in *Berold* to describe such situation as a "donation of interest" for it was not a donation, but at most a disposition - a word of wider import.

It should be noted that the Special Tax Court in *ITC1108(1697)29 SATC 155* found a 'disposition' to include the exercise by a father of his voting rights as shareholder to allot shares to his minor son and procure the declaration of dividends. Furthermore, in *CIR v Estate Kohler 1953 (2) SA 584 (A), 18 SATC 354*, it was held, in relation legislation similar to section 7(3), that *disposition* covers "all acts in the law which affect property"<sup>94</sup>.

Finally, the Court in *Joss v SIR 1980 (1) SA 674 (T)* also adopted a similar approach to *Berold's* case. In *Joss's* case the taxpayer sold shares to a company in which his minor daughter and a trust, formed for the benefit of any children to be born of him, owned some of the shares, in return for a loan on which for some period no interest was charged. The company declared dividends to the taxpayers's daughter and the trust, the amounts of which would have been smaller had interest been charged on the loan. The Commissioner assessed the taxpayer for tax

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<sup>93</sup> De Koker & Urquhart - *Income Tax in South Africa* [ Vol.1]; Page 17-27

<sup>94</sup> Williams *Income Tax in South Africa: Law and Practice* - Page382

on the full amount of the dividends [which at that time was not exempt from income]. The Court distinguished between the disposition of the shares at the proper value and the loan to the company which was interest free and held that in the aforesaid situation, which involved two separate transactions consisting of a sale at proper value followed by an interest free loan, the "loan" constituted a "disposition" for the purposes of section 7(3) and the dividend was deemed to be the taxpayer's. The Court found further that only that portion of the dividend accrued to the minor as was attributable to the interest free loan by her parent accrued by reason of a donation, settlement or other disposition. It, in the circumstances, directed that the assessment be amended to include into the taxpayer's income only such portion of the dividend as represented the aggregate of interest that should have been charged on the taxpayer's loan accounts from their inception<sup>95</sup>.

It is submitted that the aforesaid scenario in *Joss's* case is different from a single transaction consisting of a sale on credit, interest free.<sup>96</sup> Coetzee J therein in fact observed that:

"...one must be careful to distinguish between the disposition of the shares at a proper value and thereafter the loan to the company which is interest-free; there are two dispositions and it is only the latter which is a disposition within the meaning of section 7(3) of the Act."<sup>97</sup>

#### 4.7 *Miscellaneous:*

It should be noted that section 7(3) applies only as between a parent and his or her minor children and will not be applicable in respect of any income received or accrued from the date the child

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<sup>95</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.55; Page 16-23

<sup>96</sup> Williams Income Tax in South Africa: Law and Practice - Page 382

<sup>97</sup> Williams Income Tax in South Africa: Law and Practice - Page 382

ceases to be a minor.<sup>98</sup>

The word "child" does not include a grandchild and it is considered that it does not include a stepchild either. Therefore, if a grandparent makes a donation to a minor child, the income derived by the grandchild will not be deemed to be the income of the grandparent in terms of section 7(3), but will be taxable in the hands of the grandchild.<sup>99</sup>

An adopted child is included as a child in terms of the definition of "child" in section 1 and in practice the Inland Revenue accepts that an illegitimate child falls within the ambit of all sections of the Act where the words "child" or "children" appear. Thus, section 7(3) will apply equally to an adopted or an illegitimate child.<sup>100</sup>

Section 7(3) does not require that the income must have been received by the minor child and it is sufficient if the said income has merely accumulated for the purpose and with the intention that the minor child may benefit. In further elaboration of the aforesaid, Meyerowitz submits, after consideration of *Platt v CIR 1934 AD 552, 7 SATC 75 and ITC 974 24 SATC 882*, that if the aforesaid purposes and intention is present, it is of no consequence that the child has no vested right in the income or that the child may not live to benefit, for even if the child dies, thereby frustrating the parent's purpose, nevertheless the parent had that purpose.<sup>101</sup>

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<sup>98</sup> Section 103 of the Act may however be applicable in circumstances where the child is a major.  
Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.53; Page 16-21  
Williams Income Tax in South Africa: Law and Practice - Page 380

<sup>99</sup> De Koker & Urquhart - Income Tax in South Africa - Page 17 - 30

<sup>100</sup> De Koker & Urquhart - Income Tax in South Africa - Page 17 - 30 - 17 - 31

<sup>101</sup> Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.52; Page 16-20

## 5. SECTION 7(4):

Section 7(4) reads as follows:

**When income is deemed to have been accrued or to have been received**

7(4) 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 other some consideration in favour directly or indirectly of the said other person or his family.

Whereas section 7(3) applies only to a donation, settlement or other disposition made by a parent to his or her minor child, the purpose of section 7(4) is to prevent the possible circumvention of section 7(3) via *reciprocal* donations, settlements or other dispositions, in terms of *inter alia* a situation where the efficient cause of income being received by or accrued to a minor, is the donation, settlement or other disposition by a third person, but the minor's parent has in turn made a donation, settlement or other disposition or given some other consideration, directly or indirectly in favour of the third person or his family.<sup>102</sup>

*Barnett v COT, 1959(2) SA 713(FC)* demonstrates how slight the aforesaid consideration need be, for therein, an understanding between the father and the donor, in terms of which the father sold his assets to the company, the shares in which would be donated by the donor, was held to be a consideration, although the donor derived no benefit therefrom.<sup>103</sup>

**Meyerowitz** submits that the consideration must be reciprocal in the sense that there must be as

<sup>102</sup> WilliamsRC- *Income Tax in South Africa - Law and Practice* - Page 382  
Meyerowitz [SC], D - *Meyerowitz on Income Tax* - 16.56; Page 16-23

<sup>103</sup> Meyerowitz [SC], D - *Meyerowitz on Income Tax* - 16.56; Page 16-23

causal relation or connection between the act of the donor and the act of consideration given by the parent of the donee and that in the absence of reciprocity, section 7(4) will not apply.<sup>104</sup> In *COT v Paice 1964 Taxpayer 26, 25 SATC 385*, it was held that there must be a *nexus*. In *P v COT (1963), Taxpayer 8, 24 SATC 518*, the equivalent of section 7(4) was held be wide enough to cover the situation where one of the reciprocating parties is a company. In the aforesaid case it was applicable to dividends declared to minors by a company to which the parent had disposed of assets and which allotted shares to the minor children.

### 5.1 *Miscellaneous:*

A minor is taxed as a natural person. Administratively, section 68(3)(a) of the Act requires every parent to include in his return, any income received by, or accrued to any of his minor children, either directly or indirectly, from himself or his wife, together with any particulars required by the Commissioner. The aforesaid is purely a disclosure requirement and does not require that the minor child's income be included in the parent's assessable income. Furthermore, in terms of section 68(3)(b) of the Act, every parent must include in his return, any income deemed to be his in terms of section 7(3) and 7(4) of the Act.<sup>105</sup>

The guardian of a minor child (normally the father) is the "representative taxpayer" in relation to that child and as such must complete the minor's income tax return, pay in tax due by the minor and generally act as the minor's representative in his tax affairs. Where sections 7(3) and/or 7(4) apply, and the income of the minor child is deemed to be the parent's income, the

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Therefore if for example a grandfather were to donate to his grandchildren and on the grandfathers birthday his son were to give him a present unconnected with the prior donation, section 7(4) will not apply.

Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.56; Page 16-23

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Williams RC - Income Tax in South Africa - Law and Practice - Page 382 - 383

parent is entitled, in terms of *inter alia* section 90 of the Act, to recover from the child, the extra tax paid by the parent as a result thereof. This will be elaborated upon hereinbelow.<sup>106</sup>

#### 6. SECTION 7(5):

The alienation of income producing assets to, for example, a spouse or minor child, is a simple stratagem whereby a taxpayer, on a high income, can successfully avoid or reduce tax. Many taxpayers however, recoil from the finality of such a step and rather seek a mechanism for securing an immediate tax benefit for themselves by disposing of the income-producing property, but at the same time postponing the distribution of the income to the beneficiary. A favourite means of trying to achieve the aforesaid objective is via the creation of a trust in terms of which the taxpayer, although not fully and absolutely, disposes of income producing property to a trustee.<sup>107</sup>

Section 7(5), which concerns withholding trust income and attempts to prevent avoidance of tax liability stratagems, of the above referred nature, reads as follows:

**When income is deemed to have been accrued or to have been received**

**7(5) If any person made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed 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.**

<sup>106</sup> Williams RC - Income Tax in South Africa - Law and Practice - Page 382 - 383

<sup>107</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 415

Section 7(5) has been held to contemplate a two-part hypothesis, requiring, in addition to there being in existence a donation, settlement or other disposition, the following two conditions for its operation: -

- (a) There must be a stipulation or condition ("stipulation" is used hereafter to cover both terms) the effect of which is that the beneficiaries shall not receive income until the happening of an event; and
- (b) But for the stipulation, the income would be received by or accrue to the beneficiaries.<sup>108</sup>

If the above two conditions are present, each person who has made a donation settlement or disposition is taxable on the income derived therefrom, no matter who made the stipulation and no matter who founded the trust, if a trust is involved. If either condition is not present, the section does not operate.<sup>109</sup>

The decisions in the Special Income Tax Court have not been uniform in their construction of section 7(5) and in the circumstances, there has, until the Appellate Division decision of *Estate Dempers v SIR 1977 (3) SA 410 (A), 39 SATC 95 at 107*, which cast some light thereon, been uncertainty as to the proper construction of the said provision.

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Williams RC - *Income Tax in South Africa: Law and Practice* - Page 415

See also: *Estate Dempers v SIR 1977 (3) SA 410 (A), 1977 Taxpayer 150, 39 SATC 95 at 107* [where the aforesaid proposition in respect of a similar case was approved] and *SIR v Sidley 1977 (4) SA 913 (A), 1977 Taxpayer 226, 29 SATC 153*, where *Demper's* case was applied and a too technical approach was cautioned against.

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Meyerowitz [SC], D - *Meyerowitz on Income Tax* - 16.144; Page 16-50

### 6.1 The concept of "event":

The concept of "event" is central to section 7(5) of the Act and may include *inter alia*, the attainment by the donee of a particular age or marriage.

An important and controversial question, which is still an open one, is whether, in the case of a discretionary trust, the exercise by the trustee of a discretionary decision as to whether to distribute income to a trust beneficiary is an "event" within the meaning of section 7(5).

An affirmative answer was given to the aforesaid question by the Natal Provincial Division in *Hullet v CIR 1944 NPD 263, 13 SATC 58* where Carlisle J at 269, expressed the view as follows:

"As I interpret the document the beneficiaries are not entitled to claim payment of the income as of right. They receive it - or such part of it as the trustees choose to give them - if the trustees in their absolute discretion decide to pay it over. Thus their rights are contingent until the happening of an event, viz the exercise by the trustees of their discretion."

Whilst the aforesaid contention has been accepted by the Special Court in *ITC 1033(1959) 26 SATC 73*, the contrary has been held in other decisions along the reasoning that what is contemplated in the section is an event which will fix the incidence of tax once and for all in respect of the income in question. In the circumstances, the decisions from time to time of a trustee cannot bring about finality. The contrary has also been held in an unreported Special Tax Court Case which subsequently went on Appeal and was decided on grounds other than section 7(5). The question was left open by the Appellate Division in *CIR v Berold and Estate Dempers v SIR*.<sup>110</sup>

In *Estate Dempers v SIR*, the taxpayer argued *inter alia*, that:

1. the "event" contemplated in section 7(5) was:

"a single, once-and-for-all occurrence until the happening of which the beneficiary did not receive the income and after the happening of which he did. Prior to the event the income was deemed by way of fiction, to be that of the donor. After the event the fiction ceased and it became that of the beneficiary."

2. To regard the exercise of a trustee's discretion as an "event" would give rise to the following anomalies:

- (i) Income which accrued to a trust during a year of assessment would be deemed to be the donor's, even if, later in the year, the trustee decided, in the exercise of his discretion to distribute that income to the beneficiaries;<sup>111</sup>
- (ii) If the exercise of the trustee's discretion *per se* were an "event", then if he decided not to distribute the income, the "event" would nevertheless have occurred, and the donor's liability for tax under 7(5) would cease.<sup>112</sup>

The Court, notwithstanding the fact that they deemed it not necessary to deal with the above question and pronounce on the correctness of the aforesaid argument, nevertheless acknowledged that there was undoubtably some force in the submission that the exercise, by the trustee, of a

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<sup>111</sup> Agreeing with the aforesaid argument, Divaris and Stein [Silke] at §12.20, point out that the purpose of section 7(5) is to tax the income of the trust in the hands of the donor only when it is not received by the beneficiaries. De Koker & Urquhart- *Income Tax in South Africa - Vol 1* - Page 17 - 33

<sup>112</sup> Agreeing with the aforesaid argument, Divaris and Stein [Silke] at §12.20, point out that the donor's liability would cease, whether the effect of the discretion exercised was to distribute income to the beneficiaries or retain it in the trust. Thus the event encompassed by the section would appear to be one that vests the income in the beneficiaries. De Koker & Urquhart- *Income Tax in South Africa - Vol 1* - Page 17 - 33

discretionary decision as to whether to distribute income to a trust beneficiary was not an "event" as contemplated in section 7(5).<sup>113</sup>

**Divaris and Stein** similarly argue along the lines of the taxpayer in the *Estate Dempers* case, that if the exercise of a discretionary power were an event, anomalies would arise<sup>114/115</sup>.

In regard to the second condition, referred to as (b) above, namely, that but for the stipulation, the income would have been received by or have accrued to the beneficiaries, it is submitted that section 7(5) may also apply where beneficiaries do not have vested rights to income.

In the *Estate Dempers* case<sup>116</sup>, the Appellate Division held, in regard to a provision similar to

113 Williams RC - Income Tax in South Africa - Law and Practice - Page 416

114 See Footnotes 110 and 111 *supra*  
Divaris C and Stein ML SILKE ON SOUTH AFRICAN INCOME TAX VOL 2-§12.20, Page 12 - 37

115 The answer to the question as to whether the discretionary decision as to whether to distribute income to a trust beneficiary is an "event" as contemplated in section 7(5), which is still open, is of importance in regard to *inter alia* the incidence of tax in the donor's hands in respect of income which the trustee pays out during the year of assessment in which it accrues. It is currently the practice of the Commissioner not to tax the donor under the section on income which the trustee, in the exercise of his discretion, paid out in the year in which it accrued. The aforesaid practice is favourable to the donor and hence the correct answer as to whether the exercise of a trustee's discretion is an "event" and the corollary, if it is an event, whether the fact that the event has happened during the year of assessment, can affect the incidence of tax in respect of the income accrued prior to the happening of the event, is not particularly material to tax payers for so long as the practice persists.

It should further, in the aforesaid regard be noted that, in the Special Income Tax court case *ITC 1033 1964 Taxpayer 30, 26 SATC 73*, which has subsequently been criticized in an unreported case, the Court considered that if the trustee exercised his discretion within a reasonable period after the termination of the year of assessment, namely, up to the time when returns had to be submitted, this would suffice to determine the incidence of tax for that year. In *Caltex Oil Ltd v SIR 1975 (1) SA 665 (A) at 677G, 1975 Taxpayer 30 at 38, 37 SATC 1*, it was considered that the incidence of tax must be determined at the latest according to the circumstances existing at the end of the year of assessment and not by anything that may happen thereafter. In the circumstances, it is submitted that trustees who wish to exercise their discretion and distribute, in order to play safe, should do so before the end of the tax year.

Meyerowitz [SC], D - Meyerowitz on Income Tax - § 16.145 - Page 16 - 53 - 16 - 54

116 In the *Estate Dempers* case, in respect of condition [b] required for the operation of section 7(5), the Court more specifically in conclusion:

- (i) Held that a vested right was not a *sine quo non*, although if the beneficiaries have vested rights, this would be a strong, possibly decisive factor;
- (ii) Following the reasoning in (i) above concluded that, but for the stipulation withholding the income, it would have been received by the beneficiaries;
- (iii) Held furthermore, that the reference to a "fixed or contingent" event indicated that the case of a beneficiary, who in terms of the stipulation has only a contingent right to income, falls within the intended scope of section 7(5);
- (iv) Held finally, in respect of when deciding upon the crucial question of whether, in the absence of the stipulation withholding trust income, the income would have been received by or accrued to the beneficiary, regard must be had to the terms of the instrument generally, the donor's general benevolent intention, as evidenced in terms of the instrument as a whole, and all the relevant circumstances. In the aforesaid inquiry, the fact that in terms of the instrument as a whole the beneficiary had a vested right to the income would be an important factor, but was not the sole touchstone.

section 7(5) that "a vested right to income is not a *sine quo non*"<sup>117</sup>. Corbett JA, at 426 C - E, summed up that section 7(5) as follows:

" in truth the application of the devolutionary portion of the subsection [condition [b] referred to above] involves a hypothetical, notional enquiry which cannot be directed solely to questions such as whether the beneficiaries' right to income is vested or contingent. The question which the court must ask itself is whether, in the absence of the stipulation withholding trust income, this income would have been received by or have accrued to the beneficiary. In answering this question regard must be had to the terms of the instrument generally, the donor's general benevolent intention, as evinced by the terms of the instrument, and all the relevant circumstances. In this inquiry the fact that in terms of the instrument as a whole, the beneficiary has a vested right to the income would, as I have indicated, be an important factor but it would not be the sole touchstone."

The Court in the *Estate Dempers* case was therefore of the view that the surrounding circumstances may be such that section 7(5) may be applicable, even though the beneficiaries do not have vested rights to the income. However, if the beneficiaries have vested rights, then this would be a strong factor leading to the conclusion that, but for the stipulation or the condition withholding the income, it would have been received by them.<sup>118/119</sup>

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See: Meyerowitz [SC], D - Meyerowitz on Income Tax - 16.144;Page 16-51

117 Williams RC - Income Tax in South Africa: Law and Practice - Page 416

118 De Koker & Urquhart - Income Tax in South Africa - Page 17 - 34

119 The broad facts of *Estate Dempers v SIR* concerned a trust deed, wherein, averring that the donor, out of love and affection for the donee (his grandson), desired to make provision for him, settled a sum of money upon the trustees and directed -

- [1] In clause 17, that
- (i) until the donor's death the annual income may be used by the trustees in their discretion in making charitable donations and/or for the benefit of the donee and or his issue, any income not paid out during the year to become and form part of the capital of the trust;
  - (ii) 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 of the income (if any) was to accumulate in the trust.

[Thereafter, in the 1973 tax year,(i) and (ii) above were substituted by a clause which provided that the annual income may be used by the trustees for the benefit of the donee and/or issue.]

[2] In Clause 18 that:  
when the donee attained the age of 25, one-third of the total trust fund was to be paid to the donee; when he attained the age of 30, half of the remainder was to be paid to him and when he attained the age of 5 years, the balance of the trust fund was to be paid to him. Should the donee die before all the trust fund had been paid to him, his issue, (or failing issue other beneficiaries) were substituted for the donee in respect of what remained. "Trust fund" was defined as including accumulations of income.

The Commissioner taxed the donor for each of the years (including the 1973 tax year on the income which had not been paid out by the trustees during that year and his assessment was upheld by the Appellate Division.

Silke at § 12.20, concurs in the above *Demper's* view that, for the purpose of section 7(5), it is immaterial whether the beneficiary has or has not a vested right in the trust income, considering that section 7(5) applies so long as there is a stipulation that, but for its existence, the trust income would be received by or accrued to the beneficiaries whether or not the terms of the trust deed confer a vested or contingent right.<sup>120</sup>

In *ITC 823*<sup>121</sup> Newton - Thompson J laid down the following guideline:

"...the intention of the legislator in passing section 9(5) (now section 7(5)) seems to be reasonably clear where there is a stipulation as here. If the beneficiary under the trust actually or in effect receives the income of the trust or portion of it during any tax year the donor shall not pay tax on such income or portion of it, but where the trust income from the year or portion of it has not been utilised for the benefit of the beneficiary under the trust (except to accumulate it), then the income of the trust or portion of it not utilised is deemed to be the income of the donor."

It is submitted that the aforesaid analysis lends great support to the submission that section 7(5) applies irrespective of whether the beneficiary has a vested or contingent right so long as there is a stipulation or condition that, but for its existence, the beneficiaries would have received trust income, which has now been accumulated as a result of the said condition or stipulation.<sup>122</sup>

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In regard to the first condition, referred to as (a) above, the Court, despite being confronted with an argument as to whether the exercise by the trustee, of a discretionary power, constituted an event for the purposes of (the equivalent of) section 7(5), felt it unnecessary to pronounce on same.

In the circumstances, applying the aforesaid approach to the trust deed, the Court, reading the deed as a whole, found that the donee was dominantly the object of the donor's bounty and that this overriding intent to benefit the donee was not detracted from to any material degree by the substitution of his issue in the event of his predeceasing the termination of the trust, or by the power conferred upon the trustees to benefit charitable institutions. It was therefore, in the circumstances, held that but for the stipulation withholding income, the accumulated income would have accrued to or been received by the donee and accordingly, section 7(5) applied to such accumulated income.

See: Meyerowitz [SC], D - *Meyerowitz on Income Tax* - 16.144; Page 16-50 - 16-54 for a useful discussion of the salient aspect of the *Estate Dempers* case, a summarized version of a portion of which is contained hereinabove.

<sup>120</sup> De Koker and Urquhart - *Income Tax in South Africa* - Page 17 - 34

<sup>121</sup> (1956) 21 SATC 77

<sup>122</sup> De Koker and Urquhart - *Income Tax in South Africa - Vol I* - Page 17 - 34

**Williams** submits that the practice of Inland Revenue in the aforesaid regard is that where trustees distribute trust income to beneficiaries, the latter are taxed on the distributional income and the trustees are taxed in terms of section 7(5) on any undistributed (withheld or accumulated) income, whether or not the beneficiaries have a vested right to the undistributed income and whether or not the distribution of income was in the discretion of the trustee.<sup>123</sup>

The difficulty he avers, lies with undistributed income to which a trust beneficiary has a vested right under the terms of the trust, which is not distributed to him because of the non-occurrence of an event stipulated in the trust as a condition precedent to his receiving the income.<sup>124</sup>

In the aforesaid situation, such income will, in terms of section 7(1), be deemed to have accrued to the beneficiary. Section 7(1) reads as follows:

**When income is deemed to have been accrued or to have been received**

**7(1) Income shall be deemed to have accrued to a person notwithstanding that such income has been invested, accumulated or otherwise capitalized by him or that such income has not been actually paid over to him but remains due and payable to him or has been credited in account or reinvested or accumulated or capitalized or otherwise dealt with in his name or on his behalf, and a complete statement of all such income shall be included by any person in the returns rendered by him under the Act.**

Because section 7(5) is also applicable however, the income is deemed to be the income of the donor which may result in the same income being taxed twice.<sup>125</sup>

**De Koker and Urquhart** submit that in practice the Inland Revenue adopts the view that where

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<sup>123</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 417

<sup>124</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 417

<sup>125</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 417

the income or any part thereof is accumulated by the trustee because the trust-deed prevents the income from being paid to the beneficiary, or because the trustees have exercised their discretion to accumulate the income, a stipulation exists within the meaning of section 7(5) and the income so accumulated will be taxed in the hands of the donor. They submit that the aforesaid practice is well illustrated in the case of *SIR v Sidley 1977 (4) SA 913 (a), 39 SATC 153*, where the taxpayer had made donations to certain trusts. The trust-deeds provided that the trusts would terminate and the donees would receive the trust funds on the death of the donor and his wife and upon the attainment by the donees of 30 years. Although the Court did not adjudicate on the question of whether the trustee's discretion constituted an event for the purposes of section 7(5), it was nonetheless satisfied that there was a condition or stipulation which precluded the donee from receiving the income until the happening of an event (namely the death of the donor and the death of the donor spouse and the attainment by the donees of the age of 30 years), and thus section 7(5) could be invoked.<sup>126</sup>

Nevertheless, the basic principle that section 7(5) applies so long as there is a stipulation or condition, withholding income from the beneficiary, irrespective of whether or not he has a vested or contingent right to such income, was not accepted in *ITC 1328 (1980) 43 SATC 56*.<sup>127</sup>

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<sup>126</sup> De Koker and Urquhart - *Income Tax in South Africa - Vol 1* - Page 17 - 34

<sup>127</sup> It should be noted that this case was decided prior to the introduction of section 25B of the Act.

In *ITC 1328 (1980) 43 SATC 56*, the taxpayer donated shares to each of two trusts which he had created for his daughters. During the year of assessment in issue, interest and dividends accrued to one trust and interest accrued to the other. Although the income was initially taxed in the hands of the beneficiaries, the Commissioner for Inland Revenue, in additional assessments, assessed the income tax in the hands of the taxpayer instead, in terms of section 7(5), since the amounts involved were not actually paid to the beneficiaries.

The relevant clause of the trust deeds that dealt with the devolution income to the trust fund provided, essentially, that the income was to accrue to the beneficiary, but that the trustee, a company, was to determine for the benefit of the taxpayer's daughter, how the income was to be devoted and spent and the extent to which it was to be paid out. Any unexpected balance of the income was to be invested by the trustee on her behalf, administered by it for her benefit and paid over to her whenever the trustee, in his sole discretion determined. The balance of income, paid to her during her lifetime, was to be paid over to her estate on her death.

In each of the relevant years of assessment, net income not actually paid out to the beneficiaries, was credited to their trust account and reinvested on their behalf and for their benefit.

Based on the authority in *CIR v Polonsky 1942 249, 12 SATC 11*, Milne J upheld the taxpayer's argument that section 7(1) applied to deem the income that was "credited in account or reinvested or otherwise dealt with ... on behalf [of the beneficiaries]" to have accrued to them, even though it may or may not actually have accrued to them in terms of the

There are also other Special Court decisions<sup>128</sup> which hold that, where a trust contains a withholding stipulation but the beneficiaries have a vested right to the withheld income, section 7(5) does not apply and such income is taxable in the hands of the beneficiaries, not the trustees.<sup>129</sup>

**De Koker and Urquhart**<sup>130</sup> and **Divaris and Stein [Silke]**<sup>131</sup> regard the aforesaid Special Court decisions as incorrect and are of the view that in the aforesaid situation, section 7(5) takes preference over section 7(1), hence the undistributed income is taxed only in the hands of the donor.

Further arguments advanced for the aforesaid interpretation, are that section 7(5) ought to prevail over section 7(1) on the basis that *generalia specialibus non derogant* and that the meaning of section 7(1) is obscure. More specifically, Swersky argues two-foldedly that:

[a] While section 7(1) is a section of general application, section 7(5) applies only if specific criteria are fulfilled. Therefore, it is submitted, the rule of construction '*generalia specialibus non derogant*', that is that a general provision does not derogate from a specific provision, must be invoked. Thus section 7(1) may not derogate from section

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gross income in section 1, a question that the court found unnecessary.

The Special Court *inter alia* rejected the application of section 7(5) and accepted the taxpayer's argument that the income was deemed to have accrued to the beneficiaries in terms of section 7(1), since it was credited to their accounts and it could not have been the intention of Parliament to impose double taxation by means of section 7(1) and (5).

De Koker and Urquhart - Income Tax in South Africa - Vol.: 1 - 17 - 35

<sup>128</sup> ITC 5781 (unreported), approved in ITC 903 (1959) 23 SATC at 519

<sup>129</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 417

<sup>130</sup> De Koker and Urquhart - Income Tax in South Africa - Vol.: 1 - 17 - 35

<sup>131</sup> Devaris and Stein - SILKE ON SOUTH AFRICAN Africa - Vol.: 2 - § 12.20

7(5);

[b] Section 7(1) has had a chequered history and its precise meaning is obscure. In *Lategan v CIR*,<sup>132</sup> Watermeyer J did not seek to apply it to determine the meaning of the word "accrued". In *CIR v Delfos*<sup>133</sup> De Villiers JA was of the opinion that the word "accrued", wherever it is used in the definition of "gross income" means "becoming due and payable", and considered that this view was supported by the language of section 7(1), which uses the words "due and payable" in connection with all income which accrues. And in *ITC 563*<sup>134</sup> the court held that in view of the obscurity of section 7(1) as revealed by its previous history it was of no assistance in determining the meaning of "accrued".<sup>135</sup>

The Court held in the *Estate Dempers*<sup>136</sup> case that section 7(5) may apply even though the trust deed does not contain an *express* stipulation or condition to the effect that the beneficiaries shall not receive the income or some portion of the income thereunder until the happening of some event. Thus section 7(5) may be applicable if the trust contains stipulations or conditions to this effect.<sup>137</sup>

Meyerowitz submits that *Estate Dempers v SIR*<sup>138</sup> makes it plain that where income is deemed to be the donor's under section 7(5), its subsequent distribution to the beneficiaries does not

<sup>132</sup> 1926 CPD 203, 2 SATC 16

<sup>133</sup> 1933 AD 242, 6 SATC 92

<sup>134</sup> (1944) 13 SATC 319

<sup>135</sup> See: Swersky: Vested and Contingent Rights and s 7(5) 20 Income Tax Reporter 252 at 258

<sup>136</sup> 1977 (3) SA 672 (A), 39 SATC 95

<sup>137</sup> De Koker and Urquhart - Income Tax in South Africa - Vol. 1 - Page 17-37

<sup>138</sup> 1977 (3) SA 672 (A), 39 SATC 95

attract tax in their hands, because once the income has been deemed to be the donor's, it is so deemed for all time, and there is no room for any finding that subsequently it accrued to the beneficiaries as income.<sup>139</sup>

## 6.2 *A summary of the current position under section 7(5):*

It is submitted that the current position under section 7(5) can be summarized as follows<sup>140</sup>:

- (1) *Where a trust deed provides that income, or any portion thereof, which is not paid out in the year of accrual (either because the deed prevents this or leaves it to the trustees discretion), shall be accumulated until the happening of some fixed or contingent event, there is a stipulation which falls within the scope of section 7(5), namely, that accumulated income shall not be received by the beneficiaries until the happening of the stipulated fixed or contingent event.*
  
- (2) *Where such stipulation exists, section 7(5) deems the accumulated income to be the donor's if, in the absence of the stipulation, having regard to the terms of the deed generally, the donor's general benevolent intention, as evinced from the terms by the terms of the deed and all the relevant circumstances, it can be predicated that the accumulated income would have accrued to or have been received by the beneficiaries (or some of them).<sup>141</sup>*

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<sup>139</sup> Meyerowitz {SC}, D - Meyerowitz on Income Tax - 16.144 Page 16 - 51 - 16 - 52

<sup>140</sup> Meyerowitz {SC}, D - Meyerowitz on Income Tax - 16.147 Page 16 - 51 - 16 - 54 - 16 - 55  
See also: De Koker and Urquhart - Income Tax in South Africa - Page - 17 - 37, for a useful summary.

<sup>141</sup> If ITC 1328 1981 Taxpayer 86, 43 SATC 56, be rightly decided, the correctness of which is debatable, in light of the reasoning in various cases, but has nevertheless apparently not been challenged by the Revenue Department, section 7(5) will not apply where the beneficiary has a vested right to the income, in a sense that his right to income is certain, albeit that the enjoyment thereof is postponed; in such a case the income is deemed to be the beneficiary's in terms of section 7(1).

- (3) *Current income which is paid out during the year of assessment by the trustee, in the exercise of his discretion, is not deemed to be the donor's income under section 7(5) of the Act.*
- (4) *Income which is deemed to be the donor's, does not constitute income in the hands of the beneficiaries when subsequently paid out to them, whether as capital or accumulated income. It is submitted that section 7(5) may also apply where the beneficiaries do not have a vested right to income.*

### 6.3 *Apportionment:*

A question that arises is whether Inland Revenue is obliged, for the purposes of section 7(5), to follow the apportionment doctrine developed by the courts in so far as section 7(3) is concerned.<sup>142</sup> The crucial phrase used in section 7(3) and section 7(5) are the same, namely "donation, settlement or other disposition". However, where section 7(3) uses the qualifying phrase "by reason of", section 7(5) uses the phrase "in consequence of". There does not appear to be any significant difference between the two phrases, a submission supported by the Appellate Division in *CIR v Shell Southern Africa Pension Fund*,<sup>143</sup> where Nicholas JA interpreted the phrase "in consequence of" as being similar to "as a result of", both requiring the court to find causal connections. Thus it is submitted, the approach of the court to section 7(3) should also be applied to section 7(5).<sup>144</sup>

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<sup>142</sup> For example, where a taxpayer disposes of assets to a trust on an interest-free loan basis, the issue is whether only the interest-free portion of the loan should be considered for the purposes of section 7(5) in the same way that the courts approached the application of section 7(3).

<sup>143</sup> 1984 (1) SA 672 (A) at 678 - 679

<sup>144</sup> De Koker and Urquhart - *Income Tax in South Africa* - Page 17 - 37

#### 6.4 *Non-residents:*

Section 7(5) applies to residents and non-residents alike. In the circumstances, where a non-resident creates a trust in the Republic subject to a stipulation or condition contained in the trust-deed, to the effect that the beneficiaries will not receive the income until the happening of some event, any income of the trust will be deemed to be his in terms of section 7(5). It is to be noted, however, that where the trust in the Republic derives dividend income, the non-resident is exempt from normal tax on such deemed dividend income, since he is not ordinarily resident nor carrying on business in the Republic.<sup>145</sup> Moreover he is not liable for non-residents shareholder's tax, the tax imposed on the shareholder. Tax cannot be imposed on the trust either, since the income is deemed to be that of the non-resident, with the result that the dividends received by or accrued to the trust will be totally exempt from tax.<sup>146</sup>

#### 6.5 *Income:*

The meaning of the word "income", in the context of section 7(5) of the Act is important in relation to expenditure, deductible and non deductible, incurred by the trust. If "income" is interpreted in accordance with the definition in section 1 of the Act [i.e. gross income minus exempt income], the harsh result would be that the amount deemed to be "income" of the donor would be a gross amount not reduced by expenditure incurred by the trust in the production of income. *Silke* at § 12.20 suggests that "income", in the aforesaid context be interpreted as "gross income less related deductible expenditure and losses". Under this interpretation, the

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<sup>145</sup> Section 10(1)(k)(ii)

<sup>146</sup> Williams RC - *Income Tax in South Africa: - Law and Practice* - Page 418  
De Koker and Urquhart - *Income Tax in South Africa* - Page - 17 - 38

income deemed under section 7(5) to be the donor's would be the gross income of the trust, less related deductible expenditure and losses and (if the interpretation of the Inland Revenue is followed) less income distributed to the beneficiaries.<sup>147</sup>

#### 6.6 *Non-deductable expenditure:*

**Williams** submits that, in respect of the issue of in whose income non-deductible expenditure (eg of a private or capital nature) incurred by a trust whose terms bring it within section 7(5), is to be included, it appears that:

- (i) If the expenditure was laid out on behalf of the beneficiaries, then under ordinary principles or in terms of section 7(1) the beneficiaries could be regarded as having derived income equivalent to such expenditure and would ordinarily be taxed on the amount;
- (ii) If the non-deductible expenditure was outlaid in circumstances which did not allow the amount to be imputed to the beneficiaries, as aforesaid, the amount would be included in the income of the donor under section 7(5) of the Act.<sup>148</sup>

#### 6.7 *Miscellaneous:*

The donor, where the beneficiaries are his minor children, will be taxable under section 7(3) and 7(4) if section 7(5) is not applicable. Furthermore where the conditions for the application of

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<sup>147</sup> Williams RC - Income Tax in South Africa: - Law and Practice - Page 417

<sup>148</sup> Williams RC - Income Tax in South Africa: - Law and Practice - Page 418

section 7(5) are present, but the donor is deceased, the deeming falls away in respect of income after death in which case the income will be taxable in terms of section 25B, in the hands of the beneficiary, on the same basis as set out in regard to testamentary trusts.<sup>149</sup>

## 7. SECTION 7(6):

Section 7(6) of the Act is an anti-avoidance provision which concerns *inter alia*, the retention of the power to revoke the right to income. It is directed at a taxpayer who seeks to avoid or reduce his tax by disposing of income producing assets, but maintains control over the income, by retaining the power to revoke the right to income or to confer it upon someone else.<sup>150</sup> It reads as follows:

**When income is deemed to have been accrued or to have been received**

**7(6) If any deed of donation, settlement or other disposition contains any stipulation that the right to receive any income thereby conferred may, under powers retained by the person by whom the 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 the 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 is evident from the above, as was held in *ITC 543 (1942) 13 SATC 118*, that where section 7(6) applies, the income which is received by or accrues to the beneficiary, is deemed to be the income of the person vested with the power and the beneficiary incurs no liability to tax on such income. Furthermore, the said section will apply where the relevant power exists, even though it has not been exercised. If the donor has retained the power to revoke, so that section 7(6) is applicable,

<sup>149</sup> Williams RC - *Income Tax in South Africa: - Law and Practice* - Page 418

<sup>150</sup> Williams RC - *Income Tax in South Africa: - Law and Practice* - Page 418

it will cease to do so from the time the donor ceases to retain the power which cessation may be as a result of renunciation of the said power by the donor or by reason of his death.<sup>151</sup>

It has been held in *ITC 673 16 SATC 118* that section 7(6) applies where the relevant deed contains an *express* power to revoke a *vested* right to income or to confer it onto another person.<sup>152</sup>

*ITC 673 16 SATC 118* concerned a deed which provided that the donor had the right to exercise the voting powers in respect of the shares donated, to require the trustees to lend him the whole or any part of the income from time to time without security and with or without interest, to revoke the appointment of any trustee and to fill any vacancy. In addition to the aforesaid, the trustees were permitted to abandon any claim or debts due to the trust.

In respect of the *express* power referred to above, it was contended that all of the above provisions in the deed (which could result in nullifying the trust) cumulatively amounted to an implied power to revoke the right to receive income. The Court however rejected the aforesaid contention on the ground that what the section contemplates is an *express* provision in the deed which reserves the right to the donor to revoke the right to income given and to confer it upon another.<sup>153</sup>

*Meyerowitz*, in the aforesaid submits that whilst there must be such stipulation, *ITC 673*, perhaps goes too far in requiring that the donor's right to revoke must be expressly reserved and

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151 Williams RC - *Income Tax in South Africa: - Law and Practice* - Page 418

152 Meyerowitz [SC], D, - *Meyerowitz on Income Tax* - §16.151 - Page 16 - 55 - 16 -56

153 Meyerowitz [SC], D, - *Meyerowitz on Income Tax* - §16.151 - Page 16 - 55 - 16 -56

is of the opinion that it is conceivable that, in certain circumstances, the reservation of the power can be implied.<sup>154</sup>

**Williams** submits that in respect of the *vested* right, it seems that section 7(6) will not apply where the beneficiary has only a conditional right to the income, even if the deed contains a power of the kind mentioned.<sup>155</sup>

According to him, it further seems that section 7(6):

- (i) Would not apply to a trust where the trustees have a discretionary power to decide whether or not to distribute income to the beneficiaries;
- (ii) Would apply only where the donor can exercise the relevant power in his own right and thus the section would not be applicable where the terms of the trust require the power to be exercised by the donor and other trustees acting jointly;
- (iii) Would not be applicable where the power relates to the *capital* of the trust, for example where, on termination of the trust, the capital thereof will revert to the founder.<sup>156</sup>

**Meyerowitz** considers that if, in terms of the trust deed, no income is received, by, or accrues to any beneficiary, although the donor retains the power to revoke the beneficiary's right and

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<sup>154</sup> Meyerowitz [SC], D, - Meyerowitz on Income Tax - §16.151 - Page 16 - 55 - 16 - 56

<sup>155</sup> Williams RC - Income Tax in South Africa: - Law and Practice - Page 418

<sup>156</sup> Williams RC - Income Tax in South Africa: - Law and Practice - Page 418 - 419

it to another, section 7(6) cannot be invoked because the donor is only taxable on the income received or accrued to the beneficiary. In such circumstances, however, section 7(5) may be applicable.<sup>157</sup>

#### 8. SECTION 7(7):

Section 7(7) was introduced<sup>158</sup> in order to curb the practice whereby a taxpayer would cede an income-producing asset to another person for a number of years on condition that the asset be re-ceded at the end of the specified time period. During this time period the income accrues to the cessionary and the cedent thereby effectively donates money to another taxpayer from non-taxed income.<sup>159</sup>

**De Koker and Urquhart** submit that given the wide scope of the section, a settlement of an income-producing asset to a trust could well fall foul of section 7(7) if -

- [a] The transfer of the asset is not affected at arm's length so as to circumvent the requirement of donation, settlement or other disposition; and
- [b] The trust deed contains any provision whereby the donor will be entitled to regain ownership or an interest in the asset.<sup>160</sup>

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<sup>157</sup> Meyerowitz [SC], D, - Meyerowitz on Income Tax - §16.151 - Page 16 - 55 - 16 - 56

<sup>158</sup> Section 7(7) was especially introduced to overcome the situation as exemplified in *ITC 1378 (1987) 45 SATC 230*, a case wherein the history of this section is very well illustrated.

<sup>159</sup> De Koker and Urquhart - Income Tax in South Africa - Page 17 - 39

<sup>160</sup> De Koker and Urquhart - Income Tax in South Africa - Page 17 - 40 - 17 - 41

Condition [b] above, in the circumstances, requires that the powers of the trustees and the ability of the donor to invoke powers to dispose trust property for his benefit, will have to be carefully drafted.<sup>161</sup>

**De Koker and Urquhart** further submit that where a taxpayer donates shares to a trust for the benefit of his grandchildren and their issue, and he is one of three trustees, section 7(7) cannot be applied to deem the dividends received by the trust part of his gross income, since the taxpayer has only a fiduciary interest in the shares as trustees and not an interest of the nature contemplated in section 7(7).<sup>162</sup>

**9. THE RECOVERY OF TAX ON DEEMED INCOME UNDER SECTIONS 7(3),(4), (5), (6) AND (7):**

The effect of section 7(3) - (7) of the Act, is to impose liability for tax on a person [the donor] who has not actually received the income in question. To redress the aforesaid obvious inequity, such person may however, in terms of section 90 of the Act, recover so much of any tax paid by him [and any interest payable under section 89(2) or section 89 *quat*] as is due to the inclusion in his income, of income deemed to be his income from the person entitled, whether on his own behalf or in a representative capacity, to the receipt of the income so included.<sup>163</sup>

As stated above, the aforesaid tax payed, is recovered from the person entitled, whether on his own behalf or in a representative capacity, to the receipt of such income. The aforesaid right of recovery in respect of section 7 (3) - (6) is bolstered by section 91(4) of the Act, which allows

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<sup>161</sup> De Koker and Urquhart - Income Tax in South Africa - Page 17 - 41

<sup>162</sup> De Koker and Urquhart - Income Tax in South Africa - Page 17 - 41

<sup>163</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 419

tax to be recovered by the such person or the Commissioner from the assets by which such income so included, was produced.<sup>164</sup>

Section 91(4) reads as follows:

#### Recovery of Tax

**91(4) So much of any tax payable by any person as is due to the inclusion in his income of any income deemed to have been received by him or to be his income, as the case may be, in terms of sub-section (3), (4), (5) or (6) of section seven, may be recovered from the assets by which the income so included was produced.**

It has however been held in *Israelsohn v CIR 1952 3 SA 529 (A); 18 SATC 247*, that the aforesaid section does not empower the Commissioner to claim judgement against any person for the recovery of tax and that the Commissioner must first obtain an order of execution of the particular assets.<sup>165</sup>

It is evident from section 91(4) above that the parent or Commissioner has the right to recover so much of the tax "as is due to the inclusion" of the minor's income. **Meyerowitz** submits that the phrase "as is due to the inclusion" gives rise to uncertainty as it may be interpreted in the following two fashions:

- (i) The difference between the amount of total taxes payable by the parent and the amount which would have been paid by him had the minor's income not been included in his income, meaning that the minor's income must bear the tax on the last slice of the taxpayer's income; or

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<sup>164</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 419

<sup>165</sup> Joubert WA; Scott TJ - LAWSA - Vol.: 22 Part I - Income Tax - Para. 746; Page 452

- (ii) Such portion of the taxes payable as is attributable to the deemed income in the ratio it bears to the total income of the taxpayer.

**Meyerowitz** submits that of the above two, the former is the correct interpretation.<sup>166</sup>

**Williams** submits however, in practice, Inland Revenue uses the following formula to determine the amount of tax which may be recovered under section 91(4) of the Act:<sup>167</sup>

deemed income included in donor's income		tax payable by donor on his total
under section 7(3) to section 7 (6)		taxable income, including deemed
_____ X		income in terms of sections 7(3) to
taxable income of donor, including deemed		section 7(6)
income under section 7(3) to section 7(6)		

It is evident that it appears to follow interpretation (ii) discussed by **Meyerowitz** above.

#### 10. SECTION 103: - THE GENERAL ANTI-AVOIDANCE PROVISION OF THE ACT:

The specific anti-avoidance provisions of section 7(1) to section 7(7) will in most cases nullify the tax advantages to trusts. Section 103(1) of the Act - the general anti-avoidance- provision, which provides a remedy for mischief and is not specifically relevant to the taxation of trusts *per se*, may however also be invoked by the Commissioner if its pre-requisites, which relate to *inter*

<sup>166</sup> Meyerowitz [SC], S - Meyerowitz on Income Tax - § 16.59 - Page 16 - 24

<sup>167</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 419

*alia*, the nature of the transaction, the intention of the parties and the structure of the trust, are met.<sup>168</sup> **Van der Westhuizen**<sup>169</sup> has summarized them into the following four elements which must be present simultaneously before section 103 can find application:

Whenever the Commissioner for Inland Revenue is satisfied that any:

- [a] Transaction and/or operational scheme has been entered into, or carried out and  
*[Meyerowitz v CIR 1963 3 SA 863 (AD)]*
- [b] Which has the effect of avoiding, reducing or postponing the liability for the payment of any tax imposed by the Income Tax Act, and  
*[Smith v CIR 1964 1 SA 324 (AD)]*
- [c] Having regard to the circumstances, was entered into by abnormal means or in an abnormal manner, or has created rights and obligations not normal in an arms length transaction<sup>170</sup>, and *[CIR v Louw 1983 3 SA 551]*
- [d] Was entered into solely or mainly for the purpose of avoiding, reducing or postponing any tax or levy imposed by any Act administered by the Commissioner,  
*[SIR v Gallagher 1978 2 SA 463 (AD)]*

then he shall determine the liability for income tax in terms of the Income Tax Act as if the

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<sup>168</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 419 and 641

<sup>169</sup> Van der Westhuizen WM - Wills and Trusts - Page 60 - 61

<sup>170</sup> The so-called "abnormality - test" set out herein is applicable to all transactions concluded prior to 3 July 1996. It has however been retained for schemes other than schemes in a business context. A new business test was introduced in 1996. - See *The Taxpayer* June 1996.

transaction operation or scheme had not been entered into or carried out.

It should be noted that section 103(1) will apply only if the establishment or operation of the trust involved a sole or main purpose<sup>171</sup> of either tax avoidance or the postponement of tax. It is thus important to appreciate that trusts have purposes other than tax avoidance.<sup>172</sup>

In the event of section 103(1) being invoked, no additional tax will be paid and the founder will be able to withdraw trust funds as repayment of the loan in order to pay the tax. However in terms of section 103(6)<sup>173</sup> of the Act, where the transaction was entered into on or after 3 July 1996, interest on under payment of provisional tax in terms of section 89 *quat* will arise.<sup>174</sup>

It should finally be noted that in the event of section 7 being invoked by Inland Revenue against the donor, the latter can recover so much of the tax paid by him, as is due to the inclusion in his taxable income, of any deemed income in terms of section 7, whereas section 103 does not contain a similar provision, with the result that the planner, if taxed by Inland Revenue in terms of section 103(1), will not be able to withhold funds from the trust being, a repayment of the loan owed to him, in order to pay the tax.<sup>175</sup>

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<sup>171</sup> De Koker and Urquhart submit that the natural desire of a parent to benefit his child may provide a purpose in respect of the transaction which is quite innocent of tax. See De Koker and Urquhart - Income Tax in South Africa - Page 17-41

<sup>172</sup> Williams RC - Income Tax in South Africa: Law and Practice - Page 419

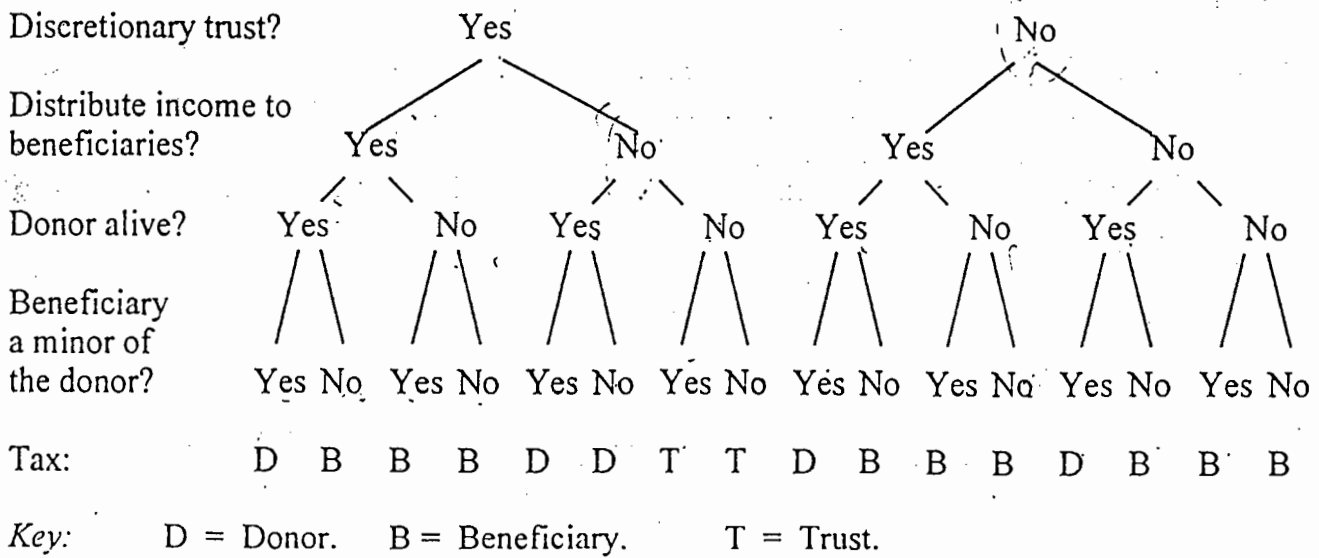
<sup>173</sup> Inserted by Income Tax Act 36 of 1996.

<sup>174</sup> De Koker and Urquhart - Income Tax in South Africa - Page 17-41

<sup>175</sup> De Koker and Urquhart - Income Tax in South Africa - Page 17-42

**F. CONCLUSION:**

A set of unique, and sometimes complex rules are in existence in respect of trust taxability and trust income may in terms of sections 25B and 7 of the Act, be taxable in the hands of the beneficiary and/or the trustee and/or the donor.<sup>176</sup> The schematic representation hereunder reflects the various possibilities which exist in the aforesaid regard.<sup>177</sup>



Trusts are extensively used in estate and tax planning and business ventures, one of the main purposes being to avoid or reduce the incidence of taxation. The aforesaid has however been made more difficult due to sections 7 and 103 of the Act. Notwithstanding the aforesaid, there are still certain tax and other advantages to a trust. A sound knowledge however of the law of taxation in so far as it affects the founder, the trustee and the beneficiaries is a prerequisite for the intelligent creation and administration of a trust, and will serve to minimize the incidence of tax.<sup>178</sup>

<sup>176</sup> Pace RP and Van der Westhuizen Wills and Trusts Page 52

<sup>177</sup> Huxam K and Haupt P Notes on South African Income Tax 1997 Page 537

<sup>178</sup> Honoré and Cameron Honoré's South African Law of Trusts-Page 361

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**C. LEGISLATION:**

*Income Tax Act No. 58 of 1962*

*Trust Property Control Act No. 57 of 1988*

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