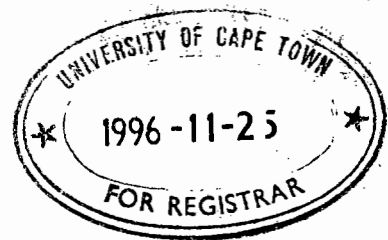


102 Law

**Dissertation in partial fulfilment of the requirements
of the Degree of Masters in Tax Law (1996)**

**DISCRETIONARY TRUSTS AND SECTION 7(5) OF
THE INCOME TAX ACT**

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A. INTRODUCTION

Discretionary Trusts have fast become a very popular vehicle in all types of business transactions, due to their extremely flexible nature and the lack of formalities required in their day to day administration. However, largely for the above reasons, there are in my submission a great many questions arising from their existence, the answers to which are not always clear. Discretionary Trusts are furthermore, because of their inherent flexibility excellent vehicles for abuse, particularly in the form of tax avoidance.

The purpose of this dissertation is to consider the Application of Section 7(5) of the Income Tax Act to a Discretionary Trust, and to attempt to answer what has been described as "the vexed question" of whether the exercise of a Trustee's discretion in a Discretionary Trust constitutes an "event" within the meaning of that Section. In addition I have given consideration as to whether "vesting" is a requirement of the operation of Section 7(5).

To do this however I have of necessity first to briefly consider the nature of Trusts generally, and Discretionary Trusts in particular, followed thereafter by a short discussion of the taxation of Trusts generally, before tackling the main topic of the dissertation. This is in my view necessary in order to establish a background against which the argument which forms the basis of the Dissertation can be considered.

B. GENERAL

Honore (The South African Law of Trusts; Third Edition) defines a Trust as follows (at 3):

"In the narrow or strict sense a Trust exists when the creator of the Trust, whom I shall call the Founder, hands over or is bound to hand over the control of an asset which, or the process of which is to be administered by another (the Trustee or Administrator) in his capacity as such for the benefit of some person (beneficiary) other than the Trustee or for some impersonal object".

In Thorne and Molenaar NNO v Receiver of Revenue, Cape Town, 1976 (2) SA 50 (C) the term Trust was defined as follows:

"In general a Trust is created by a contract, very often by a contract of donation or in virtue of an Antenuptial Contract or by way of a Will. It is created in respect of defined property transferred to a Trustee who is burdened with the obligation to administer the property for the benefit of a third person, the latter being afforded a right against the Trustee to enforce the Trustee's compliance with his obligations towards the beneficiary concerned. Generally Trusts contemplate an extended continuation of the administration of the Trust property in favour of the beneficiary, until terminated on the happening of a specified future event".

The Trust Property Control Act Number 51 of 1988 has now defined Trusts as;

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

(a) *To another person, the Trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the persons or class of persons designated in the trust instrument or for the achievement of the objects 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 (Act Number 66 of 1965);"

A Trust is not a person, and in terms of the common law, does not have legal personality. In **Friedman & Others v CIR 1993 (1) SA 353 (A)**

Joubert JA held, with reference to the case of **CIR v MacNeillies Estate 1961 (3) SA 833 (A)** that:

"Neither our Authorities nor our Courts have recognised it (the Trust) as a persona or entity"

He held therefore that:

"The conclusion is inescapable that a Trust is not a "person" within the meaning of that word in the 1962 Act".

However, subsequent to the above decision, the Income Tax Act has been amended to include "Trust" within the definition of person, and thus liable to taxation. Trust is defined therein as follows:

"Any Trust Fund consisting of cash or other assets which are administered or controlled by a person acting in a fiduciary capacity, where such person is appointed under a Deed of Trust or by agreement or under the Will of a deceased person".

A Discretionary Trust is a particular form of private trust with the peculiar attribute that the Trust income and/or capital will be distributed in accordance with the discretionary powers of the Trustees of the Beneficiaries. It does not constitute a separate category of trust, but is used on a large scale in practice. (**Olivier; Trust Law & Practise at 111**).

Fundamental to the concept of a Discretionary Trust is the distinction between "vesting" and "non-vesting". Vesting, or the acquisition of a vested right refers to the acquisition by a beneficiary of a right which cannot be defeated, and is passable to his cessionaries or his estate on his death, even if the benefits are only payable at a future date after its accrual. **(Jewish Colonial Trust Limited v Estate Nathan 1940 AD 163 at 175).**

"Non-vesting" on the other hand refers to a Trust in which the beneficiaries acquire no rights whatsoever, other than a hope or spes, in terms of which the beneficiaries' entitlement to benefits in terms of the Deed is contingent upon the happening of a future event. Until such event occurs, if at all, the beneficiaries acquire no entitlement to the benefits whatsoever.

Because of the fact that a trust is by nature a contract, its terms can be as varied as there are contracting parties. The powers given to Trustees in terms of the Deeds vary from trust deed to trust deed, many deeds providing Trustees with a varying amount of discretion, for example the discretion to re-invest funds which have accrued to beneficiaries on behalf of such beneficiaries.

The term "Discretionary Trust" refers to a "non-vesting" Trust wherein the beneficiaries acquire no rights to capital or income until the Trustees in their discretion determine. The beneficiaries' rights are accordingly no more than a hope or spes, contingent upon the exercising of the Trustees'

discretion in their favour. I have dealt with the concept of "vesting" in some detail hereunder.

C. TAXATION OF TRUSTS GENERALLY

The focus of this Dissertation is Section 7(5) of the Act, and accordingly a detailed analysis of the other relevant sections of the Act falls without the scope thereof. Sections 25 (B) and 7 are however interrelated, the operation of Section 25 (B) being subject to Section 7. Accordingly in my view it is necessary to give a brief overview of those Sections before proceeding with an examination of Section 7 (5).

As stated above, in 1991 the Income Tax Act was amended by including "Trust" within the definition of person, and by defining Trust as aforesaid.

In addition Section 25(B) was introduced, which, as stated by **Silke at 12.14 (a) (Silke on South African Income Tax)**.

"Does for Trusts and their Beneficiaries what Section 25 does for the Estate of deceased persons and the heirs and legatees under an Estate".

Section 25(B) has left intact what has become known as the "Conduit Principle", namely that where a Beneficiary has a vested right to the trust income, the Trustee merely serves as a conduit through which the income flows to the Beneficiary (**Olivier, supra at 169**).

A Testamentary Trust, into which no assets have been introduced by a donation, disposition, settlement or other disposition from a living person will be taxed in terms of Section 25(B) alone. (**Meyerowitz on Income Tax at 16.1.33**) Section 25(B)(1) establishes a "Deemed Income Rule" in that, to the extent to which income is received by a Trustee in his capacity as such, and "has been derived for the immediate or future benefit of an ascertained Beneficiary with a vested right to it", it will be deemed to be income that has accrued to the Beneficiary, and to the extent that it is not so derived, it will be deemed to be income accruing to the Trust. Section 25(B)(2) refers to the "Discretionary Trust", deeming income referred to in sub-section (1) to have been derived for the benefit of a Beneficiary, where the Beneficiary concerned has, as a result of the exercising by the Trustee of a discretion vested in him in terms of the Trust Deed concerned, acquired a vested right to such income. Section 25 B(3) deals with deductions and allowances in a Trust, which together with Practise Note 23 deems deductions and allowances to follow the path of income.

Section 25(B) is however specifically made subject to Section 7, which section will apply to Inter vivos Trusts, and Testamentary Trusts into which a donation, settlement or other disposition has been made by a living person.

Section 7(1) deems income to have accrued to a person notwithstanding the fact that although due and payable to him, it has been invested, accumulated or otherwise capitalised by him or on his behalf. Thus vesting by a Trustee to a Beneficiary by the exercising of his discretion, but withholding payment or distribution, will result in such income being required to be included in the taxable income of the Beneficiary.

Section 7(3) provides that where income accrues to a minor child and the effective cause of such accrual is a donation, settlement or other disposition by the minor's parent, such income will be deemed to be that of the parent.

Section 7(4) deems income accruing to a minor child to be that of the minor's parent, if the income accrues by virtue of a donation, settlement or other disposition from another person, and such other person has received a donation, settlement or other disposition, or other consideration whatsoever from such minor's parents.

Section 7(5) which will be dealt with in some detail hereunder, deems the income of a Trust to be the donor's to the extent that it has been withheld because of a stipulation in the Deed.

Section 7(6) deems income to be the donor's where he retains the right to revoke or confer upon another the right to receive income.

Section 7(7) deems the income to be the donor's if the asset producing the income is to be returned to him at some future date.

D. AN ANALYSIS OF SECTION 7(5)

Section 7(5) provides that if a person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by that person or anybody else, to the effect that the Beneficiaries or some of them will not receive the income or a portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of such income as would, but for the stipulation or condition, in consequence of the donation, settlement or other disposition be received by or accrue to or in favour of the Beneficiaries, will until the happening of that event or the death of the person who made the donation, settlement or other disposition, whichever first takes place, be deemed to be the income of the person concerned, and is taxable in his hands.

Section 7(5) is concerned with attempts to avoid tax through the medium of vesting an income producing asset in trust, as it will often be advantageous for the income produced from such asset to be held in the Trust, and the income generated thereby subject to tax in the hands of the Beneficiaries or the Trust as the case may be, rather than in the hands of the donor.

Thus according to **Corbett JA** in the case of **Estate Dempers v SIR 1977 (3) SA 410 (AD)**, the reasons for the introduction of the South West African equivalent of Section 7(5), namely Section 9(5) of the South West African Ordinance are:

"It seems to be aimed generally at preventing the avoidance of tax liability where and so long as the donor does not permit the Beneficiary of the gift to enjoy immediately the income to be derived therefrom" (at 421 E - F).

It appears that the following requirements must be met before Section 7(5) can apply:

1. A donation settlement or other disposition must be made;
2. The relevant income must be received in consequence of the donation, settlement or other disposition;

3. The donation, settlement or disposition must be subject to a stipulation or condition that the Beneficiaries or some of them shall not receive the income or part of the income derived therefrom until the happening of an event, fixed or contingent;
4. The person who made the donation, settlement or disposition must still be alive;

If all the above requirements are met, Section 7(5) will apply to the trust income which has been received in consequence of the donation, settlement or other disposition, until such time as the event referred to in the section has taken place. (**Olivier supra at 193**).

From the wording of the section to the effect that the stipulation or condition need not be imposed by the person making the donation, settlement or other disposition, it is in my submission clear that the section will be applicable against a donor to a Trust who is not in fact the founder thereof. Bearing in mind the judgment delivered by **Coetzee J** in **Joss v SIR 1980(1) SA 664(T)** who regarded an interest free loan to be an "other disposition", for the purposes of Section 7(3), the practice of Trusts being established by a donation of R100,00 by the donor, and thereafter financed by means of an interest free loan from a third party, often the donor or a Trustee, will clearly be subjected to the operation of the sub-section.

Although the meaning of the words "in consequence of" used in the section do not appear to have been the subject of judicial interpretation, it is my submission that they will be allocated the same meaning as the words "by reason of" employed in Section 7(3), and accordingly the test in my opinion to be applied is the causal test as expounded by **Centlivres CJ in CIR v Widan 19 SATC 341** at 351, namely that they must "be some causal relation between the donation and the income in question" (see also **CIR v Berold 1962 (3) SA 748 (AD)**).

Thus in my opinion where a nominal donation of R100,00 is made to a Trust, which then finances various ventures by means of loans, the income accruing to the Trust as a result of the ventures will not in my submission fall foul of the section, as the income will not have accrued "in consequence of" the donation, but rather in consequence of the venture, or the loans made. Should the loans be interest free however, Section 7(5) will apply (see **CIR v Widan (supra)**).

E. ESTATE DEMPERS v SIR 1977 (3) SA 410 AD

The leading case on the interpretation of **Section 7(5)** is that of **Dempers**, until which there had been some uncertainty as to the proper interpretation of this sub-section. As will be seen hereunder, I am of the opinion that **Dempers**, although coming to the correct conclusion ultimately, is in certain respects incorrect. The facts were briefly as follows:

The Trust Deed settled a sum of money upon Trustees, the tax payer (donor) declaring that the said settlement was made out of the love and affection which he had for the donee (his grandson) and his desire to make provision for him. Clause 17 of the Deed originally gave the Trustee discretion to pay the annual income to the donee (or charities) and directed the Trustee to capitalise the income not paid out in the year.

This clause was in 1973 substituted by a clause to the effect that the annual income could be used by the Trustees for the benefit of the donee/issue. Clause 18 provided that a third of the Trust Fund including capitalised income was to be paid to the donee at 25 years, one half of the balance at 30 years and the remainder at 35 years. If the donee died prior to 35 years, his issue were to substitute him in the Deed.

The Commissioner taxed the donor in each of the years (including 1973) on the income which had been accumulated, and the tax payer objected thereto on the grounds that:

- (a) The exercise of a Trustee's discretion was not an event falling within the scope of the section, and because the Trustee could pay out the income there was no stipulation that the donee should not receive the income until the happening of an event; and

- (b) The donee did not have a vested right to the income, and therefore it could not be said that but for the stipulation (if indeed there was one) the income would have accrued to or have been received by the donee.

Insofar as the argument presented in (a) above is concerned, the Court found it unnecessary to decide the question of whether the exercise of a Trustee's discretion constituted an event in terms of Section 7(5), as in **Corbett JA's** view there were "*other occurrences stipulated for in the Deed of Trust (ie other than the exercise of the Trustee's discretion) which do constitute events in terms of Section 9(5) (the South African equivalent of Section 7(5))*" (at 423 A - B).

Corbett JA was however of the opinion that there was some force in the arguments presented by the Tax payer's Counsel ie that the exercise of the Trustee's discretion did not constitute an "event" in terms of the section. These arguments will be dealt with more fully hereunder.

Insofar as the second portion of (a) above is concerned, this contention was rejected by the Court, which held that although there was no express stipulation that prohibited payment of income until the happening of the event, the effect of the clauses was in fact to withhold the accumulated portions of the income until the happening of an event, which was in the Court's opinion sufficient to satisfy the section.

Insofar as (b) above is concerned, the Court held that the use of the words "fixed or contingent" in the section indicated that a vested right to the income was not a *sine qua non* for the operation of the section. If the Beneficiaries had vested rights, this could be a strong, possibly decisive factor leading to the conclusion that, but for the stipulation withholding the income it would have been received by them, but as "contingent" is used to describe a right which is conditional and uncertain, as opposed to a vested right which is certain, unconditional, and immediately acquired *"it is difficult to see how the Beneficiary's right to the income could be anything but contingent, ie not vested"* (at 426 A).

The Court held thereafter (at 426 C - D)

"In truth the application of the devolutionary portion of the sub-section involves a hypothetical, notional enquiry which cannot be directed solely to questions such as whether the Beneficiary's 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 accrued to the Beneficiary. In answering this question regard must be had to the terms of the instrument generally, the donor's benevolent intention, as evinced by the terms of the instrument, and all the relevant circumstances. In this enquiry 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".

On the facts, the Court held that reading the Deed as a whole, the donee, (John) was dominantly the object of the donor's bounty, and that the power of the Trustees to distribute to charitable institutions did not detract from the overriding intention of the Deed.

F. IS THE EXERCISE OF A TRUSTEE'S DISCRETION AN EVENT?

Due to the particular facts of the **Dempers** case, the Court found it unnecessary to determine whether the exercise of a Trustee's discretion was "an event" within the meaning of the sub-section. This was because the Court did not have to deal with the income which the Trustees had paid out in the years of assessment, as revenue only applied the deeming provision vis a vis the accumulated income, and not the income which was relevant to the exercising of the discretion i.e. the "unaccumulated income". (See footnote 3, **Meyerowitz supra at 16.145**). Furthermore, insofar as the accumulated income was concerned, the Court found other occurrences which fell within the meaning of "event" for the purposes of the Section.

I disagree with the view of **Lyons** expressed in **1979 De Rebus 134** where he comes to the conclusion that "*Without advancing reasons, the Court excluded from the income to be taxed as the donor's income those sums actually paid out by the Trustees to the donee*". While I agree with the conclusion to which he came

(that the exercise of a Trustees' discretion is an event) this statement is in my submission incorrect as the Commissioner had not included these sums within the taxpayer's assessment, and therefore these sums were clearly not in issue before the Court. Accordingly the Court did not exclude such sums from the income, but simply was not required to consider this income on the facts. The fact that the Court dealt with the matter in this manner is therefore in my submission not authority for the proposition that the exercising of a Trustee's discretion is an event for the purposes of the section, as is suggested by Lyons.

It therefore appears in the light of the **Dempers** decision that where, as many Trust Deeds provide, the vesting date of income and capital is to be "a date one month after the death of the donor, or a date to be determined in the unfettered discretion of the Trustees, whichever is the sooner", Section 7(5) will apply to withheld income on the basis that the date one month after the death of the donor will be "an event" for the purposes of this section. But what of the situation where the vesting date of the Trust is left entirely in the discretion of the Trustees? I am of the opinion for the reasons that follow hereunder that the exercising of such a discretion must constitute an "event" for the purposes of this section, and accordingly the existence of such a clause will render the donor liable to taxation on any withheld income.

My method of dealing with the question, which has never been directly answered by the Appellate Division, is to examine Counsel for the Taxpayers' arguments in the **Dempers** case and consider whether there is indeed any weight to be attached thereto as was held by **Corbett JA**.

Counsel for the Appellant in **Dempers** argued that although "event" was in general of wide enough import to include the exercise of a discretion, in the context of the Section it could not be read to comprehend the exercise by a Trustee of his discretion to pay income to beneficiaries under a Trust Deed. It was argued in elaboration of this submission in the first place, that the kind of event contemplated by the Section 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 a fiction to be that of the donor. After the event "*the fiction ceased and it became permanently that of the beneficiary*" (at 422 D - E).

In support of this submission, Counsel argued that anomalies would arise if such exercising of a discretion was an event. Counsel used the example of a Trustee on the last day of the tax year exercising his discretion to distribute to the Beneficiaries income which had accrued to the Trust. If such exercising of discretion was an event, this would, it was argued, result in all the income which accrued during the year being deemed to be that of the donor, despite the fact that on the last day of the year it was actually

paid to, and received by the Beneficiaries. This would it was argued further be contrary to the aim of the subsection, which was to tax income in the hands of the donor only when not received by the Beneficiaries.

Insofar as the "once and for all" argument is concerned, I can see no reason why a Trustees' discretion does not fall squarely within the type of event referred to by Counsel above. If one attempts to apply Section 7(5) to income withheld in a trust, subject to a Trustees' discretion to pay such income out, it seems to me that the exercising of a discretion is a "once and for all event" insofar as the income which is subject to scrutiny is concerned. The event will occur only once insofar as withheld income is concerned, as, after the exercising of the discretion, the income will have been paid out, and accordingly insofar as that income is concerned, *"the fiction ceased and it became permanently that of the beneficiary"*. Any income which has not been paid out to the beneficiaries, but has been withheld in the trust has not yet been subject to the "event" and accordingly falls squarely within the ambit of this Section.

In my submission Counsel's argument above in support of his submission (that anomalies would arise if the exercise of a discretion was an event) is incorrect. The Section provides:

"...to the effect that the Beneficiaries shall not receive the income or some portion of the income until the happening of some event ... so much of any income as would, but for

such stipulation or condition, be received by or accrue to ... the Beneficiaries shall ... be deemed to be the income of such person".

The sub-section can only apply to so much of any income as would but for the stipulation have been received by or accrued to the Beneficiaries. It can accordingly not apply to distributed income, as the income would have been received by the beneficiaries.

The sub-section envisages an event until the happening of which income will be withheld. Once the distribution of income has been made, there is no longer a withholding of income as envisaged by the section and accordingly, logically the sub-section cannot be applicable to such income. To seek to target income which is no longer withheld, but is distributed is clearly not the intention of the sub-section.

Although **Corbett JA** did not deal directly with Counsel's argument as it was not necessary to do so, he does in my submission reject it impliedly when he states as follows at **424 H**, in summing up the position:

"Excluded from this amount of income (income withheld and therefore the subject of investigation in terms of Section 7(5)) would be the sums actually paid out by the Trustees to either the donee or his issue".

He states also at 421:

"In the case of donations, the hypothesis is that the Deed of Donation contains a stipulation to the effect that the Beneficiaries thereof or some of them shall not receive the income thereunder, or some portion thereof until the happening of some event, whether fixed or contingent. If it does, then (and here I ignore the case of income deemed to accrue or to be received) so much of any income is deemed to be the income of the donor".

The learned Judge ignores any income which would be deemed to have been received or accrue, which would clearly in his opinion fall outside of the ambit of the section. If such income falls outside of the section it could in my view hardly be argued that income which is actually received, as opposed to so deemed, would fall within its ambit.

Furthermore, in my view the tax liability of the donor and the beneficiaries can only be assessed after the last day of the year of assessment has passed, as, until such time it cannot be said that any income would, but for the stipulation have been received by or accrued to the beneficiary ie it cannot be said that any income was not actually received or accrued to the beneficiary. Any withheld income is, until the last day of the year of assessment has passed, "conditionally withheld", as the Trustees' discretion can still vest it in the beneficiaries at any time. Accordingly the withheld income cannot, as is suggested by Counsel, be deemed to be that of the donor until it can be said as a certainty that it is withheld income. If on the last day the income vests in the beneficiaries, it is in that year of

assessment, income accruing to the beneficiaries and not as is suggested by Counsel, income deemed to be the donor's.

In my submission Section 7(5) is clearly intended to apply where income is withheld from the Beneficiaries, and not when it is paid out to them. Accordingly I disagree with Counsel that the anomalies referred to will occur in practise. This is in any event, according to **Meyerowitz**, in accordance with the practise of the Commissioner, who will only target undistributed income in terms of Section 7(5).

Insofar as the second argument advanced by Counsel in the **Dempers** case is concerned, I once again disagree. Counsel's submission was that, if the exercise of a discretion was held to be an event, it would mean that once the Trustee exercises his discretion either against or in favour of the Beneficiaries, the tax liability of the donor would cease, because submitted Counsel, the question is not whether the occurrence of the event in fact resulted in the Beneficiaries receiving income, but whether the event before the occurrence of which they were not entitled to receive income, had in fact occurred. This, submitted Counsel, showed that the event contemplated by the section was one which would finally vest the income in the Beneficiaries.

This is in my view a fallacious argument. The section does not, I submit provide any basis for the statement that "once the Trustee exercised his discretion, either against or in favour of the Beneficiaries", the tax liability of the donor would cease. What is envisaged by the section is an event until the happening of which the Beneficiaries shall not receive income, ie upon the happening of which the Beneficiaries will receive income. As the exercising of a discretion not to pay income will not result in the Beneficiaries receiving income, this can in my opinion clearly not constitute an event within the meaning of the section. In my opinion the event contemplated by the section ie a Trustee's discretion, will only be the exercising of a Trustee's discretion to distribute income to the Beneficiaries. To suggest that a Trustee could possibly exercise a discretion not to distribute income to the Beneficiaries, and thereby avoid tax himself and in the hands of the Beneficiaries is patently against the intention of the sub-section, and in my view ridiculous. In any event in practise a Trustee will seldom exercise such a discretion against the Beneficiaries, as the withholding of trust income from the Beneficiaries will in most cases be a continuing state of affairs, subject only to distribution on the Trustee's positive resolution so to do.

The further submission by Counsel that the question "is not whether the occurrence of the event resulted in the Beneficiaries receiving any income, but whether the event before the occurrence of which they were not entitled to receive income had in fact occurred" is in my view equally

fallacious. The question is clearly not whether the Beneficiaries received income, as the Trustees may still, despite deciding to vest income to the Beneficiaries, decide to withhold payment thereof (in which case Section 7(1) will be applicable) until some time in the future. The question is however whether the occurrence of the event would result in income being received by or accruing to the beneficiaries.

It is however correct to state that the question is whether the event before the occurrence of which they were not entitled to receive income had in fact occurred. The logical sequelae of this statement however must in my view be that once the "event" has occurred, the Beneficiaries will be entitled to the income and accordingly again the event can only be a positive resolution by the Trustees to distribute to the Beneficiaries. If the Trustees decide not to so distribute, then clearly the Beneficiaries are still not entitled to receive income, and accordingly no event as envisaged by the sub-section can have occurred. The income will accordingly be withheld, and subject to Section 7(5).

For the above reasons I am of the view that the problems envisaged by the Taxpayer's Counsel in **Dempers** are not valid reasons for precluding the exercising of a discretion from being an event for the purposes of the sub-section.

In **SIR v Sidley 1977 (4) SA 913 AD** (decided shortly after **Dempers**) the Court was faced again with an argument regarding the question of whether the exercising of a discretion was an event for the purposes of the section. As in **Dempers**, the Deed provided for distribution on the occurrence of a future event (actually 3 events, being the donor's death, the death of his wife and the attainment of age 30 by the donee), and furthermore provided that income generated from the assets was to be utilised by the Trustees for the benefit of the Beneficiaries, but that the Trustees could in their discretion withhold such payment.

The Court as in **Dempers** left the question of whether the exercising of the discretion of the Trustees was an event open, due it said to no argument having been advanced against the anomalies referred to by Counsel in the **Demper's** matter (see hereinbefore) and due to the fact that there were other occurrences provided for in the Deed which constituted events as envisaged by the section (namely the happening of the above 3 events).

In **Sidley** Counsel for the tax payer sought to distinguish the facts from **Dempers** on the grounds that in **Dempers** the Deed provided that the Beneficiaries not receive income until the happening of the events, whereas in **Sidley** the donee did receive the income unless the Trustees decided to withhold the income, which Counsel contended took the case outside the ambit of Section 7(5). The Court rejected this argument as being erroneous, and unduly technical in stressing form over substance. The

Court held that in substance the Deed provided that the income could be devoted for the maintenance etc of the Beneficiaries, but that he or she should not receive it until the Trustees determine in their absolute discretion not to withhold it. As a true event was in any event the 3 occurrences above, the Deed fell within Section 7(5).

This argument although coming to the correct conclusion, is in my submission open to attack. In my view it cannot be said that on a proper construction of the clause the net income of the Trust would not accrue to the Beneficiaries until the Trustees decided in their absolute discretion not to withhold it. The Deed envisaged an ongoing accrual to the Beneficiaries, subject to a resolution by the Trustees not to pay such monies out ie a resolute condition as opposed to a suspensive one. Accordingly it is my submission that the Deed did not envisage a positive resolution in favour of the Beneficiaries but a negative one against them. The proper approach in my view would be to treat the Deed as such, and regard the income subjected to an accumulation by the exercise of the Trustee's discretion as being subject to Section 7(5) ie being withheld pending an event (the 3 occurrences). The income not subjected to accumulation is not withheld, and accordingly accrues to the Beneficiaries and is subject to tax in their hands in the normal course. On the authority of **Dempers** this would not therefore have been subject to the provisions of Section 7(5). The approach in my view reaches the same conclusion as the Court in **Sidley**, in a manner consistent with **Dempers**, instead of

resorting to a substance over form approach to the Deed, which in my view gives the Deed a meaning not intended by the draftsman. Prior to the end of the tax year in question and to the exercising or failure to exercise the discretion by the Trustees, the income could not have been said to have accrued to the Beneficiaries, as it cannot be said that they are unconditionally entitled to it. The accrual is subject to a resolute condition namely that the Trustees may exercise their discretion to withhold the income.

In the case of **ITC 1033 1964 Taxpayer, 30; 26 SATC 73**, decided in the Cape Income Tax Special Court, the Court was faced with a trust deed providing for the application of the income to the Beneficiaries to be entirely in the discretion of the Trustees ie a Discretionary Trust proper, not providing future distribution to be subject to any fixed future event in addition to the exercising of the discretion of the Trustees. The Court could accordingly not follow the options taken by the AD in the **Dempers** and **Sidley** case vis a vis the future event, and had to consider whether the exercising of the Trustee's discretion was an event or not.

The Court referred to the decision of **Hulett v Commissioner of Inland Revenue 1944 NPD 263** where it was held as follows:

"As I interpret the document the Beneficiaries are not entitled to claim payment of 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".

The Court accordingly had no trouble in finding that the exercising of a Trustee's discretion was an event, **Herbstein J** holding as follows:

"The word event is one of wide significance and its ambit is increased by the addition of the words "whether fixed or contingent". In principle there does not appear to be any reason why the exercising of the Trustees of a discretionary power should not be "an event" which according to the Oxford dictionary is "the fact of a thing's happening" or "thing that happens".

There is nothing in the sub-section which would justify the Court in cutting down the generality of this meaning Clauses 4(d) and 4(e) clearly have the effect of making the receipt of income by the Beneficiaries dependant on a decision by the Trustees to distribute, instead of capitalising it. Unless and until there is such a decision the Beneficiaries have no right to any portion of the income. If and when a decision to distribute income is taken, the Beneficiaries "alive at the time" become entitled to that portion of the income covered by the decision".

Accordingly the Court, after considering the other requirements of sub-section (5), considered the retained income to have been properly included within the donor's assessment.

In my submission there can be no objection to the logic expressed in the above case. Furthermore I, for the reasons referred to above, do not believe that the anomalies referred to in the **Demper's** case will in fact result if such a view is taken. What is envisaged by the section is that there will be a withholding of income in a Trust, which will be withheld until a future happening ie after the happening the income will no longer be withheld in the Trust but will be distributed to the Beneficiaries, or credited to their trust accounts. Where vesting is discretionary and the Trustees do not exercise their discretion, the income will be withheld in the trust, and the Beneficiary will have no claim thereto. Section 7(5) will apply to that income. Once the happening has occurred ie the Trustee has exercised his discretion, the income will no longer be held in the Trust, but will be distributed to the Beneficiaries, taxed in their hands, and will fall outside the ambit of Section 7(5). This accords with the clear meaning of the section, and I submit there is no reason to depart therefrom.

The mischief which the section seeks to address is, as per **Corbett JA** in **Dempers at 421 E**:

"The avoidance of tax liability where and so long as the donor does not permit the Beneficiary of the gift to enjoy immediately the income to be derived therefrom. In each case avoidance is prevented by the income in question being deemed to be that of the donor".

It would in my opinion, bearing in mind the manifest object of the legislature in enacting the sub-section, be absurd to consider that a Trustee's discretion is not an event, thereby allowing the Trustees, at will, to accomplish precisely what this section seeks to prevent.

This is precisely what **Corbett JA** stated in **Dempers** at **427 B - D** (although not referring to the Trustee's discretion as being an event); *"Finally I would simply add that any other conclusion would lead to the somewhat curious result that while Section 9(5) would clearly apply to a Trust whereunder the trust income was absolutely withheld from the ultimate Beneficiaries and accumulated for a defined period, it would not apply generally speaking to a trust in terms of which, again for a defined period, the Trustees were empowered, at their discretion either to withhold and accumulate income or to pay it to the Beneficiaries. While each case must obviously be considered on its individual merits, the latter is a form of trust which frequently occurs and having regard to the general object of the enactment, it seems unlikely that the legislature would have intended to exclude such a transaction from the operation of Section 9(5)".*

While the above argument was not specifically aimed at whether a discretion is an "event", it is in my view an entirely appropriate summing up of the position.

In conclusion therefore I am of the view that the word "event", (which is according to the Concise Oxford English Dictionary "the fact of anything happening") is of wide enough import to include the exercise of a Trustee's

discretion. This view in my opinion clearly accords with the intention of the legislature in enacting Section 7 (5), and to hold otherwise would unquestionably allow the Section to be circumvented with ease. I do not, for the reasons stated hereinbefore believe that any of the anomalies referred to by Counsel in **Dempers** will occur, or that there is any reason to interpret the Section otherwise than in accordance with its clear meaning.

G. IS "VESTING" NECESSARY FOR THE OPERATION OF SECTION 7(5)?

In **Jewish Colonial Trust Limited v Estate Nathan** (supra) **Watermeyer CJ** observed that the word "vest" is used *"to draw distinction between what is certain and what is conditional; a vested right is distinguished from a conditional right"*.

In **Durban City Council v Association of Building Societies 1942 AD 27** at **33 Watermeyer CJ** defined the word "contingent" as opposed to "vested" as *"(contingent) is used to describe the conditional nature of someone's title to the right"*.

D V Cowen, in an article written in the **1950 South African Law Journal p 404 at 407** refers to a view held by **Austen** which was referred to with approval by **Watermeyer CJ** in the **Jewish Colonial Trust case**, namely:

"When we oppose a vested to a contingent right, we are not opposing a right of one class to a right of another class, but we are rather opposing a right to the chance or possibility of a right".

This approach is in my submission true of the distinction between a vesting and a non-vesting trust, when on the one hand the beneficiaries acquire a right which is certain, while on the other hand they acquire only a contingent right, or *"the chance or possibility of a right - a hope or spes of a right"*.

A contingent right, is according to **Cowen** to be distinguished from a right which has simply been postponed, which is not necessarily contingent at all. In **Jewish Colonial Trust (supra) at 176 Watermeyer JA** explains the difference in relation to a Will, and after stating that rights (in a Will) to be enjoyed in the future may either be vested or contingent, states as follows:

"Such a future right is vested if the beneficiary is determined, and his ownership of the right is unconditional; it is contingent if his ownership of it is conditional upon some uncertain event".

Cowen states further, in my view correctly, that vested rights can be divided into two distinct classes, namely those coupled with a present right to enjoyment, and those coupled with a future right to enjoyment.

If one considers Counsel's argument in the **Dempers** case, there is in my view no logical basis for arguing that the beneficiaries must have "a vested right" to the benefits of the Trust. Aside from the use of the word "contingent" in this section (which is in my opinion conclusive proof of the intention of the Legislature), the section refers to "the beneficiaries thereof, or some of them" in the first instance, and thereafter to "the beneficiaries" in the second instance, both times using the plural of beneficiary. There is nothing in the section in my submission, to suggest that the second use of the word "beneficiaries" means anything more or less than the same beneficiaries referred to in the first instance, ie "beneficiaries or some of them".

Furthermore, if the beneficiaries have to have a vested right to bring the subsection into operation, let us consider the implications of vesting in a Discretionary Trust. Vesting occurs, on the authority of **Jewish Colonial Trust** (*supra*) on the acquisition of a right which cannot be defeated.

In a Discretionary Trust there can in my submission be two types of vesting namely:

- (1) Where the beneficiary receives the income (*dies venit*); or
- (2) Where the Trustees vest income or capital in the beneficiary, but re-invest it on his behalf ie no payment is actually made (*dies credit*,

sed nodum venit) (see Jewish Colonial Trust (supra) and D V Cowen Vested and Contingent Rights 1949 66 SALJ 404 at 413).

In the former case, in my submission **Section 7(5)** can clearly not apply, as the income is no longer withheld and will be taxed in the hands of the beneficiary. As stated above, this Section only in my view targets undistributed income.

The question of vesting and Section 7(5) was considered in the case of **ITC 1328, 1981 Taxpayer 86**. The facts were that the Trust Deed concerned provided that from the date which the Beneficiary turned 21 years the income in the Trust fund would accrue to the Beneficiary, but that the Trustees would have the unfettered discretion as to whether to pay the said sums out, or to re-invest same on her behalf. Net income which was not paid out was included by the Commissioner in the donor's income in terms of Section 7(5), and the donor objected on the grounds that as the income had accrued to the Beneficiaries, Section 7(1) applied and consequently Section 7(5) had no application. The Commissioner on the other hand contended that Section 7(1) only applied where the Beneficiary had acquired a vested right to the income, that no such vesting had occurred, and accordingly Section 7(5) was applicable.

The Court held that the Beneficiaries on attaining 21 acquired an immediate right to the income, although the enjoyment thereof was postponed until the exercise of the Trustee's discretion, and that accordingly as it was not a

necessary legal consequence of vesting that the Beneficiary should have the legal right to claim payment, vesting had in fact occurred. As vesting had occurred, Section 7(1) was applicable, and as the Act did not envisage double taxation, Section 7(5) was not applicable.

In Case (2) above, the income falls squarely within the ambit of Section 7(1), and in my view, following the line of reasoning of **ITC 1328 (supra)** the presumption against double taxation precludes such income from being taxed in the hands of the donor.

Furthermore, if one considers the first, "hypothetical" portion of the sub-section, it is my opinion clear that in most cases the stipulation itself will preclude any form of vesting to the beneficiary, the stipulation being one precluding the receipt of income until the happening of a future certain or contingent event. As most future certain events will in any event still render receipt of income to a beneficiary contingent upon the beneficiaries' survival of such event, even in the case of a certain future event many beneficiaries' entitlement to income will also be contingent. On Counsel's argument, the vast majority of Trusts, whether discretionary or not, would, if vesting was a requirement for the operation of the Section, fall outside of the ambit of Section 7(5). This cannot have been the intention of the legislature.

Furthermore, Section 7(5) applies to such income "as would but for the stipulation or condition have accrued to the beneficiary". Income which

would have accrued to the beneficiaries is income to which the beneficiaries have a vested right in terms of Section 25 B(1) or Section 25 B(2) (on the exercise of a Trustee's discretion). This can in my view only mean that Section 7(5) applies to only undistributed income to which the beneficiary has no vested right. Therefore Section 7(5) can only apply where the beneficiary has a contingent right ie before vesting has occurred.

Accordingly it is my view that vesting is not a pre-requisite for the operation of the Section.

In fact, it is my opinion that where vesting has occurred, this will specifically take the matter outside of the ambit of Section 7(5), as where the income has vested, but is withheld, Section 7(1) will be applicable, thereby deeming the income to be that of the beneficiaries. (**See ITC 1328 supra**). I accordingly disagree with **Corbett J A's** conclusion that the acquisition of a vested right by a beneficiary will be a strong, if not a decisive factor in determining whether but for the stipulation, the income would have been received by the beneficiaries. As stated above, in my view a vested right precludes Section 7(5) from applying.

I have one further criticism of an aspect of **Corbett JA's** judgment in the **Demper's case**, which although not strictly speaking relevant to the vesting argument, is linked thereto. It is accordingly in my view convenient to include it under this heading.

Counsel argued in the **Demper's case** that as the income could also have been paid out by the Trustees to various ecclesiastical and charitable institutions, it accordingly could not be said that in the absence of the stipulation, the income would have accrued to the beneficiaries, and accordingly this Section could not apply. I cannot follow the logic of this argument.

In any Discretionary Trust, where the Trustees can determine in what proportions, and to which of the beneficiaries the benefit will accrue, there can be no vesting to the beneficiaries until he has exercised his discretion. However, one thing that is certain is that once he has exercised his discretion (provided it is a positive resolution), vesting will occur in favour of at least one of the beneficiaries. I can find nothing in this section to suggest that any particular beneficiary (or all for that matter) would have to have received the income in the absence of the stipulation in order for the sub-section to be applicable.

The income with which the section is concerned, is withheld income - that is the purpose of the section - namely to allocate undistributed income to the donor. There can be no logical reason in my view for this section to be held not applicable, simply because one particular beneficiary may not have acquired the income had it not been for the stipulation. In the light of this, I fail to understand why it was necessary to go to the lengths that **Corbett JA** did to find that "John" was dominantly the object of the

Appellant's bounty and to ignore the charitable institutions for the purposes of this argument. It seems to me that there is nothing in the section to suggest that it should not have been applicable even had John not been the object of the Appellant's bounty. There is still unquestionably a donation, as a result of which income is received, which income is subject to a stipulation that the beneficiaries, or some of them shall not receive same until the happening of an event. Accordingly any income which would, but for the stipulation have accrued to the beneficiaries, would be taxable in the hands of the donor. In the event of the income accruing to the charitable institutions, this would still in my view, constitute an accrual to a beneficiary, which as it is withheld until the happening of the event, falls within the ambit of Section 7(5).

Corbett JA in his judgment states that the question is "*whether in the absence of the stipulation withholding trust income, this income would have been received by or have accrued to the beneficiary*". I can see no reason why this beneficiary had to be John, and could not have been one of the charitable institutions.

H. CONCLUSION

I agree, with some qualification, with **Meyerowitz's** summing up of the current position in terms of Section 7(5), where at **16.147** he states as follows:

- (a) Where a Trust Deed provides that the income or any portion thereof which is not paid out in the year of receipt or accrual (either because the Deed prevents this or leaves it to the Trustee's discretion) shall be accumulated until the happening of some fixed or contingent event, there is a stipulation which falls within Section 7(5) ie that the accumulated income shall not be received by the Beneficiaries until the happening of the event.

- (b) Where such a stipulation exists, the accumulated income is deemed to be the donors, if in the absence of the stipulation the income would, (on a general reading of the Deed) have accrued or have been received by the Beneficiaries. Section 7(5) will not apply where the Beneficiary has a vested right to the income - here Section 7(1) will apply deeming it to be the Beneficiary's income. (As stated above, I do not agree that it is necessary to subject the Deed to a "general reading", as only beneficiaries can at the end of the day benefit, thus in my view satisfying the subsection)

- (c) Current income paid out to the Beneficiaries during the year of assessment by the Trustee in the exercise of his discretion is not deemed the donor's income in terms of Section 7(5);

- (d) Income deemed the donor's does not become income in the hands of the Beneficiaries when subsequently paid to them.

For the reasons stated above, I disagree with the finding by Corbett JA in **Dempers** that a "vested right" is a decisive factor in considering the applicability of Section 7(5), and with his view that there was some weight to Counsel's argument that the exercise of a Trustee's discretion is not an event in terms of Section 7(5).

I. TAX PLANNING AND SECTION 7(5)

From a tax planning point of view it is my submission that should a drafter wish to preclude the taxation of trust income in the hands of the donor in terms of Section 7(5), then the beneficiaries should in the deed acquire vested rights to the capital and income, the Trustees in the Trust being empowered to re-invest or accumulate the income on behalf of the beneficiaries in their sole discretion. This will essentially provide the Trustees with the discretionary power to deal with the assets/income on behalf of the beneficiaries and retain same in the trust, but will exclude the possibility of any income generated being deemed that of the donor.

However, the above arrangement will also have the effect of removing the inherent flexibility sought by many in a discretionary trust and will provide beneficiaries with an "unassailable right", which many donors will wish to

avoid. Furthermore, "generation skipping", a goal primary in many drafters' minds is also precluded, as vesting will have occurred. A prudent tax planner will accordingly have to weigh up the wishes of the donor against the tax implications thereof, before committing himself to the above route.

It would however in my view be preferable to leave vesting in the discretion of the Trustees. The Trustee can then simply vest the income in any of the beneficiaries on the last day of the year, and preclude Section 7(5) from deeming such income to be that of the donor. If the Trustees thereafter have the right to accumulate the income on behalf of the beneficiaries, without paying it over, Section 7(5) will have been avoided, without losing the flexibility of taking vesting outside of the Trustees' discretion.

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