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The taxation of income and expenditure of Trusts in South Africa

- Are they still viable estate planning tools?

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Contents

Introduction	3
Section A	5
The background of Trusts.....	5
Definitions	5
Requirements of a valid trust	9
Advantages and Disadvantages of South Africa Trusts	14
Contractual capacity	19
<i>Contracts into before the appointment by the Master</i>	19
<i>The Turquand Rule</i>	20
<i>Other contractual formalities</i>	23
SECTION B	24
TAXATION OF TRUSTS	24
1. Income Tax.....	24
2. Donations Tax.....	32
3. Transfer duty.....	36
4. Capital Gains tax	37
SECTION C	40
Conclusion	40

Introduction

The multitude of diverse purposes to which trusts are put in today's ever changing legal and commercial environment, bear testimony to the trust's adaptability and usefulness.¹ Trusts are employed by estate planners and asset managers to effect the prudent disposition of property, either *inter vivos* or upon death; trusts feature in the fiscal strategy of many individuals and corporate entities; businessmen frequently elect to structure business ventures as trusts rather than companies, close corporations or partnerships; companies utilise trusts to secure the interests of shares and debenture holders.² The most common reasons for setting up a trust are: to protect the assets of your minor children, to reduce the amount of estate duty which may be payable in your estate, to protect your assets in the event of your insolvency and to administer assets for charitable purposes. But recently trusts have received some bad press, due to various changes in tax legislation as well as the proposals announced by the finance minister Pravin Gordhan in his Budget Speeches of both 2012 and 2013.

In his 2012 budget speech, Minister Gordhan issued a warning to trustees, advisors and tax practitioners, saying that: "Poor tax compliance is also apparent in respect of trusts and in parts of the construction sector, and the role of tax practitioners and other intermediaries will come under scrutiny." One can therefore only guess that it is this poor compliance and South African Revenue Service's (SARS) perception that trusts are used for tax avoidance that is driving its most recent scrutiny of trusts.

In the Budget Review of 2013, the following comments in regards to trusts were made: 'to curtail tax avoidance associated with trusts, government is proposing several legislative measures during 2013/2014. Certain aspects of local and offshore trusts have long been a problem for global tax enforcement due to their flexibility and flow-through nature. Also of concern is the use of trusts to avoid estate duty, which will be reviewed.

¹ F. du Toit *South African Law of Trusts Principles and Practice* (2006) 1

² Ibid

The proposals will not apply to trusts established to attend to the needs of minor children and people with disabilities.’³

With all these changes in tax legislation and proposals affecting trusts, one question arises: can trusts still be considered as good vehicles for ‘tax avoidance’?

It seems that the days are gone where individuals could place all their assets in a trust to avoid paying tax and transfer duty on fixed property. With the introduction of Capital Gains tax, having one’s home in trust meant that you cannot utilise the R2 000 000 rebate on your primary residence.⁴

This research paper will explore the taxation of the income and expenditure in today’s day and age. We will have an in-depth look into the mechanics of trusts, to ascertain whether they still have a role to fulfill in estate planning. Therefore the paper will first explore the background in trusts in Section A, Section B will deal with how trusts are tax and Section C will try and answer why trusts are still popular amidst the unfavourable changes in recent legislation.

³ Francois van Gijsen ‘What will happen to trusts now after the 2013/2014 South African budget?’ Available at <http://www.read.gaaaccounting.com>

⁴ Maya Fischer-French ‘Be cautious about trust funds.’ Available at <http://www.mg.co.za/article/2005-10-14-be-cautious-about-trust-funds>

Section A

The background of Trusts

The common law trust was introduced to South Africa after the second British Occupation of the Cape in 1806.⁵ The South African law readily received the trust as an institution but proved less perceptive to English law pertaining to trusts.⁶ The English trust was incorporated into the South African legal system not through legislative intervention, but by, for example, English trained practitioners who drew up wills and deeds creating trusts by using English terminology.⁷ As a result the South African courts were called upon to interpret these English institutions. By explaining trusts with reference to Roman Dutch law, the South African courts have over the years created unique South African trust law which bears little resemblance to its current English law counterpart.⁸

In the strict sense a trust exists when the founder of the trust has handed over or is bound to hand over to another the control of the property⁹ which, or the proceeds of which, is to be administered or disposed of by the other (trustee) for the benefit of some person other than the trustee as beneficiary or some impersonal object.¹⁰ A trust in this sense creates a fiduciary obligation. In the wide sense a trust exists whenever someone is bound to hold or administer property¹¹ on behalf of another or for some impersonal object and not for his or her own benefit.¹² Such a person has at the minimum a duty to keep the property administered separate from personal property¹³ and to avoid a conflict of interest with the beneficiary or the trust object.¹⁴

Definitions

The relevant portion of the 1985 Hague Convention is entitled *Law Applicable to Trusts and on Their Recognition* was signed on 1 July 1985. This convention defines the term 'trust' as 'the legal relationship created – inter vivos or on death- by a person,

⁵ F. du Toit *South African Law of Trusts Principles and Practice* (2006) 1

⁶ Ibid

⁷ Michael Honiball and Lynette Olivier *The Taxation of Trusts in South Africa* (2009) 2

⁸ Ibid

⁹ Edwin Cameron et al *Honore's South African law of Trusts* 5ed (2002) note 8 at 4

¹⁰ Ibid

¹¹ Ibid

¹² Ibid

¹³ Ibid

¹⁴ Ibid

the settlor, when assets have been placed under control of a trustee for the benefits of a beneficiary or for a specified purpose'.¹⁵

Statutory definition

In 1988 the legislature intervened for the first time to regulate the use of a trust, by the introduction of the Trust Property Control Act 57 of 1988. In this Act, a trust is defined as:

'the arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeaths –

- (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 66 of 1965.¹⁶

'trust instrument' means a written agreement or a testamentary writing or a Court order to which a trust was created.¹⁷

'trust property' or **'property'** means movable or immovable property, and includes contingent interests in property, which in accordance with the provisions of a trust instrument are to be administered or disposed of by a trustee.¹⁸

Parties to a trust

There are three parties to the trust, namely:

¹⁵ Michael Honiball and Lynette Olivier op cit (note 7) 3

¹⁶ Trust Property Control act 57 of 1988 s1

¹⁷ Ibid

¹⁸ Ibid

Founder/Settlor/ Donor– this is the party who creates the trust. A trust cannot be established without the donor and although the donor plays an important role, it is in most cases very short-lived, because once the trust is created, the donor plays no role in the management of the Trust.¹⁹ Any trust founder who transfers property to a trust must relinquish at least some control over the property concerned.²⁰ A founder can be a trustee as well as a beneficiary, even the sole beneficiary of a trust.²¹

Trustee- is the party who holds and administers property received from the founder for the benefit of the trust beneficiary or in pursuance of an impersonal goal.²²

Although a trust can be administered by a sole trustee, it is advisable to appoint more than one trustee to conduct the affairs of a trust, particularly to ensure that the trust administration is not disrupted by a vacancy in the office of a trustee.²³ A trustee can be a beneficiary of the trust of which he is appointed. By virtue of the fact that a trustee holds and administers property for some person other than himself, a sole trustee may however not also be the sole beneficiary of the trust.²⁴ A trustee is party to a fiduciary relationship and is obliged to conduct the administration of trust property in accordance with the terms of the trust deed and the duties imposed on him by law.²⁵

Beneficiary – is the party who derives a benefit from the creation of a trust by the founder and the administration of trust property by a trustee.²⁶ A general distinction can be drawn between income and capital trust beneficiaries. The former benefit from the income or proceed generated by the trustee's administration of trust property, whereas the latter benefit from the trust property or capital itself, usually upon termination of the trust.²⁷ A trust need not necessarily serve the interests of trust beneficiaries, but can also be created in order to achieve some impersonal object stipulated by the founder. An impersonal trust object is a particular feature of many charitable trusts.²⁸

¹⁹ F. du Toit op cit (note 5) 4

²⁰ Ibid

²¹ Ibid

²² Ibid

²³ Ibid

²⁴ Ibid

²⁵ Ibid

²⁶ Ibid

²⁷ F. du Toit op cit (note 19) 6

²⁸ Ibid

Depending on when the trust takes effect, a trust can broadly be categorised as either an inter vivos or a mortis causa trust.²⁹ Apart from the broad distinction, a trust may also be categorised as either a vested or discretionary trust.³⁰ From an income tax point of view, it is vital to determine whether the nature of a beneficiary's right to income received by or accrued to a trust whose beneficiaries have vested rights are taxed in the hands of the beneficiary and not in the hands of the trust.³¹

Vested Trusts – in general terms a vested or vesting trust refers to a trust in which the beneficiaries have vested rights to the income or capital, ie the trustees have no discretion as to whether to distribute trust income or capital to them.³² A vested trust does not mean that ownership of the trust assets vests in the beneficiaries, ownership of the assets still vests in the trustees, but for example income beneficiaries have a vested right to the income.³³ Should a beneficiary pass away before the income accrues to him or her, the right to the income falls into his or her deceased estate.³⁴ The same holds true for vested capital beneficiaries: ownership of the trust assets still vests in the trustees, they merely have certainty that when the trust comes to an end, the assets will be distributed to them.³⁵ The mere fact that the trust is a vesting trust does not mean that the beneficiaries are immediately entitled to the trust income.³⁶ A trust can still be regarded as a vesting trust when beneficiaries do not have the immediate right to enjoy the income, but the income is accumulated or capitalised by the trustees to be enjoyed by the beneficiaries in the future. In *Hilda Holt Will Trust v CIR*³⁷ the facts were that the testatrix created a trust from the residue of her estate, directing that a beneficiary be paid an annuity from the income and if the income is insufficient, the trust capital be used. Three tax exempt institutions would be entitled to the income (in fixed percentages) and to the capital after the death of the annuitant.³⁸ As the capital beneficiaries were tax exempt institutions it was of vital importance to establish whether they had vested or

²⁹ Michael Honiball and Lynette Olivier op cit (note 7) 4

³⁰ Ibid

³¹ Ibid

³² BA Van der Merwe ' Meaning and Relevance of the Phrase 'Vested Right ' in Income Tax Law SA Merc LJ 2000 319

³³ Michael Honiball and Lynette Olivier op cit (note 7) 5

³⁴ Ibid

³⁵ Ibid

³⁶ Ibid

³⁷ 1992 (4) SA 661 (A)

³⁸ Michael Honiball and Lynette Olivier op cit (note 7) 6

discretionary rights.³⁹ The problem the court was dealt with on the basis that, if the annuitant's right was of a usufructuary nature, then the rights vested in the capital beneficiaries.⁴⁰ However if the annuitant's right were of a fideicommissary nature, the capital beneficiaries would have discretionary rights.⁴¹ The court held that that the annuitant's rights were not of a fiduciary nature, but of a usufructuary nature and, due to the considerable wealth of the estate, the testatrix only saw it as a remote possibility that the trust capital would be used to supplement the annuity.⁴² The annuitant thus had no right to the capital and therefore her interest could not be seen of a fiduciary character, she was in effect a usufructuary, and the capital beneficiaries were the ultimate owners.⁴³ The mere fact that the extent of the ultimate bequest to the charities was not fixed, did not in itself make the bequest conditional.⁴⁴

Discretionary Trusts – refers to a trust where distribution of income and capital to beneficiaries is within the discretion of the trustees.⁴⁵ The fact that a beneficiary has a discretionary right does not mean that he/she does not have a right but only a mere *spes*.⁴⁶ A discretionary beneficiary does indeed have a right, but he/she does not have a right to ownership of the trust property.⁴⁷

Requirements of a valid trust

A trust need not be in writing to be valid. The Trust property Control Act is only applicable to trust reduced to writing.⁴⁸ However, to avoid any uncertainty and disputes regarding the exact contents of the trust deed, it is advisable that the trust terms be reduced to writing.⁴⁹

³⁹ Michael Honiball and Lynette Olivier op cit (note 7) 6

⁴⁰ Ibid

⁴¹ Ibid

⁴² Ibid

⁴³ Ibid

⁴⁴ Ibid

⁴⁵ Ibid

⁴⁶ Ibid

⁴⁷ Ibid

⁴⁸ Michael Honiball and Lynette Olivier op cit (note 7) 7

⁴⁹ Ibid

Typically, one of the following ways creates a trust:

1. A written trust document created by the founder and signed by both the founder and the trustees (often referred to as an inter vivos trust or living trust)⁵⁰;
2. An oral declaration⁵¹;
3. The will of a decedent, usually called a testamentary trust; or a court order (for example in family proceedings).⁵²

According to Coertze the requirements for a valid trust are: ⁵³

1. The founder has the intention to create a trust⁵⁴
2. Which intention is expressed in a mode appropriate to create a trust;⁵⁵
3. The trust object, property and beneficiaries are indicated with sufficient certainty; and ⁵⁶
4. The trust object is lawful.⁵⁷

For a valid trust to be created: ⁵⁸

- (a) *The founder must intend to create one-* the intention to create a trust in the strict sense⁵⁹ is whereby the founder intends that the transferee should hold an office⁶⁰ by virtue of which duties attaching to the office will descend to a successor in office rather than to the deceased trustee's executor.⁶¹ Such a person is to purely hold the property in an administrative capacity.⁶² The

⁵⁰ Cameron op cit (note 9) at 118

⁵¹ Ibid

⁵² Ibid

⁵³ L I Coertze *Die Trust in die Romeins-Hollandse Reg* (1948) 117

⁵⁴ Ibid

⁵⁵ Ibid

⁵⁶ Ibid

⁵⁷ Ibid

⁵⁸ Cameron op cit (note 9) at 117

⁵⁹ Cameron op cit (note 9) at 118

⁶⁰ Ibid

⁶¹ Ibid

⁶² Ibid

intention to create a trust between living persons (inter vivos) must be shared by the founder and the prospective trustee.⁶³

The legal effect of lack of intention to create a trust:

When the testator or donor uses words that are held to be indefinite,⁶⁴ so that an intention to create a trust is lacking, the effects depends on whether the testator or donor intended to benefit the person to whom the property was given.⁶⁵ If the intention to benefit was present, the supposed trust is disregarded and the legatee or donee takes free of any burden.⁶⁶ If, on the other hand the person to whom the property is given is not intended to be a beneficiary,⁶⁷ the gift is invalid and may be recovered by the founder or his estate.⁶⁸ If the intention to create a trust is lacking because the trustee is insufficiently independent,⁶⁹ the maxim that the real transaction prevails over the apparent one applies and the transaction is construed as agency, partnership, sale etc according to the intention of the parties.⁷⁰

(b) *Expression of intention in a mode apt to create an obligation* – the intention to form a trust must therefore be contained in either a will, contract, court order, statute or treaty⁷¹

(c) *A definition with reasonable certainty of the trust property* – whatever for the trust subject to a particular trust takes, it is essential that such property be determined with reasonable certainty.⁷² Failure to adequately identify the subject-matter of the trust will render the trust invalid.⁷³

(d) *The object of the trust must be defined with reasonable certainty* – the beneficiaries of the trust must be clearly identified or at least be ascertainable.⁷⁴ Should this not be the case the trust will fail for want of a certain object.⁷⁵ If the founder

⁶³ Ibid

⁶⁴ Cameron op cit (note 9) 137-138

⁶⁵ Ibid

⁶⁶ Ibid

⁶⁷ Ibid

⁶⁸ Ibid

⁶⁹ Ibid

⁷⁰ Ibid

⁷¹ Ibid

⁷² F. du Toit op cit (note 5) 30

⁷³ Ibid

⁷⁴ Ibid

⁷⁵ Ibid

intends his trust to attain an impersonal object, he must stipulate such object with sufficient certainty.⁷⁶

Charitable trusts are however traditionally construed benevolently by South African courts.⁷⁷ Therefore, if the charitable intent of the trust founder is beyond doubt, the trust will be maintained despite an omission to define its object with the precision otherwise required.⁷⁸ However, this lenient approach to charitable trusts has its limits beyond which it may not be pressed.⁷⁹ In *Re Estate Grayson*⁸⁰ a testator attempted to create what appeared to be a charitable trust. The terms of the trust were however stated in exceedingly vague terms.⁸¹ The Court held the trust to be invalid as the testator failed to impose a binding obligations to create a trust on his executors. It has however been argued that, had a charitable trust deserving of a benevolent construction indeed been at hand in casu, the trust object and more particularly, the steps to be taken in order to realise the object, were not defined with sufficient precision by the testator so as to ensure its effective execution.⁸² The trust in the Grayson case might there well have failed on an alternative ground, namely by virtue of an imprecise indication of its object.⁸³

(e) *Lawfulness of the trust object* –the trust object will be unlawful if it is illegal, contrary to public policy or *contra bonos mores*.⁸⁴ It is important to understand that the object of the trust is not always the same as the purpose of the trust.⁸⁵ It is possible to have a lawful object of a trust, but that the trust can be used for illegal purposes.⁸⁶ Such a trust would not be rendered invalid, but rather that all transactions entered into will be rendered void or voidable in terms of the law of contract.⁸⁷ A factor which determines if the object is lawful, is public policy. This is especially relevant when the object of the trust is to

⁷⁶ Ibid

⁷⁷ F. du Toit op cit (note 5) 31

⁷⁸ F. du Toit op cit (note 5) 32

⁷⁹ Ibid

⁸⁰ 1937 AD 96.

⁸¹ Ibid

⁸² Ibid

⁸³ Ibid

⁸⁴ Ibid

⁸⁵ <http://www.bissetts.com/the-objects-of-a-trust/>

⁸⁶ Ibid

⁸⁷ Ibid

benefit a charity that is created in terms of a will.⁸⁸ Normally there is a tug of war between the principles of freedom of testation & the right as set out in our Bill of Rights.⁸⁹ In the case of *Minister of Education v Syfrets Trust*⁹⁰, the testator provided that a charitable trust be created upon his death, in terms of which bursaries would be given to students at the University of Cape Town. However, the only students who were white, male and non-Jewish could apply.⁹¹ An application was brought by the Minister to have the discriminatory provisions set aside and the Court granted an order removing the limitations based on race, gender and religion, so that the objects of the trust were in line with the Constitution.⁹² However this decision was somewhat criticised by in the 2009 case of *Ex parte BOE Trust*.⁹³ The court in this case held that where an object is severable from the rest of the trust instrument, such provisions must be struck down, and if not, the entire trust instrument must be set aside.⁹⁴ Based on the decision in the *BOE Trust* case, a court cannot vary provisions of a trust instrument as it deems fit, as was done in the Syfrets matter.⁹⁵ Section 13 of the Trust property Act⁹⁶ now regulates how the provisions of a Trust deed should be varied. This section states that the Court may only vary the provision of a trust deed is:

1. The trust founder could not have foreseen that public policy would change; and
2. The consequences of the provision would hamper the achievement of the object of the Trust, be prejudicial to the trust beneficiaries, or one contrary to public policy.

⁸⁸ Ibid

⁸⁹ Ibid

⁹⁰ 2006 (4) SA 205 (C)

⁹¹ *Minister of Education v Syfrets* supra (note 101)

⁹² Ibid

⁹³ 2009 (6) SA 470 (WCC)

⁹⁴ Ibid

⁹⁵ Ibid

⁹⁶ Act 66 of 1965

Advantages and Disadvantages of South Africa Trusts

Advantages:

(a) Few regulatory requirements:

- Although Section 4 of the Trust Property Control Act⁹⁷ provides that the trust document must be lodged with the Master, the trust itself does not have to comply with any drafting or formation formalities. In essence, by accepting trust documents, the Master's office merely acts as a registry for the recording of trust deeds;⁹⁸
- Unlike in the case of a company director, no restrictions or limitations exist on who may be appointed as a trustee, although in practice the Master requires that at least one trustee be an accountant or other financially competent person;⁹⁹
- No rules regulate the maintenance of trust capital;¹⁰⁰
- Trustees are not obliged to hold an annual general meeting with the beneficiaries;¹⁰¹
- Subject to the provisions of the trust deed, the distribution of the trust income is within the discretion of the trustees;¹⁰²

(b) Perpetual succession

- No limit exists on the duration of the trust, the period the trust will last is laid down in the trust¹⁰³
- A change in trustees does not have any effect on the existence of the trust, although a simultaneous change of all trustees and all beneficiaries has been held to be the creation of a new trust (ITC 1699 63 SATC 75)¹⁰⁴

⁹⁷ Ibid

⁹⁸ Michael Honiball and Lynette Olivier op cit (note 7) 10-12

⁹⁹ Ibid

¹⁰⁰ Ibid

¹⁰¹ Ibid

¹⁰² Ibid

¹⁰³ Ibid

¹⁰⁴ Ibid

(c) Limited Liability

- Unlike the position of many offshore jurisdictions, one of the biggest advantages of a South African trust is that the trustees are only liable for the debts of the trust in their representative capacity.¹⁰⁵

(d) Flexibility – Drafting or amending the trust deed is relatively free of formalities, e.g. provided that the provisions are not *contra bones mores* and that the requirements for a valid trust are complied with, a founder may freely express his or her wishes in a trust deed.¹⁰⁶ A founder may provide for the number of trustees as well as whether the trust will be a vested or discretionary trust. The trust deed may also be amended subsequent to the formation of the trust as long as it is done with the agreement of the founder while he or she is still alive or with the agreement of the beneficiaries who have accepted the benefits.¹⁰⁷

(e) Asset protection- one of the main advantages of a trust is that trust assets are kept separate.¹⁰⁸ However, it should be noted that where the trustees do not properly manage the affairs of the trust, the court will not hesitate to sequester the trust so that the trust will no longer provide asset protection benefits which the founder thought it would provide.¹⁰⁹ In *Nel NO v Cilliers*¹¹⁰ an individual was the sole trustee of two trusts, the AL2 Vervoer Trust and the Cilliers Family Trust. The main asset of the Cilliers Family Trust was a game farm which the trust funded via a loan from AL2 Vervoer Trust. The affairs of the Trust were not managed by the trustee, but by her husband. During the course of managing the affairs of the trust, the husband paid moneys to himself and made loans to a fictitious Close corporation, which funds presumably also found their way into his own pocket. When the Cilliers Family Trust started running into financial difficulties, the husband, without the authority and against the interests of the beneficiaries, disposed of the trust's major asset, the game farm. The high court did not hesitate to grant an order for sequestration of the estate of the trust.¹¹¹

¹⁰⁵ Ibid

¹⁰⁶ Ibid

¹⁰⁷ Michael Honiball and Lynette Olivier op cit (note 7) 12

¹⁰⁸ Ibid

¹⁰⁹ Ibid

¹¹⁰ [2008]ZAFSHC 22

¹¹¹ Ibid

- (f) No audit required – although section 15 of the Trust Property Control Act imposes a duty on a person who audits a trust, to report irregularities, no duty exist to appoint an auditor for the trust.¹¹²

Disadvantages:

- (a) Lack of regulation – the fact that trusts are mainly unregulated leads to their biggest disadvantage.¹¹³ Due to the fact that the South African trusts are not a common-law institution, persons using a trust can never predict how disputes arising from the trust will be settled.¹¹⁴
- (b) Negative tax consequences – trusts have always been used to obtain tax benefits.¹¹⁵ The legislature is well aware of this practice and is slowly but surely introducing legislation that eliminates the use of a trust to obtain certain tax benefits.¹¹⁶
- (c) Possible invalidity of the trust – founders of a trust are often not familiar with the requirements for a valid trust and sometimes want to retain control of trust assets.¹¹⁷ It may therefore be found that in such circumstances a valid trust does not exist.¹¹⁸ In addition to the possible invalidity of the trust itself, one or more clauses of the trust deed of a valid trust may be invalid.¹¹⁹ In *Minister of Education v Syfrets Trust Ltd NO and Another 2006 (4) SA 205 (C)*, the court was asked to express a view on the validity of clauses in the trust deed conferring benefits on a specified group of persons, namely males of European decent, who were not Jewish, to the exclusion of all other persons.¹²⁰ The court held that such provisions constituted unfair discrimination and as such were contrary to public policy.¹²¹

¹¹²Michael Honiball and Lynette Olivier op cit (note 7) 13-14

¹¹³ Ibid

¹¹⁴ Ibid

¹¹⁵ Ibid

¹¹⁶ Ibid

¹¹⁷ Ibid

¹¹⁸ Ibid

¹¹⁹ Ibid

¹²⁰ Ibid

¹²¹ Ibid.

Types of trusts:

- (a) Testamentary trust – sometimes referred to as a will trust such a trust is created in terms of the will of a deceased person.¹²² Because such a person is not alive at any time during the trust's existence the income falls to be taxed in the hands of either the trust or the beneficiaries.¹²³ A testamentary trust is taxed on the income it retains and its beneficiaries are taxed on the income it distributes.¹²⁴
- (b) Inter Vivos Trust – this trust is formed by a living person. Which means that such founder could be liable for tax on income received by the trust.¹²⁵ Once the founder has died it is obviously no longer possible to tax the founder.¹²⁶ In such a case the trust and the beneficiaries will be the only taxpayers subject to tax.¹²⁷ By virtue of the fact that the inter vivos is created by *stipulatio alteri*, the acquisition of rights by the trust beneficiaries is governed by contractual principles.¹²⁸ The creation and revocation of inter vivos trusts and the acquisition of rights by the beneficiaries under them are regulated by the rules of contract.¹²⁹ There exist two types of contracts, namely
- A contract between the donor and the trustee¹³⁰. Here the trustee accepts the duties imposed upon him/her in terms of the trust deed¹³¹ and the trustee acquires formal ownership of the trust assets subject to the terms prescribed in the trust deed.¹³²
 - A contract between the trustee and the beneficiaries¹³³. Here the trust benefits are offered to the beneficiary by the trustee and accepted by the beneficiary.¹³⁴

¹²² Phillip Haupt *Notes on South African Income Tax* 32ed (2013) 795

¹²³ Ibid

¹²⁴ Ibid

¹²⁵ Ibid

¹²⁶ Ibid

¹²⁷ Ibid

¹²⁸ F. du Toit op cit (note 5) 36

¹²⁹ 'General trust infor' Available at http://www.graaffs.co.za/general_trusts.htm [Accessed on 13 January 2014]

¹³⁰ Ibid

¹³¹ Ibid

¹³² Ibid

¹³³ Ibid

¹³⁴ Ibid

- (c) Vested trusts – this refers to a trust in which the beneficiaries have vested rights to the income and the capital, in other words the trustees have no discretion as to whether to distribute trust income or capital to them.¹³⁵ A vested trust does not mean that ownership of the trust assets vests in the beneficiaries, ownership still vests in the trustees.¹³⁶ Should a beneficiary pass away before the income accrues to him or her, the right to the income fall into his or her deceased estate.¹³⁷
- (d) Discretionary trusts – refers to a trust where distribution of income and capital to the beneficiaries is within the discretion of the trustees.¹³⁸
- (e) Special Trusts – Section 1 of the Income Tax Act 58 of 1962 paragraph (a) of the definition of special trust reads that the trust is created solely for the benefit of one or more persons with a disability as defined in Section 6B1 where such a disability incapacitates such person or persons from earning sufficient income for their maintenance, or from managing their own financial affairs: Provided that
- aa) such trust shall no longer be deemed to be a special trust, if the person for whose benefit the trust was created died and
 - bb) where such trust was created for the benefit of more than one person, all persons for whose benefit the trust was created must be relatives to each other.¹³⁹

This type of trust can be created inter vivos or testamentary.

Paragraph (b) determines that a trust created by or in terms of a will of a deceased person, solely for the benefit of the beneficiaries who are relatives in relation to the deceased person & who are alive on the date of death of the deceased person (including any beneficiary who has been conceived but not yet born on that date) where the youngest of whose beneficiaries is on the last day of the year of assessment of that trust under the age of 18 years.¹⁴⁰ The benefit of being classified as a special trust is that for income tax purposes the

¹³⁵ Michael Honiball and Lynette Olivier op cit (note7) 5-7

¹³⁶ Ibid

¹³⁷ Ibid

¹³⁸ Ibid

¹³⁹ Income Tax Act 62 of 1962

¹⁴⁰ Ibid

rate will not be fixed at 40%, but the sliding scale that varies from 18% to 40% that is applicable to individuals.¹⁴¹

Contractual capacity

Trustees are co-owners of trust property, in the absence of provision to the contrary in the trust deed, no single trustee can take binding decisions. Trustees must act jointly, must consult with each other and must strive to reach an agreement.¹⁴²

Contracts into before the appointment by the Master

In terms of section 6(1) of the Trust Property Control Act, a trustee may only act on behalf of a trust once he or she has been authorised by the Master of the High Court to do so.¹⁴³ The true meaning of Section 6(1) came under scrutiny in a couple of court cases. In *Simplex v Van der Merwe* 1996 (1) SA 111(W), the validity of a sales agreement entered into by trustees on behalf of the trust was being contested.¹⁴⁴ Although the trustees had already been appointed by the Master as trustees and had already accepted the appointment by the time the agreement was concluded, the necessary authority to act as trustees had only been granted by the Master almost three months after the signing of the lease agreements. It was argued on behalf of the trustees that the prohibition in Section 6(1) was directory and not peremptory.¹⁴⁵ The Court, however did not share their view and argued that the phrase 'shall act' clearly is of a peremptory nature, indicating an unambiguous prohibition on acting as a trustee until authorised by the Master to do so.¹⁴⁶ In *Kropman and Others v Nysschen* 1999 (2) SA 567 (T) the court was faced with a similar question. Without reference to the *Simplex* decision, it was found that the object of section 6(1) was to protect the interests of the trust.¹⁴⁷ As a result, acts performed by trustees prior to their authorisation by the Master were not necessarily void.¹⁴⁸ The overall test was whether or not the interests of the trusts were prejudiced.¹⁴⁹ If, on the facts, the trust was not prejudiced by

¹⁴¹ Professor Keith Jordaan et al *Silke: South African Income Tax* (2010) 659

¹⁴² Michael Honiball and Lynette Olivier op cit (note 7) 16

¹⁴³ Ibid

¹⁴⁴ Ibid

¹⁴⁵ Ibid

¹⁴⁶ Ibid

¹⁴⁷ Ibid

¹⁴⁸ Ibid

¹⁴⁹ Ibid

failure to comply with the provisions of section 6(1), it was possible retrospectively to validate the unauthorised acts.¹⁵⁰In *Van der Merwe v Van der Merwe* 2000 2 SA 519 (K) the court looked at both these decisions, whereupon it found that the *Simplex* decision to be the correct one.¹⁵¹The court found that it is a well-established principle that the word 'shall' is indicative of the fact that actions performed in contradiction are, in fact, void and not merely invalid.¹⁵²As a result, action taken prior to the necessary authorisation cannot be ratified retrospectively.¹⁵³

The Turquand Rule

Currently it is a moot point whether the so-called Turquand rule is applicable to trusts.¹⁵⁴This rule is well established in company law and was originally laid down by the Exchequer Chamber in *Royal British Bank v Turquand* 1856 6E and B 327; 1943-1860 ALL ER 435.¹⁵⁵The rule which states that an innocent third party who contracts with a company may assume that all internal formalities have been complied with was accepted with approval in a company law context in numerous South African cases.¹⁵⁶The Turquand rule, however, would not apply if the third party was aware that the internal requirements had not been met or where action taken was prohibited by the founding documents of the company.¹⁵⁷In such circumstances, the third party is no longer deemed innocent and as a result, his or her interests cannot outweigh those of the company.¹⁵⁸In essence, the Turquand rule is a rule of equity, and justification for its existence is found in the fact that an outsider dealing with a company is not in a position to establish whether the internal requirements have indeed been satisfied.¹⁵⁹Although it is an undisputed fact that the Turquand rule applies to companies, the South African courts were confronted with the issue whether the rule also applies to trusts.¹⁶⁰In *Vrystaat Mielies (Pty) Ltd v Nieuwoudt* ¹⁶¹ the facts were that C & W concluded an

¹⁵⁰ Michael Honiball and Lynette Olivier op cit (note 7) 17

¹⁵¹ Ibid

¹⁵² Ibid

¹⁵³ Ibid

¹⁵⁴ Michael Honiball and Lynette Olivier *The Taxation of Trusts in South Africa* (2009) 18-19

¹⁵⁵ Ibid

¹⁵⁶ Ibid

¹⁵⁷ Ibid

¹⁵⁸ Ibid

¹⁵⁹ Ibid

¹⁶⁰ Ibid

¹⁶¹ 2003 2 SA 262 (OPA)

agreement with Nieuwoudt (in his capacity of a trustee of the JJ Boerdery Trust) for the purchase of mealies from the trust.¹⁶² C and W subsequently ceded their rights under the agreement to Vrystaat mielies (Pty) Ltd.¹⁶³ The trust denied liability under the contract on the basis that it was void, as Nieuwoudt had no authority to bind it.¹⁶⁴ Under the trust deed, the trustees had broad powers to run the business of the trust, the deed provided that where there were more than two trustees; the majority of the trustees could bind the trust.¹⁶⁵ Where there were only two trustees, both had to act to bind the trust.¹⁶⁶ In the light of these facts Nieuwoudt was not authorised to bind the trust.¹⁶⁷ The applicant argued that the trust should be liable on the basis of the Turquand rule, as the absence of Nieuwoudt's contractual capacity was due to the non-compliance of an internal requirement.¹⁶⁸ The court a quo simply applied the decision in the *Man Truck and Bus Ltd v Victor*¹⁶⁹ and applied the Turquand rule and did not find it necessary to deal with one of the exceptions to the rule, namely where it is clear from the public documents that the person who acted did not have the authority to do so, despite the fact that the trust deed made it clear that where there were only two trustees (which appears to be the case on the facts), both had to act to bind the trust.¹⁷⁰ It is submitted that the correct application of the Turquand rule to the fact of that particular case would have clearly resulted in the rule being inapplicable.¹⁷¹ On appeal, the Supreme Court of Appeal had a golden opportunity to express an authoritative view on whether the Turquand rule did indeed apply to trust.¹⁷² As on the facts, however, the trust deed did not provide for a general but only a limited delegation of powers, namely where a document needed to be signed, it was held that the rule was not applicable.¹⁷³ As such the court refused to express a view on the applicability

¹⁶² Michael Honiball and Lynette Olivier op cit (note 7) at 21

¹⁶³ Ibid

¹⁶⁴ Ibid

¹⁶⁵ Ibid

¹⁶⁶ Ibid

¹⁶⁷ Ibid

¹⁶⁸ Ibid

¹⁶⁹ 2001 2 SA 562 (NKA) the facts were briefly that a managing trustee bound the trust as surety for the debts of another trust. The deed of surety was signed without the consent of the other trustee, however and without the trust deed authorising the trustees to stand surety. The High Court held that the Turquand rule could be applied to the trust

¹⁷⁰ Michael Honiball and Lynette Olivier op cit (note 7) at 21

¹⁷¹ Ibid

¹⁷² Ibid

¹⁷³ Ibid

of the Turquand rule.¹⁷⁴In a separate, but concurring judgment, Harms JA expressed concern as to the role of the Turquand rule as far as trusts were concerned.¹⁷⁵ As indicated above, no separate register of trust and trustees exist.¹⁷⁶A person who wants to inspect a trust deed has to apply to the Master for consent, which consent may be refused. In addition, a person dealing with trust should be aware of the fact that trustees have to act jointly in order to bind a trust.¹⁷⁷The result is that it will depend on the facts of each case whether, firstly, the trust deed provides for a delegation of authority and whether, secondly, the majority of trustees delegated the power to act.¹⁷⁸In *Land and Agricultural Bank v Parker*¹⁷⁹, the Supreme Court of appeal expressed an obiter view that the Turquand rule 'may well in suitable cases have a useful role to play in securing the position of outsiders who deal in good faith with trusts that concluded business transactions.¹⁸⁰ The impression is created that, as an equity principle, the Turquand rule should be applied to trusts.¹⁸¹If the rationale behind the Turquand rule is taken into account, namely that it is a rule of equity aimed at tempering the doctrine of constructive knowledge, there would be no reason why it should not apply to trusts.¹⁸²The rule cannot be applied without any limitations, however, and should be applied in conjunction with general trust rules. One of the basic trust rules is that a single trustee cannot bind a trust, unlike for example the case of a partnership, where every partner has the right to bind the other parties.¹⁸³It is settled, therefore that a trust cannot be bound by majority rule, but that all trustees have to act to bind it. The only instance in which the Turquand rule can, therefore, be applied within the trust context, is when all the trustees have acted but certain internal requirement have not been complied with.¹⁸⁴As such, it is submitted that the *Vrystaat Mielies* case was incorrectly decided, whilst the *Parker* case was correctly decided.¹⁸⁵In addition, the Turquand rule can only apply to trusts if the trust deed were freely available.

¹⁷⁴ Michael Honiball and Lynette Olivier op cit (note7) at 21

¹⁷⁵ Ibid

¹⁷⁶ Ibid

¹⁷⁷ Ibid

¹⁷⁸ Ibid

¹⁷⁹ 2005 (2) SA 77 (SCA)

¹⁸⁰ Michael Honiball and Lynette Olivier op cit (note7)at 22

¹⁸¹ Ibid

¹⁸² Ibid

¹⁸³ Ibid

¹⁸⁴ Ibid

¹⁸⁵ Ibid

This would mean that Section 18 of the Trust Property Control Act has to be amended to remove the requirement that only people who, in the master's opinion, have a sufficient interest may have access to the trust deed.¹⁸⁶ An application of the Turquand rule means that, in weighing up the various interests, the interest of third parties outweighs those of the trust beneficiaries. This should be seen in light of the fact that trusts can, on a large scale, be used as vehicles through which to conduct business, and not merely as vehicles through which to conduct, and not merely as vehicles through which to protect assets.¹⁸⁷

Other contractual formalities

Where other contractual formalities are required, these must be adhered to by the trustees in order to ensure that a valid contract comes into existence.¹⁸⁸ In the case of *Thorpe v Trittenwein* 2007 (2) 172 (SCA), the trust deed provided for three trustees, and one of these trustees signed an agreement of sale of immovable property as purchaser on behalf of the trust.¹⁸⁹ In South Africa, it is a requirement that all agreements for the purchase and the sale of immovable property must be in writing.¹⁹⁰ The trust sought a court order that the agreement was enforceable in circumstances where the seller had sold the property to a third party pending fulfillment of a suspensive condition.¹⁹¹ The court held that because one trustee had signed the agreement on his own, without the co-signature of the other trustees and without their written authorisation for him to sign on behalf of the trust, the contract was void.¹⁹² The court held further that the subsequent ratification in writing by the other trustees could not validate an invalid agreement.¹⁹³

¹⁸⁶ Michael Honiball and Lynette Olivier op cit (note 7) at 22

¹⁸⁷ Ibid.

¹⁸⁸ Ibid

¹⁸⁹ Ibid

¹⁹⁰ Ibid

¹⁹¹ Ibid

¹⁹² Ibid

¹⁹³ Ibid

SECTION B

TAXATION OF TRUSTS

As any asset manager or financial planner will attest, the trust is instrumental to the implementation of sound fiscal plans for estate owners.¹⁹⁴ Provided estate and financial planning are undertaken with the necessary knowledge and skill, some tax saving can usually be achieved through the utilisation of a trust.¹⁹⁵ However, the trust is by no means a prime vehicle for tax avoidance or tax saving.¹⁹⁶ In fact, in most cases where a trust is employed, tax saving is but a secondary consideration.¹⁹⁷

In the National Budget, tabled in Parliament on 27th February 2013, the Minister of Finance indicated that government was proposing several legislative measures regarding trust to curtail perceived tax avoidance associated with trusts.¹⁹⁸ The treasury also indicated its concern regarding the use of trusts to avoid estate duty which it intended to review.¹⁹⁹ It was pointed out that the proposals in the Budget would not apply to those trusts established to cater for the needs of minor children and people with disabilities, ie the so-called special trusts.²⁰⁰

1. Income Tax

In terms of section 1 of the Income tax act²⁰¹, income tax is levied on the income that is received by or accrues to a person, section 1 of the act further defines 'person' to include *inter alia* any trust. A trust is then defined as 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 a deceased person. Section 1 furthermore defines 'representative taxpayer' so as to include a trustee in respect trust income. We can thus infer from the definitions that a trust itself is a person (a taxable entity) for the purpose of

¹⁹⁴ F. du Toit op cit (note 5) at 131

¹⁹⁵ Ibid

¹⁹⁶ Ibid

¹⁹⁷ Ibid

¹⁹⁸ Beric Croome (ENS)' The future taxation of trusts' available at <http://thesait.org.za> [accessed 24 February 2014]

¹⁹⁹ Ibid

²⁰⁰ Ibid

²⁰¹ Act 58 of 1962

the Income Tax Act and the trustee is the representative taxpayer *vis-a-vis* the trust in respect of taxable trust income.

Not all trust income is taxable in the hands of the trustee.²⁰² The conduit principle dictates that income passing through a trust in favour of a beneficiary with a vested right to income, retains its identity as such and the trust merely serves as a conduit through which the income flows to the beneficiary.²⁰³ Two Appeal Court cases, *Armstrong v CIR* 1938 (AD) and *SIR v Rosen* (AD) held that income passing a trust retains its identity.²⁰⁴ The trust merely acts as a conduit pipe through which the income flows.²⁰⁵ Therefore, if the trust receives South African dividend income and distributes it to the beneficiary in the year of receipt, it retains its nature as a dividend, and is exempt from tax in the beneficiaries' hands.²⁰⁶ In *Rosen's* case the court held that, even where a beneficiary received an annuity from a trust, the income would still retain its identity so that if the trust had only dividend income, the full annuity received by the beneficiary would constitute the receipt of a dividend.²⁰⁷ There is one statutory exemption to the conduit principle, namely section 10(2).²⁰⁸ This section provides that notwithstanding the exemptions provided for in sections 10(1)(k) and 10(1)(h), these exemptions will not apply in respect of any portion of an annuity.²⁰⁹ Consequently the dividend exemption will not be available to a trust beneficiary if the dividends are paid out by way of an annuity.²¹⁰ Similarly, the interest exemption will not be available to a non resident trust beneficiary if the interest is paid out by way of an annuity.²¹¹

As mentioned before income tax is a tax on income received by or accruing to in favour of any person during the year of assessment, excluding receipts or accruals of a capital nature. In the case of a resident, the tax is levied on worldwide income, while in the case of a person other than a resident the tax is levied on income from a source within or deemed to be within the

²⁰² F. du Toit op cit (note 5) at 132

²⁰³ Ibid

²⁰⁴ Phillip Haupt op cit (note 122) at 805

²⁰⁵ Ibid

²⁰⁶ Ibid

²⁰⁷ Ibid

²⁰⁸ Michael Honiball and Lynette Olivier op cit (note 7) at 73

²⁰⁹ Ibid

²¹⁰ Ibid

²¹¹ Ibid

republic.²¹²In relation to a trust the word 'resident' means a trust established or formed in the Republic or which has its place of effective management in the Republic.²¹³

Section 25B: Income of trusts and beneficiaries of trusts

This section is the principal taxing section relating to trusts.²¹⁴ In essence the section provides that (subject to section 7) the income of the trust is taxed either in the trust or in the hands of the beneficiaries.²¹⁵ Consequently, the amount will either be taxed in the hands of the trust at the applicable trust tax rate or it will be taxed in the hands of the beneficiary at the beneficiary's tax rate.²¹⁶ Section 25B makes it clear that these provisions are subject to the provisions of section 7, the so-called tax back or attribution provisions.²¹⁷ Therefore, where any of the provisions of section 7 apply to tax the donors of assets donated to a trust on income derived by reason of or in consequence of such donation, section 25B will not apply.²¹⁸ The result is that the income will not be subject to taxation under both section 7 and section 25B.²¹⁹

The income of the beneficiary

In terms of Section 25B (2), where the beneficiary has acquired a vested right to any income in consequence of the exercise by the trustee of a discretion vested in him in terms of the trust deed, agreement or will of the deceased, such income shall be deemed to have been derived for the benefit of the beneficiary.²²⁰ The income accrues to the beneficiary when the right to receive it, whether presently or in the future is vested in him in the year of assessment, whether or not the income is actually paid to him in that year.²²¹ This means that it is the beneficiary and not the trustee that will be taxed on the income. In *Estate Munro v CIR* it was held that even if income

²¹² Edwin Cameron op cit (note 9) at 444

²¹³ Ibid

²¹⁴ Phillip Haupt op cit (note 122) at 796

²¹⁵ Ibid

²¹⁶ Michael Honiball and Lynette Olivier op cit (note 7) at 74

²¹⁷ Ibid

²¹⁸ Ibid

²¹⁹ Ibid

²²⁰ Cameron (note 9) at 446

²²¹ Ibid

from trust is not paid directly to the beneficiary but is expended by the trustee for his benefit, the income will be taxed in the hands of the beneficiary.²²² This rule also applies where the income is accumulated or capitalised or otherwise dealt with in the beneficiary's name.²²³ Where the beneficiary has a vested right to the income retained in the trust, section 7 (1) applies.²²⁴ This means that the beneficiary is certain to get the income at some time in the future, only his enjoyment of it has been postponed.²²⁵ If he dies before the income is paid out to him, it will go to his estate.²²⁶

The income of the trust

Amounts that are received by or accrue to the trustee are deemed to accrue to the trust and where the income is retained in the trust, it will be taxed in terms of section 25B, to the extent to which such income has not been derived for the immediate or future benefit of any ascertained beneficiary with a vested right to the income, in which case it will be taxed in terms of section 7(1).²²⁷

Section 7(5) is one of the most important tax back provisions, and applies to a donation, settlement or other disposition subject to a stipulation or condition, whether imposed by the donor or some other person, that some or all of the beneficiaries thereof shall only receive the income or a portion of the income upon the happening of some event, whether the event be fixed (certain) or contingent in nature.²²⁸ In such a scenario, so much of the income that would, but for the above-mentioned stipulation or condition, have accrued to the said beneficiaries, will, until the happening of such event or the death of the donor, whichever occurs first, be taxable in the hands of the donor.²²⁹ A typical event envisaged by this provision is the attainment of a certain age or the conclusion of a marriage by a beneficiary.²³⁰ The award of withholding of trust benefits at the discretion of a trustee also qualifies as an event for the purpose of the subsection.²³¹ Therefore, where a founder has made a donation

²²² *Estate Munro v CIR* 1925 TPD 693

²²³ *ibid*

²²⁴ Phillip Haupt *op cit* (note 122) at 803

²²⁵ *Ibid*

²²⁶ *Ibid*

²²⁷ Edwin Cameron *op cit* (note 9) at 451

²²⁸ *Ibid*

²²⁹ F. du Toit *op cit* (note 5) at 135

²³⁰ *Ibid*

²³¹ *Ibid*

towards the creation of a trust, the deed of which provides that the trust's beneficiaries are entitled to trust benefits only upon the exercise of a discretionary power of appointment in their favour by the trust's trustees, all income on all initial donation will be taxable in the hands of the founder.²³² However, should the trustees exercise the discretion, in consequence of which rewards stemming from the donation are awarded to beneficiaries in the year of assessment, the event as envisaged by section 7(5) will have occurred and the rewards will henceforth be taxable in the hands of the beneficiaries in terms of section 25B, unless of course any other subsection of section 7 dictates that someone other than the beneficiaries is to be taxed on such rewards.²³³ Any undistributed income will remain taxable in the hands of the donor.²³⁴

Section 25B(2) applies irrespective of the manner in which the trust was created, i.e. inter vivos by means of a trust deed, by agreement or as a testamentary trust.²³⁵ Section 25B(2) applies as long as the trustees have some discretion as to the vesting of either capital or revenue, or both, in the hands of the beneficiary. ²³⁶Section 25b(1) and (2) envisage an inquiry in three stages; firstly it has to be established whether received or accrued income is taxable in the hands of a particular individual in terms of section 7 of the act.²³⁷ If so, that individual is liable for payment of income tax on the received or accrued income.²³⁸ Secondly, if a beneficiary has received or is by virtue of a vested right entitled to income which has been received by or accrued to a trust, but which is not taxable under section 7, such income becomes taxable in the hands of the beneficiary.²³⁹ Finally, if all income has been received by or accrued to a trust, but is neither taxable under section 7, nor has any beneficiary received or is any beneficiary vested with a right to such income, the income is taxed in the hands of the trust of which the trustee is the representative taxpayer.²⁴⁰

²³² F. du Toit op cit (note 5) at 135

²³³ Ibid

²³⁴ Ibid

²³⁵ Michael Honiball and Lynette Olivier op cit (note 7) at 76

²³⁶ Ibid

²³⁷ F. du Toit op cit (note 5) at 133

²³⁸ Ibid

²³⁹ Ibid

²⁴⁰ Ibid

The income assessable to the donor

Section 7 of the Income Tax Act is essentially an anti-avoidance provision. Section 7 (1) provides that income shall be deemed to have accrued to a person, notwithstanding the fact that such income has been invested, accumulated or otherwise capitalised by such person or that such income has not been actually paid over to such person, but remains due and payable to him or has been credited in account or reinvested or accumulated or capitalised or otherwise dealt with in his name or on his behalf.²⁴¹

In terms of Section 7(2) any income received by or accrued to any person is deemed to be income accrued to such person's spouse in certain circumstances where the income was derived by the spouse in consequence of a donation, settlement or other disposition made by the other spouse.²⁴² The sole purpose of such donation must be to avoid the donor's liability for any tax payable but for such donation.²⁴³ This section is therefore an anti-avoidance provision which prevents spouses splitting income between them and thereby reducing their combined tax liability.²⁴⁴ In a trust context, this provision could apply if one spouse donates assets to a trust of which the other spouse is a vested beneficiary.²⁴⁵

In terms of section 7(3) income is 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, the income has been received by or accrued to or in favour of that child, or it has been accumulated for the benefit of that child.²⁴⁶ This provision applies if the parent sets up a vesting or discretionary trust for the benefit of his or her minor children, in which case the parent will continue to be taxed on the income, and not the trust nor the minor children beneficiaries of the trust.²⁴⁷

Section 7(4) renders income which has been received by or which has accrued to a minor child in consequence of a donation, settlement or other disposition made by another person, taxable in the hands of the such child's parent if the

²⁴¹ F. du Toit op cit (note 5) at 134

²⁴² Michael Honiball and Lynette Olivier op cit (note 7) at 84

²⁴³ Ibid

²⁴⁴ Ibid

²⁴⁵ Ibid

²⁴⁶ Ibid

²⁴⁷ Ibid

parent or his spouse has in turn made a donation, settlement or other disposition or has given some consideration, whether directly or indirectly, in favour of the donor or his family.²⁴⁸section 7(4) can ostensibly apply even after the death of the donor, for example A (who is married to C) make a donation to B and B reciprocates by effecting a donation for the creation of an inter vivos trust in favour of A and C's minor children.²⁴⁹ Section 7(4) will apply in this scenario, the income derived from the trust will be taxed in the hands of A during his lifetime and upon his death the trust income will be deemed to be C's by virtue of the fact that section 7(4) ascribes tax liability to the minor child's parent, irrespective whether that parent is the one who has affected the donation concerned or is the donor parent's spouse.²⁵⁰

The effect of section 7(5) is that it taxes the donor on income accumulated in a trust as a result or consequence of a condition and which is not paid out or distributed to the beneficiaries.²⁵¹Consequently, section 7(5) does not apply to current income paid out during the tax year of receipt or accrual by the trustee in the exercise of his discretion.²⁵²It was made clear in *Estate Dempers v CIR*²⁵³that if income is deemed to be that of a donor in terms of section n 7(5) and is taxed in the hands of the donor, it will not be taxed again in the beneficiary's hands when eventually distributed.²⁵⁴

Section 7(5) applies to any person who makes a donation, therefore some commentators have argued that the section applies to both residents and non-residents.²⁵⁵

A settlement on trustees in trust (in respect of an offshore trust) and a donation by the founder to trustees in trust (in respect of a South African trust) would both be gratuitous disposals of property to the trustees of the trust.²⁵⁶In *Joss v SIR*²⁵⁷it was indicated by Coetzee J that 'other dispositions'

²⁴⁸ F. du Toit op cit (note 5) at 135

²⁴⁹ Ibid

²⁵⁰ Ibid

²⁵¹ Michael Honiball and Lynette op cit (note 7) at 86

²⁵² Ibid

²⁵³ 1977 (3) SA 410 (A)

²⁵⁴ Michael Honiball and Lynette Olivier op cit (note 7) at 86-87

²⁵⁵ Ibid

²⁵⁶ Ibid

²⁵⁷ 1980 (1) SA 674 (T)

excluded transactions made for full value in money or money's worth and that there had to be an element of liberality.²⁵⁸ Consequently, the sale of an asset to the trustees of a trust at full market value would not be a donation, settlement or other disposition, even if the seller is the original settlor or founder of the trust.²⁵⁹ Furthermore, in *Ovenstone v SIR* 1980 AD (2) SA 721 (A), it was held that the words 'other disposition' should be interpreted as having the same meaning as donation or settlement.²⁶⁰ In other words the court held that the *eiusdem generis* or 'restrictive' interpretation rule should apply.²⁶¹ Consequently, a settlement on a trust would fall within the provisions of section 7, even if such amount is below the section 54 donation tax exemption threshold.²⁶² Further, the granting of an interest free loan to the trust, for example as a result of a sale of an asset on loan account for estate planning purposes is regarded as a continuing donation, especially where the relevant assets are income producing.²⁶³ Further applying the same reasoning, it is arguable that an interest free loan advanced to a beneficiary by a trust (as opposed to an interest-free loan advanced to the trust by the founder) is also a continuing donation, resulting in a donations tax liability for the trust and/or a section 7(5) tax back implication (applying section 7(5) because the trust earned such income as the beneficiaries had refrained from charging interest on their loan accounts.²⁶⁴ The better view however is that section 7(5) only applies to interest-free loans advanced to the trust because it is an anti-avoidance provision which seeks to tax the donor in circumstances where he does not want to be the donee to immediately enjoy the donation (estate *Dempers v SIR* 1977 (3) SA 410 (a) 39 SATC 95 at 1077).²⁶⁵ We can thus safely say that income of a discretionary trust which arises from a donation, settlement or other disposition will always be taxed in the hands of the donor in terms of section 7 (5) unless it is distributed to the beneficiary. Such income will only be taxed in the trust once the donor has died.

²⁵⁸ Michael Honiball and Lynette Olivier op cit (note 7) at 87

²⁵⁹ Ibid

²⁶⁰ Ibid

²⁶¹ Ibid

²⁶² Ibid

²⁶³ Ibid

²⁶⁴ Michael Honiball and Lynette Olivier op cit (note7) at 88

²⁶⁵ Ibid

Both section 7(5) and 7(8) require that the income be received by the trust as a consequence of the donation, settlement or other disposition. Section 7 therefore attempts to tax a person on the income generated by a trust on the gratuitous disposition made by that person, but only to the extent that there is a direct causal link between the donation and the income.²⁶⁶

Section 7(6) states that if a person makes a donation or an interest-free loan to a trust and the donor retains the power to vary or change the beneficiaries who are entitled to receive any income resulting from that donation or loan, then the income that is received by a beneficiary will be deemed to be that of donor for as long as the donor retains the power to vary or change the beneficiaries.²⁶⁷ Section 7(6) therefore applies when a person seeks to avoid or reduce tax by disposing of an income-producing asset while retaining control over the income generated from that asset.

Special trusts

As mentioned previously a special trust is taxed at the same progressive tax rates that apply to natural persons, but without being entitled to claim the normal tax rebates contained in section 6 of the income tax act.

2. Donations Tax

Donations tax is not a tax on income, but a tax on the transfer of assets.²⁶⁸ Under section 54 to 64 of the Income Tax Act²⁶⁹ deals with donations tax.²⁷⁰ It imposes a tax on persons who may want to donate their assets in order to avoid income tax and estate duty.²⁷¹ Donation tax is payable on the value of any property disposed of under any donation by a resident.²⁷² An individual will be resident if he or she is ordinarily resident or is a resident pursuant to the so-called physical presence test.²⁷³ Donations tax does not apply to non-residents even if they donate South African assets.²⁷⁴ Section 55 states that a donation is any gratuitous disposal of property or any gratuitous waiver or renunciation of a right.²⁷⁵ The common law meaning of the term 'donation'

²⁶⁶ Michael Honiball and Lynette Olivier op cit (note 7) at 88

²⁶⁷ Ibid

²⁶⁸ Phillip Haupt op cit (note 122) at 734

²⁶⁹ 58 of 1962

²⁷⁰ Phillip Haupt op cit (note 122) at 734

²⁷¹ Ibid

²⁷² Phillip Haupt op cit (note 122) at 735

²⁷³ Michael Honiball and Lynette Olivier op cit (note 7) at 176

²⁷⁴ Phillip Haupt op cit (note 122) at 735

²⁷⁵ Income Tax Act 58 of 1962

requires sheer liberality or disinterested benevolence on the part of the donor, with the donor becoming impoverished & the donee becoming enriched.²⁷⁶In *CSAR v Welch's Estate*²⁷⁷ the question was whether the fact that the statutory definition does not refer to liberality or disinterested benevolence means that a donation for the purposes of donations tax is different to what is understood under the common law as a donation.²⁷⁸The facts of the case were that a trust was formed to administer maintenance payments. Assets were transferred to a trustee to use the income that the assets produced to comply with maintenance obligations. The Tax court held that as the transferor did not receive any quid pro quo from the trustees for the transfer of the assets, he made a donation for the purposes of section 55.²⁷⁹The decision was reversed on appeal. In *Welch's Estate v CSARS* 66SATC 303, the Supreme Court of Appeal held that although the word 'donation' has been defined for purposes of donations tax, it still carries its common law meaning of a disposition motivated by 'pure liberality' or 'disinterested benevolence'.²⁸⁰If the legislature intended to do away with the common-law meaning of the term, it would have done so in cleared terms.²⁸¹The result is that donations tax is not payable merely because a donor is impoverished and the donee is enriched.²⁸²A donation only exists where the disposition was not made to comply, for example, with a legal obligation.²⁸³ For a disposition to be regarded as a donation, it has to have been motivated by pure liberality or generosity.²⁸⁴ In a trust context this means that where, for example, a trust is set up to comply with the donor's statutory duty to provide for minor children after divorce or upon death, the donor will not only be liable for donations tax.²⁸⁵

The person liable to pay the tax is the donor, but if the donor fails within three months of the donation taking effect, the donor and the donee are jointly and

²⁷⁶ Michael Honiball and Lynette Olivier op cit (note 7) at 177

²⁷⁷ Ibid

²⁷⁸ Ibid

²⁷⁹ Ibid

²⁸⁰ Ibid

²⁸¹ Ibid

²⁸² Ibid

²⁸³ Ibid

²⁸⁴ Ibid

²⁸⁵ Ibid

severally liable for the tax.²⁸⁶In a trust context this means that a South African resident trust has to account for donations tax on all gratuitous disposals made by it.²⁸⁷Donations tax is also payable by the founder if a trust is set up by a donation.²⁸⁸In addition, the beneficiary may also be liable for donations tax in circumstances where such beneficiary renounces his or her rights as a trust beneficiary for an amount which is less than the market value of the right.²⁸⁹

Exemptions from donations tax

Section 56 provides for several exemptions from donations tax. The aim of successful estate planning, therefore, is to reduce the value of an estate during the taxpayer's lifetime without attracting any donations tax.²⁹⁰

The following exemptions apply specifically to trusts:

- (a) Casual gifts – donations tax is not payable by a trust in respect of casual gifts made by a trust outside the context of the trust deed that does not exceed R10 000 in value per tax year.²⁹¹
- (b) Maintenance – donations tax is not payable in respect of so much of any bona fide contribution made towards the maintenance of any person, other than the beneficiary of the trust, as the commissioner considers to be reasonable.²⁹²This exemption is not restricted to natural persons and is therefore available to trusts.²⁹³ In *ITC 1119 30 SATC 159* it was held that the recipient of the maintenance paid by the trust set up by a former spouse cannot claim the exemption provided for under section 10 (1)(u) as the exemption is only available if the maintenance was paid by a spouse or former spouse.²⁹⁴He opposite view was reached in *ITC 1584 57 SATC 63*. In

²⁸⁶ Phillip Haupt op cit (note 122) at 734

²⁸⁷ Michael Honiball and Lynette Olivier op cit (note 7) at 176

²⁸⁸ Ibid

²⁸⁹ Ibid

²⁹⁰ Ibid

²⁹¹ Section 56(2)(a)

²⁹² Section 56(2)(c)

²⁹³ Michael Honiball and Lynette Olivier op cit (note 7) at 178

²⁹⁴ Ibid

terms of which the donee will not obtain any benefit thereunder until the death of the donor²⁹⁵

- (c) Donation *mortis causa* – although a trust is not a separate entity under South African common law, the assets donated to it will not form part of the deceased estate of the donor.²⁹⁶ This however, only holds true for *inter vivos* trusts.²⁹⁷ Where the trust only comes into existence on the donor's death (ie trusts *mortis causa*), the assets donated to such trust still forms part of the deceased estate for estate duty purposes. As these assets will be subject to estate duty, a donation *mortis causa* is exempt from donations tax under section 56(1)(c) of the Act.²⁹⁸
- (d) Donations under which the donee will not obtain any benefit until the death of the donor – it is trite law that a testator is free until death to revoke his or her will.²⁹⁹ This right is known as the right of free testation.
- (e) Donations pursuant to a trust – section 56(1)(l) provides for an exemption if such property is disposed of and in pursuance of any trust.³⁰⁰ This exemption would only apply in respect of distributions made by the trustees to the beneficiaries in accordance with the relevant will or trust deed, and not, for example, donations to other persons, nor would it apply to the amount which the founder or settlor settles on the trust to found the trust, or subsequently.³⁰¹

²⁹⁵ Michael Honiball and Lynette Olivier op cit (note 7) at 178-179

²⁹⁶ Ibid

²⁹⁷ Ibid

²⁹⁸ Ibid

²⁹⁹ Ibid

³⁰⁰ Michael Honiball and Lynette Olivier op cit (note 7) at 183

³⁰¹ Ibid

3. Transfer duty

Transfer duty is an indirect tax paid on the acquisition of fixed property in South Africa.³⁰² Property is valued for transfer duty purposes either when the consideration is payable by the person who acquires the property, at the amount of the consideration or when no consideration is payable, at its declared value.³⁰³

Transfer duty is payable by the purchaser and has to be paid within six months of the date of acquisition of the property.³⁰⁴ Transfer duty varying from 0 to 8 percent is payable on the value of any property acquired.³⁰⁵ A legal person (such as a company) or a trust pays transfer duty at the same rate as natural persons with effect from 23 February 2011.³⁰⁶

No duty is payable:

- (i) In respect of a change in the registration of property acquired as a result of the termination of the appointment of an administrator of a trust under a will or other written instrument or of a trustee of an insolvent estate;³⁰⁷ or
- (ii) When a trust has been founded by a natural person for a relative as defined in the Estate Duty Act, roughly one within the third degree of that relative³⁰⁸; or
- (iii) Where trust property is restored by the trustee of an insolvent estate to the insolvent³⁰⁹

For the exemption to apply not only must the trustee transfer the property to the beneficiary but the transfer must be made in pursuance of the written instrument under which the trustee was appointed.³¹⁰ The transfer of one property by one trustee to another trustee is also exempt.³¹¹

³⁰² Phillip Haupt op cit (note 122) at 986

³⁰³ Ibid

³⁰⁴ Ibid

³⁰⁵ Ibid

³⁰⁶ Ibid

³⁰⁷ Section 9(4)(a) of the Transfer Duty Act

³⁰⁸ Section 9(4)(b)

³⁰⁹ Section 9(4)(c)

³¹⁰ Cameron op cit (note 9) at 488

³¹¹ Cameron op cit (note 9) at 489

4. Capital Gains tax

A trust is a non-natural person therefore 66.6% of the net capital gain is included in taxable income unless it is a special trust.³¹² Parts X and XII of the 8th Schedule have provisions which deem the trust's income to be taxable in the hands of the donor or s beneficiary.³¹³

A trust will have a disposal for capital gains tax purposes in one of the two ways: either by concluding a transaction for the disposal with a third party (for example the sale of a trust asset to a third party) or by vesting a trust asset in a beneficiary (par11(d) of the 8th schedule).³¹⁴ A transaction with a third party at arm's length will result in a normal capital gain calculation.³¹⁵ When an asset vests in a beneficiary, the proceeds will be deemed to be the market value, as the trust and the beneficiary are connected persons and the base cost for the trust will usually be the value when the trust acquired the assets, either by way of a bequest, donation or purchase.³¹⁶ Paragraph 80, which is subject to paragraphs 68,69,71 and 72 provides that if a trust distributes an asset to a beneficiary (who is a south African resident), the gain made by the trust on the disposal of that asset is taxable in the beneficiary's and not in the hands of the trust.³¹⁷ This is subject to anti-avoidance provisions where the beneficiary is a spouse (paragraph 68) or minor child (paragraph 69).³¹⁸ A distribution of an asset by a trust give rise to a capital gain, because the distribution is a disposal for the purposes of paragraph 11, and the beneficiary is a connected person in relation to the trust, so the asset is deemed to have been disposed of by the trust at market value.³¹⁹ This paragraph also provides that if the trust sells an asset and makes a capital gain, it is not taxed on the gain if it vests the gain in a South African beneficiary.³²⁰ The beneficiary is taxed o the gain instead, if the gain is vested in the beneficiary in the same year it arises.³²¹ If only a portion of the capital gain is vested in the beneficiary, he or she is taxed on that portion, with the rest being taxed in the trust.³²²

³¹² Phillip Haupt op cit (note 122) at 911

³¹³ Ibid

³¹⁴ Ibid

³¹⁵ Ibid

³¹⁶ Ibid

³¹⁷ Ibid

³¹⁸ Ibid

³¹⁹ Ibid

³²⁰ ibid

³²¹ Ibid

³²² Ibid

There are a few exceptions to this rule:

- if the gain is vested in a non-resident beneficiary, the trust is taxed.³²³
- if the gain is vested in a tax-exempt public benefit organisation, or tax-exempt recreational club, or in the Government or any provincial administration, the trust is taxed.³²⁴
- If the gain is vested in any entity exempt from tax in terms of section 10(1)(b),(cA),(cE),(d), or (e) the trust is taxed³²⁵
- A trust cannot distribute a gain which it has acquired from another trust³²⁶

Paragraph 70 deals with gains retained in the trust and are worded in much the same way as section 7(50) of the Income Tax Act, which deals with income earned and retained by the trust.³²⁷ If a South African resident makes a donation, settlement or similar disposition to a trust and the trust makes a capital gain as a result of that donation or disposition, the resident is taxed on the capital gain, instead of the trust if the gain is not distributed or vested to a beneficiary who is a South African resident.³²⁸ This is beneficial if the resident is an individual as only 33.3% of the gain is taxed of the 66.6% that would be taxed if the gain was taxed in the trust's hands and if the resident is a natural person, the capital gain is further reduced by the annual exclusion.³²⁹ Further advantage can be taken where the gain is vested in multiple natural person beneficiaries, all of whom are entitled to the R30 000 annual exclusion.³³⁰

Paragraph 71 is similar to the normal income provisions in section 7(6), so if a distribution of the capital gain is made by a beneficiary and the creator of the trust has the right to revoke the beneficiary's right to the capital distribution, then the donor is taxed on the gain so distributed.³³¹

³²³ Phillip Haupt op cit (note 122) at 911

³²⁴ Ibid

³²⁵ Ibid

³²⁶ Ibid

³²⁷ Phillip Haupt op cit (note 122) at 914

³²⁸ Ibid

³²⁹ Ibid

³³⁰ Ibid

³³¹ Ibid

Paragraph 72 deals with capital gains distributed by a trust to a non-resident.³³² Basically if the gain can be attributed to a gratuitous disposition made by a South African resident, then the South African resident is taxed on the gain instead of the non-resident or the trust.³³³

Paragraph 73 states that where both an amount of income and capital gain are derived by reason of, or are attributable to a donation, settlement or other disposition then the capital gain attributed to the 'donor' may be limited to what the trust earned by reason of the fact that the donor did not charge a market related rate of interest.³³⁴

Reduction or waiver of a debt owing by the trust (paragraph 12(5)) - this paragraph provided that where a debt owed by a person (the debtor) to a creditor has been reduced or discharged by that creditor for no consideration or for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged the debtor will be treated as having acquired a claim to so much of that debt as was reduced or discharged, which will have a base cost of nil and be treated as having disposed of that claim to proceeds equal to that reduction or discharge.³³⁵

Effective from 1 March 2013, any reference to paragraph 12(5) has been deleted and a new paragraph 12 A came into law. The new paragraph 12A has been inserted to deal with the reduction or cancellation of debts and implies that amounts may be waived by the executor of a deceased estate without CGT becoming payable but this section has not been tested by our courts and should be interpreted with caution.³³⁶

³³² Phillip Haupt op cit (note 122) at 914

³³³ Ibid

³³⁴ Ibid

³³⁵ Interest Free Loans - The situation post March 2013" available at <http://www.schoemanlaw.co.za/wp-content/uploads/2013/06/interest-free-loans-the-situation-post-march-2013>

³³⁶ Ibid

SECTION C

Conclusion

Estate Planning is an important exercise aimed at increasing, preserving and protecting assets during a person's lifetime and providing for the disposition and continued utilisation of these assets after his death. The minimisation of estate duty often however dominates the motivation behind estate planning and many tools, structures and techniques used as part of the estate planning exercises are aimed at reducing or avoiding estate duty. One of these tools is the trust and more specifically a discretionary inter vivos or testamentary trust.³³⁷ The reason why is so, is that a vested right to trust capital, as well as vested right to income, clearly falls within the definition of property for estate duty purposes.³³⁸

Once the trust is in existence, a popular estate planning mechanism is for the trustees to make loans to the beneficiaries rather than make distributions to them.³³⁹ In this manner, the amount advanced as an asset remains an asset of the trust and does not form part of the dutiable property of the beneficiary.³⁴⁰

Trusts remain a very useful estate planning tool if set up and managed properly. The unique feature of a trust as has been pointed out in this document is the separation of legal and beneficial ownership.

Many clients and financial advisors focus only on the estate duty saving achieved by transferring growth assets to a trust. This potential benefit should never be considered apart from the other tax and non-tax advantages and disadvantages of trusts.

The fact that trusts are receiving more scrutiny from SARS should not deter financial advisors from recommending them as useful estate planning tools. What is imperative is that the trust is set up properly and that the founder and trustees have an understanding of the legislation and adhering thereto. It is up to the trustees whether the scrutiny from the courts and SARS will affect them or not. As long as trustees remain aware of their fiduciary duties and ensure that the trust is administered correctly by ensuring that regular trustee meetings are held, that all decisions are recorded and that the trust's accounting and tax affairs are up to date.

³³⁷ Michael Honiball and Lynette Olivier op cit (note 7) at 198

³³⁸ Ibid

³³⁹ Michael Honiball and Lynette Olivier op cit (note 122) at 201

³⁴⁰ Ibid

When considering a trust as an estate planning tool, it is important to remember that a best advice and best practice approach should be followed, ensuring that a trust is structured with the primary objective of providing certainty for the succession and protection of assets.

In today's environment, the only downfall of a trust, is where it is structured as a silo to provide one single solution as opposed to it being a keystone to a well conceptualized and implemented estate plan taking into account the individual's assets, lifestyle and obligations together with the needs both currently and in the future of the individual and his or her family.

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