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Rudd, Reinhard, (2017) The taxation of trusts: a comparative study of South Africa and the United Kingdom, University of the Witwatersrand, Johannesburg, https://hdl.handle.net/10539/27035

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UNIVERSITY OF THE WITWATERSRAND
School of Accountancy

THE TAXATION OF TRUSTS: A COMPARATIVE STUDY OF SOUTH AFRICA AND THE UNITED KINGDOM

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2017

A research report submitted to the Faculty of Commerce Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree Master of Commerce (specialising in Taxation)

Declaration:

I hereby declare that this research report is my own original work and that all the sources have been reported and acknowledged. It is submitted for the degree of Master of Commerce to the University of Witwatersrand, Johannesburg. This report has not been submitted for any other degree or examination at this or any other university.

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Date:

ABSTRACT

Trusts are widely used both in South Africa and internationally for a variety of different purposes. In South Africa, trusts have come under fire from National Treasury as a result of what is perceived to be the use of trusts as a tax avoidance vehicle. Not only in South Africa, but also globally, the trust has become somewhat notorious for its use as an instrument for tax avoidance and the concealment of wealth. In South Africa, National Treasury has responded to these concerns by proposing a number of amendments to the existing tax legislation aimed at curbing the use of trusts for tax avoidance purposes, some of which have been severely criticised by the public.

The fact that the use of trusts to avoid tax is an international phenomenon raises the question on how jurisdictions other than South Africa are taxing trusts and whether the South African legislature can apply the principles used in other jurisdictions in determining the direction that our own legislation should take. In this report, this is assessed through a comparative analysis of the rules relating to the taxation of trusts in South Africa with those of another jurisdiction, namely the United Kingdom.

At its outset, this report provides an overview of the history of the modern trust of South Africa and the United Kingdom, both of which have their roots in the English common law trust. This is followed by an analysis of the taxation regime relating to trusts in each state. Finally, a comparative analysis is done of the taxation of trusts in each state, with the aim of determining the main differences between the taxation regimes applied in each state.

Key words

Trusts, South African Revenue Service (SARS), Her Majesty's Revenue and Customs (HMRC), Income Tax Act, Estate Duty Act, Taxation of Chargeable Gains Act, Inheritance Tax Act, South Africa, United Kingdom.

Table of contents

Chapter 1: Introduction.....5

1.1. Background.....5

1.2. Research problem.....8

1.3. Research methodology.....10

1.4. Scope and limitations.....11

1.5. Chapter outline.....11

Chapter 2: An overview of the trust in the United Kingdom and South Africa.....13

2.1. Introduction.....13

2.2. United Kingdom.....13

2.3. South Africa.....17

2.4. Conclusion.....21

Chapter 3: The taxation of trusts in the United Kingdom.....22

3.1. Introduction.....22

3.2. The taxation of trusts in the United Kingdom.....22

3.3 Conclusion.....37

Chapter 4: The taxation of trusts in South Africa.....38

4.1. Introduction.....38

4.2. The taxation of trusts in South Africa.....38

4.3. Conclusion.....56

Chapter 5: A comparison of the taxation of trusts in the United Kingdom and South Africa..58

5.1. Introduction.....58

5.2. General aspects regarding the taxation of trusts.....58

5.3. Income tax.....59

5.4. Capital gains tax.....63

5.5 Inheritance tax, estate duty and donations tax.....67

Chapter 6: Conclusion.....72

References.....76

Chapter 1: Introduction

1.1. Background

The reformation of the taxation of trusts in South Africa has been on the radar of National Treasury for some time. On 27 February 2013 the Minister of Finance at the time, Pravin Gordhan, announced as part of his 2013 Budget Speech that the taxation of trusts will come under review to prevent abuse (National Treasury, 2013a:21). In the National Budget Review of the same year, National Treasury proposed several legislative measures to curb tax avoidance associated with trusts (National Treasury, 2013b:54). In 2016, additional legislative measures aimed at preventing the avoidance of donations tax and estate duty through the use of trusts were also proposed by National Treasury (National Treasury, 2016a:49).

There is no doubt that the trust is a highly useful and adaptable instrument, as attested to by its wide range of uses both in South Africa and internationally (Olivier & Honiball, 2011:114). Estate planners and asset managers use trusts for the prudent disposition of property; businessmen frequently make use of trusts as a structure for business ventures; medical-aid schemes and pension funds are often managed through trust arrangements by health and insurance enterprises; and companies make use of trusts to secure the interests of shareholders and debenture-holders, and these are but the tip of the iceberg (Du Toit, 2007:1).

Although the flexibility of the trust makes it an attractive instrument to its users, it also, perhaps not surprisingly, raises a number of concerns with revenue authorities regarding those who would abuse the trust to avoid taxation. Despite the prevalent use of trusts in South Africa, statistics from the South African Revenue Service (SARS) reveal a disconcerting disparity between the number of registered trusts and the number of tax

returns received. According to these statistics, a mere 33 per cent of active registered trusts are tax compliant. (Davis Tax Committee, 2016:7).

Not only in South Africa, but also globally, the trust has become somewhat notorious for its use as an instrument for tax avoidance and the concealment of wealth (Garton, 2015:74). In July 2013, a report released by the Australian Taxation Office (ATO) indicated that both the use of trusts in Australia as well as the exploitation of legal boundaries in order to avoid tax through trusts had increased significantly in recent years (Australian Taxation Office, 2013:12). In the United States of America the Internal Revenue Service has reported a proliferation of abusive tax evasion schemes through the use of trusts, which is of concern seeing as the filing of trust tax returns has become the third most frequently filed income tax return (after individual and corporate tax returns) in the country (Internal Revenue Service, 2016).

In South Africa, National Treasury has expressed particular concern over the use of trusts to avoid tax through income-splitting, as well as the avoidance of estate duty and donations tax. In order to combat these methods of tax avoidance, a number of legislative measures were proposed as part of the 2013 National Budget Review, namely that:

- Discretionary trusts should no longer act as flow-through vehicles. Taxable income or losses should be fully determined at trust level with distributions to be treated as deductible payments to the extent of taxable income.
- Trading trusts should in like manner be taxed at the entity level, with distributions treated as deductible payments to the extent of taxable income.
- In order to target schemes designed to shield income from global taxation, distributions from offshore foundations should be treated as ordinary revenue. (National Treasury, 2013b:54)

Furthermore, in order to address the perceived avoidance of estate duty and donations tax through the use of trusts, the South African government has proposed to implement

measures to ensure that assets transferred by way of loans to trusts are included in the estate of the founder at death and that interest-free loans advanced to trusts are categorised as donations (National Treasury, 2016a:49). Section 7C of the Income Tax Act No. 58 of 1962 has since been implemented in order to give effect to some of these proposals.

In the First Interim Report on Estate Duty released in January of 2015, the Davis Tax Committee (DTC) also made a number of recommendations regarding required changes to the taxation of trusts, indicating that the very same rules which were originally intended to serve as anti-avoidance provisions in the use of trusts are today employed to avoid tax. The changes recommended by the Davis Tax Committee (2015:7) include the following:

- The deeming provisions of sections 7 and 25B should be repealed insofar as they relate to South African resident trusts.
- The deeming provisions of sections 7 and 25B should be retained insofar as they relate to non-resident trusts.
- Trusts should be taxed as separate taxpayers.
- Relief should be provided to 'special trust' arrangements.
- Transfer pricing adjustments should not be implemented in the event of financial assistance or interest-free loans advanced to trusts.

In light of the proposed changes, which will without a doubt, if implemented, have far-reaching implications for taxpayers, the DTC has made it clear that trusts must not only be seen as vehicles used for tax avoidance, but that taxpayers must be allowed to make use of trusts where it makes sound commercial sense to do so. (Davis Tax Committee, 2015:7)

Interestingly, the recommendation made by government to categorise interest-free loans advanced to trusts as donations and to charge an imputed interest is directly opposed to the recommendation of the DTC, who clearly recommended that no attempt should be made to implement transfer pricing principles in such circumstances (Davis Tax Committee, 2015:7). Not surprisingly, government was criticized by the public for departing from the

recommendations of the DTC in this regard (National Treasury, 2016b:14). Section 7C of the Income Tax Act No. 58 of 1962 which has since been enacted does not charge an imputed interest, but treats the foregone interest as a donation for donations tax purposes (this section is discussed in more detail in Chapter 4 of this report).

There is no doubt, therefore, that the rules relating to the taxation of trusts in South Africa have attracted severe scrutiny and are in need of some form of adaptation. On the one hand, the rules need to be robust enough to prevent tax evasion, while at the same time not being so stringent that any legitimate use of the trust is undermined. The fact that the use of trusts to avoid tax is an international phenomenon therefore raises the question on how jurisdictions other than South Africa are taxing trusts and whether the South African legislature can apply the principles used in other jurisdictions in determining the direction that our own legislation should take.

1.2. Research problem

The objective of this research report is to address the following research problem:

How does South African tax law on trusts compare to that of the United Kingdom?

The United Kingdom was selected for the comparative analysis of this report for the following reasons:

1. The South African trust has its historic roots in the English common law trust. The South African trust, although heavily influenced by established Roman-Dutch legal principles, therefore shares a common heritage with the trust of the United Kingdom and both countries have an established legal history pertaining to trusts. (Olivier & Honiball, 2009:2).

2. The United Kingdom is a member of the Organisation for Economic Co-operation and Development (OECD). The OECD is an organisation consisting of 35 member countries which seeks to promote policies to improve the economic and social well-being of people around the world. The OECD sets international standards on a number of matters including general taxation and tax evasion. (Organisation for Economic Co-operation and Development, 2015). Although South Africa is not a member of the OECD, the country does collaborate with the organisation on a wide array of policy issues (Organisation for Economic Co-operation and Development, 2016).
3. The United Kingdom is a contracting state to the Hague Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition and one of the few states to have ratified the convention. The aforementioned convention seeks to establish common provisions on the law applicable to trusts internationally and to deal with the most important issues relating to the recognition of trusts. (Hague Conference The, 2015a)
4. The United Kingdom and South Africa form part of The Commonwealth. The Commonwealth is made up of a group of collaborative nations supporting each other in meeting international objectives. Members of The Commonwealth share a common heritage in language, law, education, culture and democratic traditions. (Commonwealth, 2015).
5. The United Kingdom applies a tax on the estate of a deceased person called the Inheritance Tax (Her Majesty's Revenue and Customs, 2017a) which can be likened to Estate Duty in South Africa. Bearing in mind that many of the amendments proposed by National Treasury to the way trusts are taxed in South Africa are aimed at preventing the avoidance of Estate Duty (National Treasury, 2013b:54), the fact that the United Kingdom applies a similar tax on deceased estates increases the comparability of the taxation of trusts between the two jurisdictions.

Sub-problems:

The following sub-problems will be addressed:

What is the origin of the trust and can a trust in the South African context be likened to that of a trust in the United Kingdom?

What are the rules relating to the taxation of trusts in South Africa in terms of the provisions of the South African Income Tax Act No. 58 of 1962?

What are the rules relating to the taxation of trusts in the United Kingdom (UK) in terms of the provisions of the UK Income Tax Act 2007?

How does the taxation of trusts in South Africa compare to that of the United Kingdom?

1.3. Research methodology

In order to determine what the rules relating to the taxation of trusts in South Africa and the United Kingdom are respectively, a literature review will be performed using, amongst others, statutes, books, government publications, electronic resources and thesis. Thereafter a comparative analysis will be performed in respect of the provisions relating to the taxation of trusts in South Africa compared to that of the United Kingdom. Findings from the comparison will further be analysed to determine how the provisions relating to the taxation of trust in South Africa compare to those of the United Kingdom.

1.4. Scope and limitations

This report specifically addresses the provisions of the South African Income Tax Act relating to the taxation of trusts. These provisions are sections 7, 7C and 25B as well as paragraphs 11(1)(*d*), 13(1)(*a*)(iiA), 38, 39, 62(*a*) – (*e*), 68, 69, 71, 72, 73, 80(1), 80(2) and 80(3) of the Eighth Schedule. In terms of the United Kingdom legislation, only provisions in respect of the taxation of trusts in terms of the Income Tax Act 2007, the Taxation of Chargeable Gains Act 1992, the Inheritance Tax Act 1984, the Income Tax (Trading and Other Income) Act 2005, the Finance Act 2004, the Finance Act 2005 and the Finance Act 2006 are considered in this report. Any provisions contained in any other piece of legislation are not included in the scope of this report. Provisions relating to Scotland are excluded from the scope of this report. Provisions relating to non-resident trusts are not included in the scope of this report.

1.5. Chapter outline

Chapter 1 - Introduction

- Background
- Research problem
- Research methodology
- Scope and limitations

Chapter 2 – An overview of the trust in the United Kingdom and South Africa

This chapter provides an overview of the history of the trust institution in the United Kingdom and South Africa as well as of the development of the trust to its modern-day form. Statutory definitions and the types of trusts that exist in each jurisdiction are also considered.

Chapter 3 – The taxation of trusts in the United Kingdom

This chapter sets out and explains the provisions relating to the taxation of trusts in the United Kingdom in terms of the UK Income Tax Act 2007, The Taxation of Chargeable Gains Act 1992, The Inheritance Tax Act 1984, the Income Tax (Trading and Other Income) Act 2005, as well as the Finance Acts of 2004, 2005 and 2006.

Chapter 4 – The taxation of trusts in South Africa

This chapter sets out and explains the provisions relating to the taxation of trusts in South Africa in terms of the Income Tax Act No. 58 of 1962.

Chapter 5 – A comparison of the taxation of trusts in the United Kingdom and South Africa

Based on the information set out in chapters 3 and 4, a comparison is drawn between the taxation provisions relating to trusts in the United Kingdom and South Africa. A table format is used, indicating the tax treatment applied in each jurisdiction for a number of transactions relating to trusts.

Chapter 6 – Conclusion

Based on the comparison made in chapter 5, a conclusion is drawn with regards to the taxation of trusts in the United Kingdom compared to South Africa.

Chapter 2: An overview of the trust in the United Kingdom and South Africa

2.1. Introduction

In order to determine whether the South African trust can be likened to the United Kingdom trust, this chapter begins by providing a brief history of the origins of the trust in each jurisdiction. Next, consideration is given to the definitions of a trust in each jurisdiction, as well as the types of trusts that exist. Finally, consideration is given as to whether the South African trust can be considered a true trust. In this report the terms 'founder', 'donor' and 'settlor' are used interchangeably.

2.2. United Kingdom

2.2.1. A brief history

The trust originated in England during the middle-ages in the form of an institution known as the 'use', which involved the practice of granting land to an intermediary (Du Toit, 2007:12). By the thirteenth century, the use was commonly employed in various spheres of English society (Du Toit, 2007:12). It was common practice, for example, for crusaders to transfer land to a trusted friend with the intention of regaining ownership upon their return from a crusade, or should a crusader not return, to transfer the land to a nominated beneficiary (Du Toit, 2007:12). Similarly, Franciscan friars would transfer land to local communities for the use of the friars, as the former were bound by an oath of poverty and could not own land themselves (Du Toit, 2007:12). For a time, it was even possible to transfer land to another for one's own use and to thereby put it beyond the claims of creditors (Garton, 2015:37).

The use, therefore, allowed person A (known as the *feoffor*) to transfer ownership of property to person B (known as the *feoffee*) for the use of person C (known as the *cestui que use*). The *feoffee* was bound by oath to carry out the wishes of the *feoffor* and to bestow any stipulated benefit on the *cestui que use*. (Du Toit, 2007:12).

The interests of the *cestui que use* were, however, not effectively protected by English common law, which failed to provide a remedy against a *feoffee* who neglected to carry out his duty under the use (Du Toit, 2007:12). The inadequacy of the common law courts was largely due to a lack of adaptability to new claims, the complexity of pleadings and the limited range of available remedies (Garton, 2015:38).

In the absence of a remedy at common law, it became practice for an aggrieved party to petition the chancellor for relief (Du Toit, 2007:13). In order to achieve justice, the chancellor could order specific remedial measures on a wide variety of discretionary grounds (Garton, 2015:38). This resulted in the development of a body of law known as 'equity', which provided relief against the rigidity of the common law and was applied in the Courts of Chancery as opposed to the Common Law Courts in order to ensure that the division between equity and common law was strictly maintained (Du Toit, 2007:13).

It was therefore recognised in equity that the *feoffee* held the property for the benefit of the *cestui que use*, despite the fact that the *feoffee* held legal ownership of the property. The interest of the *cestui que use* was, at first, regarded merely as a claim against the *feoffee*. From the fifteenth century, however, it became recognised as a form of ownership in the property held to use and gave rise to the concept of dual ownership, which soon became a pertinent feature of English law. (Du Toit, 2007:13).

In 1535 the Statute of Uses was passed, with the aim of curtailing the exploitation of the use, which was often employed for highly questionable purposes, including the avoidance of liability towards creditors (Du Toit, 2007:13). In essence, the statue provided that the creation of a use should confer legal title on the beneficiary, instead of merely creating a number of enforceable rights (Garton, 2015:40). With the implementation of the Statute of Uses, the *feoffee* no longer held any rights to the property held to use, and as a result, the functionality of the use was effectively curtailed (Du Toit, 2007:13).

Despite this fact, certain categories of use were beyond the scope of the Statute of Uses (Garton, 2015:41). This included a use upon a use, as well as an active use under which a *feoffee* had certain active duties to perform (Garton, 2015:42). Consequently, the restrictive effect of the statute could effectively be overcome (Du Toit, 2007:13). Soon thereafter, a use to which the statute did not apply and which would be enforced by Chancery became known as a 'trust' (Garton, 2015:44).

During the centuries that followed, trust law was further developed by the Court of Chancery, largely in response to a shift in family wealth-holding (Garton, 2015:46). The Industrial Revolution and the emergence of the limited liability company contributed to the emergence of investment assets other than land and led to a change in the role of trustees from passive land owners to active investment managers (Garton, 2015:46). The emergence of trusts for investment assets therefore played a vital role in the development of the modern trust. (Garton, 2015:46).

2.2.2. Definitions and types of trusts

The rules of trust law in the United Kingdom are not based on any statutory definition. Instead, decisions by the courts have expounded the rules of trust law on which the trust institution is based. (Hayton as cited in Du Plessis, 2014:27).

The United Kingdom is, however, a contracting state to the Hague Convention on the Law Applicable to Trusts and on their Recognition and one of the few states to have ratified the convention, thereby making it part of their statutory law (Hague Conference The, 2015a). In terms of this convention, a trust refers to the legal relationships which have been created when a trustee has been given control over certain assets by a person known as the settlor, either *inter vivos* or at the death of that person, for the benefit of a beneficiary, or for a specified purpose. In terms of the convention, a trust has three characteristics. Firstly, a trust is characterised by the fact that the assets placed under the control of the trustee are part of a separate fund and do not form part of the trustee's own estate. Secondly, the title to the

assets held in trust is held in the name of the trustee or another person on behalf of the trustee. Lastly, the trustee is given both the power and duty, in terms of which he is held accountable, to manage, employ, or dispose of the trust assets in accordance with the trust's terms and in terms of any further duties imposed on him by law. The fact that the settlor has reserved certain rights and powers, or that the trustee has certain rights as a beneficiary, are not necessarily regarded as being inconsistent with the existence of a trust. (Hague Conference The, 2015b).

Section 43 of the Inheritance Tax Act defines a 'settlement', which includes any disposition of property, either effected by instrument, parol or by operation of law, whereby the property is held in trust for a person in succession or for a person subject to a contingency, or held by trustees in trust in order to accumulate any income of the property, or where the power to accumulate income is not held, the power to make payments out of that income at the discretion of either the trustees or another person, or where property would be so held if the disposition were regulated by the law of the United Kingdom.

In practice, the terms 'settlement' and 'trust' are used interchangeably, although it should be noted that a 'settlement' is wider than a trust for tax purposes (Maston, 2016:9).

'Settled property' is defined in section 466 of the Income Tax Act 2007 (UK Income Tax Act) as any property held in trust. The definition is subject to certain exclusions, including property held by a person as a nominee for another person.

Various types of trusts exist, including bare trusts, in which the beneficiaries have the right to all income and capital of the trust if they are older than 18, interest in possession trusts, in which the trustees must distribute all trust income to the beneficiaries as it arises, discretionary trusts, where trust income and capital can be distributed at the discretion of the trustees, accumulation trusts, in which trust income is added to the trust capital, and settlor-interested trusts, from which the settlor, their spouse or civil partner derives a benefit. The

tax treatment of each type of trust is different and is explained in more detail in chapter 3 of this report. (Her Majesty's Revenue and Customs, 2017d).

2.3. South Africa

2.3.1 A brief history

Despite the retention of Roman-Dutch law during the second occupation of the British at the Cape in 1806, a number of English legal principles and institutions inevitably made their way into the South African legal system. British settlers continued to incorporate the trust as an institution through wills, deeds and land transfers, so that the trust became a readily accepted feature of legal and commercial practice at the Cape and later, throughout what was to become modern-day South Africa. (Du Toit, 2007:13).

The validity of the trust from a South African perspective was called into question for the first time in 1915 in *Estate Kemp v McDonald's Trustee*, where the courts had to decide whether South African law could give legal effect to the trust (Du Toit, 2007:14). The court firmly held that the English law of trusts does not at all form part of South African law, but concluded that despite this fact, the trust had become so firmly ingrained in South African legal and commercial practice that it would be impossible to eradicate (Du Toit, 2007:14).

The South African law of trusts has, since then, largely been developed through court decisions (Geach & Yeats, 2007:11). The findings of the court in *Braun v Blann and Botha* NNO provides a case in point, where it was held that a trust and a *fideicommissum*, which is a Roman-Dutch law concept, are distinct and separate legal institutions (Geach & Yeats, 2007:11). Decisions by the court have also emphasised that the legal nature of an *inter vivos* trust is very different from that of a testamentary trust (Geach & Yeats, 2007:12). In South African law, the legal principles that apply to an *inter vivos* trust are found in the law of contracts, while the laws governing a *mortis causa* or testamentary trust are much less

certain and are, to some extent, still under development through case law (Geach & Yeats, 2007:18). The influence of the courts have, therefore, resulted in the development of a unique trust law in South Africa which bears little resemblance to its English law counterpart (Olivier & Honiball, 2009:2).

In modern South Africa, trust law is not codified or contained in a single statute, but is instead based on the common law (Roman-Dutch Law) and on principles established through case law (Geach & Yeats, 2007:4). Despite the legislature's limited contribution to the development of trust law, the most important contribution is undoubtedly the Trust Property Control Act (Du Toit, 2007:21). The aim of the Act is, however, not the codification of trust law, but rather the regulation of certain administrative aspects in respect of trusts, including the role of the Master of the High Court and the imposition of certain duties and obligations on trustees (Geach & Yeats, 2007:5).

2.3.2 Definitions and types of trusts

There are a number of definitions of a trust. Section 1 of the Trust Property Control Act defines a trust as the arrangement through which, by way of the trust instrument, ownership in property is transferred from one person to a trustee, in order to be administered or disposed of in accordance with the provisions of the trust instrument, for the benefit of the persons designated in the trust instrument or in order to achieve a stated objective. The definition also includes the arrangement by which ownership in property is made over to the beneficiaries designated in the trust instrument, but where control of the property is placed with the trustee in order for the property to be administered in accordance with the provisions of the trust instrument. The definition excludes the case where property is administered by an executor, curator or tutor in terms of the Administrations of Estates Act 66 of 1965.

Section 1 of the Income Tax Act No. 58 of 1962 (hereafter referred to as the SA Income Tax Act) defines a trust as a trust fund which is administered and controlled by a person acting in a fiduciary capacity and who is appointed under the will of a deceased person, under a deed

of trust or by way of agreement. This definition is discussed in more detail in chapter 4 of this report.

In broad terms, there are three kinds of trusts in South Africa. The so-called 'ownership trust', the first kind, is where a founder transfers ownership of property to a trustee for the benefit of defined beneficiaries. Secondly a 'bewind trust' is where a founder transfers the control over property to the trustees, but ownership of that property is transferred to the beneficiaries. Lastly, where any person is entrusted with the affairs of another, we find the third kind of trust, for example, where an agent holds assets on behalf of a principal. (Olivier & Honiball, 2009:3).

Trusts can further be categorised as either vested trusts or discretionary trusts. In a vested trust, the beneficiaries have vested rights to the income or capital of the trust and distribution of trust income or capital is therefore not subject to the discretion of the trustees. In a discretionary trust, trust income or capital is distributed to the beneficiaries at the discretion of the trustees. The distinction between a vested or discretionary trust is vital from an income tax perspective, as trust income to which beneficiaries have a vested right can be taxed in the beneficiaries' hands. (Olivier & Honiball, 2009:4).

2.3.3. The nature of the South African trust

It has long been held that a real trust cannot exist in civil-law jurisdictions or mixed jurisdictions where property law is based on civilian concepts (Du Toit, 2007:14). Such jurisdictions operate under the principle of single or unitary ownership, and are therefore fundamentally incompatible with the concept of dual ownership, which some believe to be the essence of a trust (Du Toit, 2007:14). The question therefore arises as to whether the South African trust is a true trust.

Many modern scholars are of the view that the essence of the trust does not necessarily lie in the duality of ownership, but rather in the protection that such duality provides to the interests of the trust beneficiaries (Du Toit, 2007:14). Where ownership of an asset vests in

both the trustee and the trust beneficiary, such dual ownership protects the beneficiary from any claims of a trustee's private creditors against the asset in case of the trustee's insolvency (Du Toit, 2007:15). Duality of ownership is, however, not the only means of achieving the protection of a beneficiary's interests (Du Toit, 2007:14). According to various scholars, the same protection can be achieved by vesting two separate estates in a trustee, as is allowed for in many civilian and mixed legal systems, including South Africa (Du Toit, 2007:14). In this manner, the essence of a trust is maintained even though ownership of the assets does not vest in more than one person (Du Toit, 2007:14).

The principle of dual estates is applied in South African trust law, where the trustee of an ownership trust is vested with two distinct estates, being that of the trust, as well as his own personal estate. In the case of a trustee's insolvency, any claims of the trustee's private creditors lie only against his personal estate and not against the estate of the trust. In like manner, unless there has been a breach of trust by a trustee, trust beneficiaries only have a claim against the trust estate and not against the personal estate of the trustee. (Du Toit, 2007:15).

The interests of a trust beneficiary are further protected in South African law, as in English law, by the fiduciary position that a trustee holds in relation to a trust beneficiary. In both South African as well as in English law, trusteeship is regarded as an office in terms of which a trustee is required to carry out his duty with the aim of securing the interests of the trust beneficiaries. Should a trustee fail to carry out his fiduciary duty, the South African High Court has the power to intervene in order to secure the interests of the beneficiaries. (Du Toit, 2007:15).

Furthermore, both South African law and English law provide for the occurrence of real subrogation, which ensures the continuity of the trust estate and thereby protects the interests of the trust beneficiaries. Where a trust asset is, for example, disposed of, real

subrogation requires that the proceeds on disposal of the asset, or any asset acquired as a substitute for a trust asset, remain subject to the trust. (Du Toit, 2007:15).

While functional differences certainly exist between the South African and English trust, it is clear that a number of core elements are shared between them. These include a duality of interests, the fiduciary capacity of the trustees, as well as real subrogation. It can therefore be concluded that the South African trust, despite being different to the English trust in some respects, is indeed a true trust. (Du Toit, 2007:16).

2.4. Conclusion

Although considerable differences exist in the modern trust law of the United Kingdom and South Africa, the trust as it currently exists in both jurisdictions has its roots in the English institution which developed from the ‘use’ during and after the middle-ages. There is no single statutory definition of a trust in either jurisdiction, and in both, the courts played a major role in the development of trust law. Although the legal basis of the South African trust differs significantly from that of the United Kingdom, the South African trust possesses the essential characteristics of a trust and is therefore regarded as a ‘true’ trust.

Chapter 3: The taxation of trusts in the United Kingdom

3.1 Introduction

This chapter provides an overview of the taxation of trusts in the United Kingdom. The general principles are briefly discussed at first, followed by a more in-depth discussion of the income tax treatment of trust income in the hands of the trustees, the beneficiaries and the settlor. Next, the capital gains tax and inheritance tax consequences of trusts are considered. At the end of the chapter, an overview of the tax treatment of trust for the vulnerable is given.

3.2 The taxation of trusts in the United Kingdom

In the United Kingdom, a trust is included in the definition of a 'settlement' found in section 43 of the Inheritance Tax Act. This definition also applies for income tax and capital gains tax purposes, subject to certain exceptions which are discussed below. (Inland Revenue, 2004:27).

Concerning the taxation of trusts, the United Kingdom follows a hybrid approach, alternating between the personification of the trust and treating it as a transparent entity. (Garton, 2015:98). Personification refers to instances where the trust is, in essence, taxed as a separate legal entity, whereas transparency is applied where the trust beneficiaries are taxed as if the trust did not exist (Garton, 2015:96). Reflecting this hybrid approach, a two-tier process is followed in most cases, whereby income tax is firstly imposed on trustees and secondly, on trust beneficiaries. (Garton, 2015:98). The tax year starts on 6 April each year and ends on 5 April the following year (Her Majesty's Revenue and Customs, 2017d).

The normal charging provisions apply in relation to a trust, whereby a trustee who is resident in the United Kingdom is subject to tax on worldwide income, whereas a non-resident trustee is in general only subject to tax on income from a source in the United Kingdom. (Kessler as cited in Du Plessis, 2014:75). Refer below for a further discussion on the residency of the trustees.

3.2.1. Taxation of trustees

Initially, trust income is taxed in the hands of the trustees. In terms of section 474 of the UK Income Tax Act, the trustees of a trust are treated as a single and separate person for income tax purposes, distinct from the persons who are the trustees of the trust from time to time. The trustees have no beneficial entitlement to the trust income and their personal tax circumstances are therefore irrelevant in determining the income tax to be levied on such income. (Garton, 2015:98).

In terms of section 475 of the UK Income Tax Act, the single person represented by the trustees will be resident in the United Kingdom if all the trustees of that trust are United Kingdom residents. Where at least one trustee is a United Kingdom resident and at least one trustee is a non-resident, the person represented by the trustees will still be resident if the settlor of the trust meets certain further requirements which are stipulated in section 476 of the UK Income Tax Act. These requirements include that the settlor must be resident, ordinarily resident or domiciled in the United Kingdom at the time the trust was created, either at death or while the settlor is alive.

Although the trustees are treated as a separate person representing the trust, this person is not regarded as an individual for income tax purposes (Maston, 2016:42). Consequently, all income arising from trust assets is taxable, as no personal or other allowances are applicable (Garton, 2015:99). Furthermore, all trust income, other than dividend income, is taxed at the basic rate of tax of 20% for the 2016 - 2017 tax year, as the higher rate applicable to individuals does not apply (Maston, 2016:42). Dividend income is taxed at the basic dividend rate of 7.5% (Her Majesty's Revenue and Customs, 2017d). Where income has been subject to tax at source, the trustees are only required to pay an amount equal to the difference between the tax charged at the applicable rate and the amount of tax paid at source (Maston, 2016:72). For example, where building society interest has been subject to

tax at source at a rate of 20%, the trustees will be liable to pay the additional 25% required to meet the full applicable rate of tax of 45% (Maston, 2016:72).

One important exception applies to the rate of tax levied on trust income where that income is accumulated income or discretionary income (Garton, 2015:99). Section 480 of the UK Income Tax Act defines discretionary income as income payable at the discretion of the trustees or any other person. Such income includes cases where the trustees or any other person may exercise discretion over whether income must be accumulated, to which person income must be paid or how much income is to be paid to any person.

Section 479 of the UK Income Tax Act provides that any accumulated or discretionary income which arises to the trustees, excluding such income of a trust established solely for charitable purposes, must be taxed at the trust rate of 45% on income other than dividend income and at the dividend trust rate in the case of dividend income (Garton, 2015:99). From 6 April 2016 the dividend trust rate is 38.1% (Her Majesty's Revenue and Customs, 2017b). The purpose of section 479 of the UK Income Tax Act is to discourage the use of accumulation trusts and discretionary trusts as tax shelters by taxing income which has been generated and accumulated at the rate which would apply to individual beneficiaries, instead of at the trustees' rate (Garton, 2015:99).

In order to provide relief to smaller trusts which would otherwise be subject to the higher trust rate and dividend trust rate, section 491 of the UK Income Tax Act provides that the first £1 000 of trust income for these trusts must be taxed at the basic rate (Inland Revenue, 2004:9). Where the same settlor has made more than one settlement, the £1 000 is divided equally among all the settlements, up to a maximum of five settlements (Maston, 2016:72).

In summary, income, other than dividend income, in which a beneficiary has an interest in possession is taxed at the basic rate of 20%, while accumulated and discretionary income above £1 000 is taxed at 45% (Maston,2016:59;72).

Where trust income is mandated to the beneficiaries of an interest in possession trust, such income is not included in the income of the trustees, but is taxed directly in the hands of the beneficiary (Her Majesty's Revenue and Customs, 2017f).

Expenses incurred by the trustees are deductible from property and trading income in the ordinary way where a trade is carried on by the trustees (Maston, 2016:64). Non-personal reliefs and losses, like trading losses and capital allowances, may be claimed by trustees and business losses from property income can be carried forward (Maston, 2016:43). Where the trustees suffer a deficiency of income in a given year as a result of exceptional expenses, such deficiency can be carried forward and applied against income in the next year (Maston, 2016:43).

3.2.2. Taxation of beneficiaries

In the second stage, trust beneficiaries are subject to tax on any trust income which has been distributed to them, or to which they are entitled, whether distributed or not. In this instance, the trust is treated as being transparent and as a result, additional tax might be payable by the beneficiaries despite the fact that the trust income has already been subject to tax in the hands of the trustees. Whether additional tax is payable depends on the beneficiary's income from other sources (Garton, 2015:100). Beneficiaries are required to account for trust income on their tax returns on a gross basis, i.e. the amount before taking into account any taxes already paid by the trustees. The beneficiary will be liable for tax on the gross amount of trust income by applying the marginal tax rate applicable to that beneficiary and is subsequently entitled to a credit for the tax already paid by the trustees on the trust income attributable to that beneficiary. Where the beneficiary is, for example, subject to the higher marginal tax rate of 40%, while the trust income attributable to the beneficiary has only been subject to tax at the basic rate of 20%, the beneficiary will, in effect, be liable for the additional tax of 20% above the amount already paid by the trustees.

Where the tax paid by the trustees exceeds the amount of tax payable by the beneficiary, the beneficiary is entitled to recover the excess amount from HMRC. (Garton, 2015:100).

Income to which a beneficiary has an interest in possession retains its character in the hands of the beneficiary, so that, for example, dividends received by the trust will also be treated as dividends in the hands of the beneficiary (Maston, 2016:70). In an accumulation and discretionary trust, income which is distributed to a beneficiary does not retain its character, and the trustees must indicate that the income has been fully subject to tax at 45% (Maston,2016:71-72). Where income has been mandated to a beneficiary, the trustees have no liability to income tax and instead, the beneficiary is taxed directly in relation to the income received (Maston, 2016:70).

From the perspective of the trustees, as mentioned earlier, the trust rate will not apply to trust income which has been distributed to the beneficiaries or to which they are entitled (Garton, 2015:99). The reason for the application of the basic rate to such income is to ensure fairer treatment of the beneficiaries who might be subject to tax at lower rates or are non-taxpayers and to reduce the number of credits that would otherwise need to be claimed (Inland Revenue, 2004:11).

3.2.3. Anti-avoidance provisions and taxation of the settlor

The Income Tax (Trading and Other Income) Act 2005 (Trading and Other Income Act) contains certain anti-avoidance provisions which apply to all ‘settlements’ (Garton, 2015:101). The term ‘settlement’ is very widely defined in section 620 of the Trading and Other Income Act and includes ‘any disposition, trust, covenant, agreement, arrangement or transfer of assets’. The settlor is defined in this section as the person who made the settlement.

In order for the anti-avoidance provisions to apply, some element of ‘bounty’ must be present (Maston, 2016:29). The anti-avoidance provision will therefore not apply where a transaction is considered to be fully commercial (Maston, 2016:29). In *Jones v Garnett* the court held

that an element of ‘bounty’ is present in an arrangement where the settlor provides a benefit which would not have been provided had the transaction taken place at arm’s length (House of Lords, 2007:3).

The anti-avoidance provisions cover three distinct areas. Firstly, sections 624 to 628 of the Trading and Other Income Act apply where the settlor, their spouse or civil partner retains an interest in the settlement. Secondly, section 629 of the same Act deals with the situation where an unmarried minor child of the settlor receives a benefit from the settlement. Lastly, sections 633 to 643 of the same Act apply where the settlor, their spouse or civil partner or minor child receives a capital payment from accumulated income in the settlement. (Garton, 2015:101).

In broad terms, and subject to certain exceptions, any income arising under a settlement in which the settlor, their spouse or civil partner retains an interest is deemed to be that of the settlor (Garton, 2015:102). Sections 624 to 628 of the Trading and Other Income Act will not apply where it can be shown that income arose from property in which the settlor has no interest (Garton, 2015:102). The settlor is deemed to have an interest in property if that property, or any derived property, is or may become applicable to the benefit of the settlor or his spouse or civil partner in any circumstances whatsoever. (Maston, 2016:27). In order for income to be deemed to be that of the settlor, the settlor must be living at the time the income is assessable (Maston, 2016:29).

Any amount of income paid to or for the benefit of an unmarried minor child of the settlor under the settlement will also be deemed to be that of the settlor, unless the amount is below £100. An exception applies where income is accumulated under a capital settlement for the benefit of the settlor’s unmarried minor child. In this case, the trustees will be liable for tax at the trust rate, unless the income is distributed to the unmarried minor beneficiary or is used for their maintenance, education or benefit. (Garton, 2015:102).

Where a capital sum is paid to the settlor, their spouse or civil partner, that amount is deemed to be income of the settlor. A capital sum is widely defined and includes loans to the settlor and payments made to the settlor in breach of trust. (Garton, 2015:103).

The trustees are liable to pay tax on income covered by the abovementioned anti-avoidance provisions (Maston, 2016:44). In terms of section 646 of the Trading and Other Income Act, the settlor is entitled to claim a credit for the amount of tax paid by the trustees on income which has been deemed to be that of the settlor under sections 624 to 629.

3.2.4. Capital Gains Tax

In the United Kingdom, capital gains tax is levied on the disposal of 'chargeable assets' (Garton, 2015:103). Essentially, the tax is imposed on the difference between the value of the asset at the acquisition and the value at the date of disposal (Garton, 2015:103). Different rates of tax apply, ranging from 10% to 28% for the 2017 tax year, depending on the type of taxpayer, as well as the type of asset disposed of (Her Majesty's Revenue and Customs, 2017c). Individuals and trustees for disabled persons are entitled to an annual exempt amount of £11 100 for the 2017 tax year (Maston, 2016:93). In order to prevent tax-avoidance through the creation of multiple trusts, which would each be entitled to their own annual exempt amount, other trusts are entitled to an annual exemption equal to half the amount provided for individuals (Garton, 2015:105). For the 2017 tax year, the trustees of a trust other than a trust for disabled persons are entitled to an annual exempt amount of £5 550 (Her Majesty's Revenue and Customs, 2017c).

Section 68 of the Taxation of Chargeable Gains Act 1992 (Taxation of Chargeable Gains Act) defines settled property as any property held in trust where the trustee is not a bare trustee or a nominee (Maston, 2016:46). In a bare trust, a beneficiary over the age of 18 is absolutely entitled to the trust income and capital, despite the fact that the assets are held in the name of a trustee (Her Majesty's Revenue and Customs, 2017d). In this case the property is treated as belonging to the beneficiary and is not considered to be 'settled

property' for capital gains tax purposes (Garton, 2015:105). Where the trustees of a bare trust transfer trust assets to a beneficiary, no liability for capital gains tax arises (Her Majesty's Revenue and Customs, 2017d).

In terms of section 70 of the Taxation of Chargeable Gains Act, the creation of a settlement is deemed to be a disposal of assets by the settlor (Garton, 2015:105). Therefore whether assets are transferred to the trustees on creation of the settlement or subsequently, the transfer will constitute a disposal for capital gains tax purposes (Maston, 2016:85). The settlor, rather than the trustees, is liable for any capital gains tax which may arise as a result of the disposal (Garton, 2015:105).

Where business assets are transferred to a trust, or where the assets are transferred to a trust subject to the 'relevant property' inheritance tax regime, hold-over relief is available on the disposal (Maston, 2016:101,103). The term 'hold-over relief' refers to the postponement of capital gains tax on lifetime gifts, usually until the asset is sold (Garton, 2015:104). Inheritance tax will be discussed later in this chapter.

Where chargeable assets are disposed of by trustees in the course of administering the trust, the trustees are liable for capital gains tax on the disposal. Other than the application of the lower annual exemption amount mentioned above, the capital gains tax on these gains are calculated using the same method applicable to individuals (Garton, 2015:106).

Where existing trustees retire, or where new appointments are made, no disposal of assets arises as the trustees are treated as a single and continuing body of persons (Maston,2016:46).

A deemed disposal of trust property takes place at the termination of a life-interest in possession on the death of the life tenant where the property continues to be settled property (Garton, 2015:106). A life tenant is a beneficiary who is entitled to the income of the trust for life (Her Majesty's Revenue and Customs, 2017e:5). In most cases, the base values of the assets are deemed to be equal to the market value at the date of death (Maston,

2016:91). Consequently, no chargeable gain arises and the result is merely an increase in the base value of the property (Garton, 2015:106). This treatment is consistent with that of non-settled property on the death of an individual (Garton, 2015:106).

A deemed disposal also takes place once a beneficiary becomes absolutely entitled to any portion of the settled property (Maston, 2016:86). When this occurs, the assets are deemed to have been disposed of and reacquired by the trustees at market value and any resulting capital gain will be chargeable to capital gains tax (Garton, 2015:106). Once again, where the disposal resulted from the death of a life tenant, no chargeable gain will arise and the result is merely an increase in the base value of the asset. (Garton, 2015:106).

Where a loss results from the deemed disposal of an asset where a beneficiary becomes absolutely entitled to such asset, and the loss cannot be offset against past trust gains, the beneficiary is entitled to offset the loss, but only against a subsequent gain arising from the disposal of that asset (Maston, 2016:88).

In terms of section 17 of the Taxation of Chargeable Gains Act, the disposal of an asset shall be deemed to take place at market value where the asset is not disposed of by way of a bargain made at arm's length, and in particular where the asset is disposed of by way of a gift or on a transfer to a settlement by a settlor.

Section 18 of the Taxation of Chargeable Gains Act provides that where an asset is disposed of between connected persons, such a disposal is deemed to take place otherwise than by way of a bargain made at arm's length.

Section 993 of the UK Income Tax Act defines the term connected person. In terms of this definition a trustee of a settlement is a connected person in relation to a settlor who is an individual, as well as any person connected with such an individual. A connecter person in relation to an individual includes their spouse or civil partner, their relatives, as well as the relatives of the person's spouse or civil partner.

As a result, transactions entered into between the trustees and the settlor are deemed to take place at market value. Furthermore, any loss on a disposal which took place between the trustees and the settlor can only be offset against a gain made on a disposal to the same person (Maston, 2016:85).

3.2.5. Inheritance Tax

In the United Kingdom, certain transfers of property are subject to a tax referred to as the inheritance tax (Garton, 2015:109). In substance, the inheritance tax is a form of estate duty (Garton, 2015:109). For inheritance tax purposes a 'settlement' is defined as a disposition of property, where the property is held in trust for persons in succession, for any person subject to a contingency, on trust to accumulate income, or on trust where the trustees have the discretion to make payments (Maston, 2016:125).

The standard rate of inheritance tax is 40% of the amount above the threshold of £325 000 (Her Majesty's Revenue and Customs, 2017a). A different threshold applies where, for example, a taxpayer gives his or her home to their children, and a reduced rate of 36% applies to certain assets where a taxpayer leaves more than 10% of the net value of their estate to charity at death (Her Majesty's Revenue and Customs, 2017a). Where the trustees of a trust pay inheritance tax on transfers into a trust, inheritance tax is levied at a reduced rate of 20% (Her Majesty's Revenue and Customs, 2017f). If the person who made the transfer dies within seven years of making the transfer, an additional 20% inheritance tax charge is levied (Her Majesty's Revenue and Customs, 2017f).

In terms of section 1 of the Inheritance Tax Act, inheritance tax must be charged on the value transferred by a chargeable transfer. Where value is transferred by an individual, provided the transfer is not an exempt transfer, a chargeable transfer arises. Exempt transfers include gifts of up to £3 000 per year, transfers between spouses and gifts to charities. (Garton, 2015:110).

Where an *inter vivos* transfer of value by an individual constitutes a gift or is made to certain trusts, such a transfer is classified as a potentially exempt transfer. If the transferor of a potentially exempt transfer dies within seven years of the transfer, it becomes a chargeable transfer. Otherwise, the potentially exempt transfer becomes an exempt transfer. Before 22 March 2006 transfers to most trusts, other than discretionary trusts, were treated as potentially exempt transfers. Transfers made to trusts after 22 March 2006 will only be classified as potentially exempt if the trust meets specific requirements. These requirements are discussed in more detail below. (Garton, 2015:110).

At the date of a person's death, a transfer of value is deemed to have taken place immediately before the person's death. In this manner, inheritance tax operates as a death duty. The value transferred is the amount by which the estate of the person has been diminished as a result of the disposal. (Garton, 2015:110).

Trusts, except for bare trusts, are treated differently from an inheritance tax perspective depending on whether it was formed before or after 22 March 2006 (Garton, 2015:113). In a bare trust, the property concerned is treated as if it was beneficially owned by the beneficiary (Maston, 2016:20). Any property in the bare trust at the date of death of a beneficiary who is under the age of 18 would form part of the beneficiary's chargeable estate for inheritance tax purposes (Maston, 2016:21). The transfer of property to the beneficiary at the age of 18 will have no inheritance tax implications (Maston, 2016:21).

3.2.5.1. Trusts formed before 22 March 2006

The inheritance tax treatment of trusts created before 22 March 2006 depends on whether a beneficiary holds an interest in possession in settled property (Garton, 2015:114). An interest in possession exists where the holder of the interest has the immediate entitlement to any income produced by the settled property as it arises (Maston,2016:127). An interest in possession trust is a trust in which all trust income, after deducting any relevant expenditure,

must be passed on by the trustees to the trust beneficiaries as it arises. (Her Majesty's Revenue and Customs, 2017d).

Where there is an interest in possession, the trust is regarded as being transparent for inheritance tax purposes. The person entitled to the income is therefore treated as the beneficial owner of the relevant portion of trust capital, regardless of the fact that the person has no actual entitlement to capital. Consequently, where a chargeable event relating to the settled property occurs, the property forms part of the estate of the holder of the interest for inheritance tax purposes. Where capital is distributed to the beneficiary, no inheritance tax arises, as the beneficiary is already deemed to be the owner of the property. (Garton, 2015:114).

Relevant property is defined in section 58 of the Inheritance Tax Act as settled property in which no interest in possession is held, which is essentially a reference to property held in a discretionary trust (Garton, 2015:117). Cash, shares, residential property and land held in a trust would, for example, form part of relevant property (Her Majesty's Revenue and Customs, 2017g). In contrast to the treatment of an interest in possession trust, a discretionary trust is personified for inheritance tax purposes (Garton, 2015:117). Inheritance tax is firstly charged on the settlor when property is initially settled (Garton, 2015:117). Secondly, an inheritance tax charge at 30% of the normal charge at lifetime rates is levied every ten years on settled property, which is referred to as the periodic charge (Garton, 2015:117). The ten-year anniversary is determined from the date that property is first settled, even if additional property is settled at a later date (Maston, 2016:140). Where property is settled in terms of a will, the ten-year anniversary will be determined from the date of the settlor's death (Maston. 2016:141). The periodic charge is levied on the value of all relevant property held in the settlement immediately before the ten-year anniversary (Maston, 2016:142).

Lastly, inheritance tax is charged when settled property ceases to be relevant property, at for example, the termination of the trust, or when an interest in possession is appointed in the fund (Garton, 2015:117).

One notable exception to the rules applicable to relevant property is found in what is referred to as accumulation and maintenance trusts. In broad terms, these are trusts created for the benefit of minors in which there is no interest in possession. Where such a trust meets the requirements of section 71 of the Inheritance Tax Act, it is exempt from the normal tax charges on relevant property and is instead treated as a potentially exempt transfer. Settled property in an accumulation and maintenance trust is, in effect, treated as belonging to the beneficiary and the trust is therefore regarded as being transparent. (Garton, 2015:118).

Where assets are transferred out of a trust an inheritance tax exit charge of up to 6% is levied on the transfer of all relevant property. Transfers out of a trust include where trust assets are distributed to beneficiaries or where a beneficiary becomes absolutely entitled to a trust asset. Certain transfers are not subject to the exit charge. These include where an asset is transferred out of a trust within three months of the trust's creation or within three months following a ten–year anniversary. (Her Majesty's Revenue and Customs, 2017g).

3.2.5.2. Trusts formed on or after 22 March 2006

The Finance Act 2006 radically altered the taxation of trusts under inheritance tax in two particularly significant respects. As mentioned earlier, transfers made during the settlor's lifetime to most trusts before this date were treated as potentially exempt transfers. From 22 March 2006 only transfers to interest in possession trusts in favour of a disabled person or a bereaved minor can qualify as potentially exempt transfers. As a result, the creation of any other trust during the settlor's lifetime will be a chargeable transfer subject to inheritance tax. (Garton, 2015:120).

In addition, any trust created on or after 22 March 2016, other than a few exceptions, including a trust in favour of a disabled person and a trust for a bereaved minor, will be

subject to the relevant property regime which previously applied predominantly to discretionary trusts. (Garton, 2015:120).

A trust for a bereaved minor is a trust established by reason of intestacy or under the Will of a deceased parent, provided certain requirements set out in section 71*A* of the Inheritance Tax Act have been met (Maston, 2016:128).

3.2.6. The pre-owned assets regime

An anti-avoidance mechanism known as the pre-owned assets regime was implemented by the Finance Act 2004. In essence, the regime provides for a charge to income tax which is applied to the value of the enjoyment of 'pre-owned assets'. Pre-owned assets are assets which were previously owned by the taxpayer and which the taxpayer has disposed of. The regime is aimed at schemes in which taxpayers appear to have given away their assets, thereby benefiting from the inheritance tax exemption on lifetime gifts, while in reality retaining enjoyment of the assets. An exemption applies where the total amount chargeable under the regime does not exceed £5 000. Certain special rules apply to land, chattels and intangible property. (Maston, 2016:36-38).

3.2.7. The tax treatment of trusts for the vulnerable

In order to prevent the charging of higher tax rates on income accumulated in a trust with vulnerable beneficiaries, where it could be undesirable to distribute all trust income to a beneficiary each year, certain special provisions relating to trust with vulnerable beneficiaries were enacted. In terms of these provisions, the trustee and a vulnerable beneficiary may irrevocably elect for the income of the trust to be subject to tax based on the beneficiary's individual circumstances, and in effect apply the transparency method of taxation. (Garton, 2015:101).

The Finance Act 2005 contains provisions relating to the taxation of trust income and chargeable gains accruing to trustees of trusts for the benefit of vulnerable people. A

vulnerable person is defined in section 23 of the Finance Act 2005, as being either a disabled person or a relevant minor.

Section 38 of the Finance Act 2005 defines a disabled person as a person who is incapable of managing his affairs or administering his property as a result of mental disorder as defined in the Mental Health Act 1983. A disabled person also includes any person who is entitled to a personal independence allowance, a disablement pension, a Constant Attendance Allowance or an Armed Forces Independence Payment (Her Majesty's Revenue and Customs, 2017d). A relevant minor is defined in section 39 of the Finance Act 2005 as a person under the age of 18 with at least one deceased parent.

The trustees of a trust with a vulnerable beneficiary are entitled to a reduction against their income tax liability. In terms of sections 26 to 28 of the Finance Act 2005, the reduction is calculated as the difference between what their liability for tax on trust income would have been if there had been no claim for special treatment, and the income tax that the vulnerable person would have been liable for if trust income had been paid to them directly. (Her Majesty's Revenue and Customs, 2017d).

Similarly, the trustees are entitled to a reduction in their liability for capital gains tax, calculated as the difference between the amount that would have been payable had there been no reduction, and the amount that the beneficiary would have been liable to pay had the gains arisen in their hands. This reduction does not apply in the year that the beneficiary dies. (Her Majesty's Revenue and Customs, 2017d).

As mentioned earlier, transfers of property to a trust in favour of a vulnerable beneficiary will qualify as a potentially exempt transfer for inheritance tax purposes (Maston, 2016:237). Therefore, if the settlor dies more than seven years after the transfer, it will become an exempt transfer and no inheritance tax will be charged (Her Majesty's Revenue and Customs, 2017d). There is also no inheritance tax charged on a transfer of property out of a trust to a vulnerable beneficiary (Her Majesty's Revenue and Customs, 2017d). At the death

of the vulnerable beneficiary, assets held in the trust on their behalf form part of their estate and inheritance tax may be charged (Her Majesty's Revenue and Customs, 2017d).

3.3. Conclusion

The United Kingdom follows a hybrid approach, alternating between the personification of the trust and treating it as a transparent entity. (Garton, 2015:98). Trust income is firstly taxed in the hands of the trustees. (Garton, 2015:98). Secondly, trust beneficiaries are subject to tax on any trust income which has been distributed to them and are subsequently entitled to a credit for the tax already paid by the trustees (Garton, 2015:100). Income arising under a settlement in which the settlor retains an interest is deemed to be that of the settlor. (Garton, 2015:102).

Capital gains tax is charged to the settlor at the creation of a trust (Maston, 2016:85). Where trustees dispose of trust assets, the trustees are liable for capital gains tax on the disposal (Garton, 2015:106). A deemed disposal at market value takes place where a beneficiary becomes absolutely entitled to any portion of the settled property (Maston, 2016:86).

Trusts are treated differently from an inheritance tax perspective depending on whether it was formed before or after 22 March 2006 (Garton, 2015:113). Before 22 March 2006 transfers to most trusts, other than discretionary trusts, were treated as potentially exempt transfers. Transfers made to trusts after 22 March 2006 will only be classified as potentially exempt if the trust meets specific requirements. (Garton, 2015:110). At the date of a person's death, a transfer of value is deemed to have taken place immediately before the person's death (Garton, 2015:110). Where assets are transferred out of a trust an inheritance tax exit charge is levied on the transfer of all relevant property. (Her Majesty's Revenue and Customs, 2017g).

Chapter 4: The taxation of trusts in South Africa

4.1. Introduction

This chapter provides an overview of the taxation of trusts in South Africa. At first, general principles applicable to the taxation of trusts in South Africa are considered, followed by a more in-depth look at the income tax and capital gains tax provisions applicable to trusts. Finally, the rules relating to the taxation of special trusts are considered, followed by a brief overview of the donations tax and estate duty provisions relating to trusts. Unless indicated otherwise, all section references in this chapter are references to the Income Tax Act 58 of 1962 and all paragraph references are references to the Eighth Schedule of the Income Tax Act 58 of 1962.

4.2. The taxation of trusts in South Africa

In South Africa trusts are treated as taxable entities in their own right (Olivier & Honiball, 2009:65). This results from the specific inclusion of a trust in the definition of a 'person' in section 1 and applies despite the fact that a trust is not considered to have a separate legal persona in terms of South African common law (Olivier & Honiball, 2009:65). As a person, a trust may become liable for both income tax and capital gains tax (Geach & Yeats, 2007:234).

A trust is given a wide definition in section 1 which includes both *inter vivos* and *mortis causa* trusts, as well as foreign trusts, and which applies for both normal tax as well as for capital gains tax purposes (Olivier & Honiball, 2009:65). In terms of this definition, every type of trust, even verbal trusts, which are ordinarily not regarded as valid trusts in terms of the Trust Property Control Act, will be treated as a person for tax purposes (Geach & Yeats, 2007:234).

Where gross income accrues to or is received by a trust, the trust itself will therefore be taxable. There are, however, two instances in which the income of a trust is not taxed in the hands of the trust but rather in that of another person. In the first instance, special rules

apply where the income of a trust is distributed to the trust beneficiaries or to which the beneficiaries have a vested right, which could result in the beneficiaries being taxed on the income instead of the trust. The rules relating to the treatment of such distributions are contained in section 25B and will be discussed in more detail later in this chapter. In the second instance, the founder or donor of a trust may become taxable on the income of the trust in terms of section 7 where a causal link exists between the receipt or accrual of trust income and a donation or disposal to a trust. Section 7 will also be discussed in more detail later in this chapter. (Olivier & Honiball, 2009:66).

The rate of tax for a trust depends on whether the trust is a so-called 'normal' trust or a special trust. The provisions relating to special trusts are discussed in more detail later in this chapter. A normal trust is taxed at a flat rate equal to the top marginal rate for individuals, whereas a special trust is taxed using the sliding-scale rates applicable to individuals (Geach & Yeats, 2007:238). For the 2017 year of assessment, the top marginal rate for individuals is 41% (45% for the 2018 year of assessment). Unlike individuals, however, trusts do not qualify for either the rebates granted to individuals in terms of section 6, or the interest exemption in terms of section 10(1)(i) (Olivier & Honiball, 2009:67). The year of assessment of a trust ends on the last day of February each year. (Olivier & Honiball, 2009:67)

4.2.1. The residence of a trust

Any person, including a trust, must account for tax in South Africa upon the receipt or accrual of any gross income. The gross income of a non-resident differs from that of a resident insofar as it only includes amounts from a source within or deemed to be within South Africa. (Olivier & Honiball, 2009:67).

In South Africa, a natural person is a resident if that person is ordinarily resident in South Africa or if that person meets the requirements of the so-called physical presence test in terms of the definition of 'resident' in section 1 (Olivier & Honiball, 2009:67).

A trust is a resident if it is established or formed in South Africa or if it has its place of effective management in South Africa. A trust which is deemed to be exclusively resident of another country for purposes of applying any double tax agreement is specifically excluded from being a resident. (Olivier & Honiball, 2009:67).

Consequently, any trust formed in South Africa would be a tax resident in South Africa, even if the trust has no South African trustees or is effectively managed outside South Africa (Olivier & Honiball, 2009:68).

An offshore trust which is effectively managed in South Africa is also considered to be a South African tax resident (Olivier & Honiball, 2009:69). In Interpretation Note 6 (Issue 2), released on 3 November 2015, SARS has provided guidance on the interpretation and application of the term 'place of effective management' in determining the tax residence of a company (South African Revenue Service, 2015:3). Even though the interpretation note deals with effective management in the context of companies, the principles do, however, apply to other types of entities, including trusts (South African Revenue Service, 2015:3).

In determining the place of effective management, definitive rules cannot be laid down, but instead all relevant facts and circumstances must be considered on a case-by-case basis (South African Revenue Service, 2015:7).

In interpreting the meaning of place of effective management, SARS has found the rulings of certain overseas court cases useful. In *Her Majesty's Revenue and Customs v Smallwood & another*, which deals specifically with the place of effective management of a trust, it was held by the court that it needed to be determined where the real top level of management of the trust was exercised. The court found that there was a distinction between the key management and commercial decisions of the trust and the day-to-day management exercised by the trustees and that the place of effective management is determined by the former. (South African Revenue Service, 2015:5).

Important factors to consider when determining the place of effective management of a trust include the place where the trustees meet to conduct the business of the trust, as well as the place where the trust assets are managed (Olivier & Honiball, 2009:71).

4.2.2. The conduit principle

In *Armstrong v CIR* it was held by the court that income received by a beneficiary from a trust retains its nature. This is referred to as the conduit principle in terms of which, for example, interest income received by a trust and distributed to a beneficiary during the same tax year will retain its nature as interest in the hands of the beneficiary. Consequently, if the interest qualifies for an exemption, the beneficiary will be entitled to the exemption despite the fact that the income was received in the form of a distribution from the trust. The position is less clear in the instance where the income is capitalised in the trust and only distributed to a beneficiary in a subsequent year. In this case, certain commentators maintain that the income would not retain its nature. (Olivier & Honiball, 2009:72).

In South Africa, the first mention of the conduit principle is contained in *CIR v Polonsky*, where it was held by the court that the trustees were no more than a 'conduit pipe' and held no material interest in the income of the respondent's wife (Olivier & Honiball, 2009:72).

The principle was later confirmed by the Appellate Division in *Estate Dempers v SIR* where the court held that accumulated trust income retained its nature despite a specific provision in the trust deed to the contrary. (Olivier & Honiball, 2009:72).

One exception to the conduit principle is found in section 10(2). In terms of this section, the exemptions provided for in section 10(1)(k), relating to local dividends, and section 10(1)(h), relating to interest received by non-residents, do not extend to any portion of an annuity. As a result, a beneficiary will not be entitled to either of these exemptions if the income from the trust is distributed in the form of an annuity. (Olivier & Honiball, 2009:73).

4.2.3. Section 25B

Section 25B contains certain special rules applicable to the taxation of trust income which apply specifically to trusts in addition to the general taxation principles (Olivier & Honiball, 2009:73). The provisions of section 25B are, however, subject to the provisions of section 7 (Olivier & Honiball, 2011:136). In essence, section 25B(1) provides that income to which the beneficiaries have a vested right or which has been distributed to them will be taxed in the hands of the beneficiaries, whereas the trust will be taxed on any undistributed trust income (Olivier & Honiball, 2011:136).

Section 25B(2) specifically applies to a discretionary trust (Olivier & Honiball, 2009:75). In terms of this section, where a trustee exercises a discretion in terms of the trust deed which results in the acquiring of a vested right to any amount referred to in section 25B(1) by a beneficiary, that amount shall be deemed to be derived for the benefit of the beneficiary (Du Toit, 2007:145). The amount will therefore be taken into account in determining the income tax liability of the beneficiary and not that of the trust (Olivier & Honiball, 2009:75).

Due to the view held by some that undistributed trust income changes its nature to capital, subsection (2A) was inserted into section 25B. In terms of this section, any resident who acquires a vested right to any capital of a non-resident trust must include that amount in the income of that resident. This will only apply where that capital arose from any receipts or accruals of the trust which would have constituted income if such trust had been a resident in any previous tax year during which that resident had a contingent right to that amount, and if that amount has not been subject to tax in South Africa. (Olivier & Honiball, 2009:76)

Section 25B(2A) therefore delays the tax liability of the resident beneficiary until the acquisition of a vested right to the trust income, as the section only applies when the beneficiary acquires such a vested right (Olivier & Honiball, 2009:77).

In terms of section 25B(3), any allowance or deductible expenditure incurred in producing the income of a trust will be deductible by the same person and in the same proportion in

which the income has been allocated. If no income has been allocated to a beneficiary, all allowable expenditure incurred in the production of the trust income will therefore be deductible from income by the trust. Where an amount of income has been allocated to a beneficiary, any related deductions can be offset against that income in the same proportion that the allocated income bears to the total income of the trust. (Geach & Yeats, 2007:243).

Sections 25B(4) to (7) contain certain ring-fencing provisions with regard to the deductions allowed in determining the taxable income of a beneficiary (Olivier & Honiball, 2009:82). Section 25B(4) provides that deductions and allowances claimed by beneficiaries as contemplated in section 25B(3) are limited to the income received from the trust by the beneficiary (Olivier & Honiball, 2009:82). As a result, tax losses may not be distributed to a beneficiary by a trust (Geach & Yeats, 2007:244).

In the case where the deductions allowed in terms of section 25B(3) exceed the trust income which accrues to or is received by the beneficiary, section 25B(5)(a) provides that the excess amount is deemed to be a deduction of the trust and this deduction is limited to the taxable income of the trust. Where the trust is not subject to tax in South Africa, the excess must, however, be carried forward to the immediately succeeding year of assessment and allowed as a deduction in determining the taxable income of the beneficiary in that succeeding year. (Olivier & Honiball, 2009:83).

If the deductions and allowances as contemplated in sections 25B(4) and 25B(5)(a) exceed both the amounts included in the income of the beneficiary as well as the taxable income of the trust, the excess amount must be allowed as a deduction against income from the trust included in the beneficiary's income in the immediately succeeding year of assessment in terms of section 25B(6). (Olivier & Honiball, 2009:83).

Where the beneficiary is not subject to tax on the relevant income in South Africa, section 25B(7) provides that the abovementioned ring-fencing provisions do not apply (Olivier & Honiball, 2009:83).

4.2.4. Section 7

Section 7 contains a number of anti-avoidance provisions which regulate when income is deemed to have accrued to or to have been received by a person (Du Toit, 2007:146). The provisions of this section are aimed at preventing tax avoidance through income splitting by rendering income resulting from a 'donation, settlement or other disposition' taxable in the hands of the donor (Du Toit, 2007:146). In essence, section 7 provides that where income accrues to a person as a result of a donation, settlement or other disposition, the income will be taxed in the hands of the person who made the donation, settlement or other disposition and not the person who received the income (Geach & Yeats, 2007:243). Although the application of section 7 is not limited to trusts, most of the subsections are, to some extent, relevant to trusts (Olivier & Honiball, 2009:84).

The words 'donation' and 'settlement' used in section 7 are readily interpreted as dispositions containing an appreciable element of generosity. The term 'other disposition' is interpreted as indicating dispositions of the same kind or nature as that of a 'donation' or 'settlement'. (Du Toit, 2007:146). For the purposes of applying section 7, the failure to charge market-related interest on a loan is considered to be a continuous donation (Stiglingh *et al*, 2017:841).

Section 7(9) provides that the amount by which the market value of any asset which has been disposed of exceeds the consideration received shall be deemed to be a donation for purposes of the application of section 7 (Du Toit, 2007:146).

In terms of section 7(1), income shall be deemed to have accrued to a person, despite the fact that such income has been invested, accumulated or otherwise capitalised or that such income has not actually been paid over to that person. Where the beneficiaries of a trust have a vested right to income which has been retained in the trust for purposes of investment on behalf of the beneficiaries, that income is therefore taxable in the hands of the

beneficiaries, even if the amounts have not yet been distributed to them. (Du Toit, 2007:146).

Section 7(2) provides that any income which has been received by or accrued to a person in consequence of a donation, settlement or other disposition made by that person's spouse, shall be deemed to be the income of that person's spouse. In order for section 7(2) to apply, the sole or main purpose of the donation made by the spouse must have been to avoid the donor's liability to pay tax. In the context of a trust, this provision could be applicable where one spouse donates an asset to a trust and the income generated by that asset vests in the other spouse as a beneficiary of the trust. (Olivier & Honiball, 2009:84).

Where income accrues to or is received by a minor child (under the age of 18) in consequence of any donation, settlement or other disposition made by that child's parent, that income will, in terms of section 7(3), be deemed to have been received by that parent and will therefore be taxable in the parent's hands. If a minor child is a beneficiary of a vesting or discretionary trust which generates income as a result of a donation made by the parent, the parent will be taxed in the income and not the trust or the minor child beneficiary. (Olivier & Honiball, 2009:85).

In order to prevent a parent from circumventing the provisions of section 7(3) by having a third party make the donation, section 7(4) provides that any income accrued to or received by any minor child of any person, in consequence of a donation, settlement or other disposition made by the other person, must be deemed to be the income of the parent of that minor child, if such parent has made a donation, settlement or other disposition in favour of that other person or his or her family (Olivier & Honiball, 2009:85).

Section 7(5) will apply where a person has made a donation, settlement or other disposition and, firstly, the donation, settlement or other disposition is subject to a condition or stipulation, and secondly, as a result of the condition or stipulation, the beneficiaries will not receive the income or a portion thereof until the happening of some fixed or contingent

event. The effect of section 7(5) is that the resulting income will be deemed to have been received by or accrued to the person who made the donation, settlement or other disposition until such time as the event takes place or that person's death. (Olivier & Honiball, 2009:86)

'An event' for the purposes of section 7(5) includes, for example, a provision in the trust deed that income may only be distributed once a beneficiary reaches a certain age. The position is, however, less clear on whether the distribution of income by way of the exercising of a discretion by the trustees constitutes such an event, as attested to by the conflicting outcomes of various court cases in this regard, including *ITC 775* and *ITC 823*. (Olivier & Honiball, 2009:90).

Section 7(6) is aimed at preventing tax avoidance by the founder of a trust who retains the right to elect different beneficiaries in each year of assessment. In the absence of this provision, the founder of a trust could potentially avoid tax by effecting the award of income to the beneficiary with the lowest marginal tax rate in each year. The section therefore provides that where a person has a right to receive income in consequence of a donation, settlement or other disposition and the donor retains the power to revoke such a right or to confer it upon another, the relevant income will be taxable in the hands of the donor. (Du Toit, 2007:149).

Where the right of a person to receive income from an asset is ceded to another, while that person retains ownership of the asset, or the right to regain ownership at a future date, section 7(7) will apply. The resulting income will be taxable in the hands of the cessionary. In the context of a trust, section 7(7) will apply if income is ceded to a trust or if a trust attempts such a cession. (Olivier & Honiball, 2009:93).

Section 7(8) applies where any amount is received by or accrues to a non-resident as a result of a donation, settlement or other disposition made by a person who is a resident, and that amount would have constituted income in the hands of the non-resident had they been resident. The amount received by or accrued to the non-resident which is attributable to such

a donation, settlement or other disposition, will be included in the income of that resident person. Section 7(8) applies to all non-resident persons, including any non-resident trust. Where a resident, for example, donates an amount to a non-resident trust, any income attributable to the amount donated will therefore be included in the income of the donor. (Olivier & Honiball, 2009:95).

4.2.5. Connected persons

The term ‘connected person’ is defined in section 1. The definition applies for all income tax and capital gains tax purposes (Olivier & Honiball, 2009:99).

In the case of a natural person, section 1 defines a connected person as any relative of that person as well as any trust of which such natural person or such relative is a beneficiary.

In relation to a trust, a connected person includes any beneficiary of such a trust, as well as any other connected person in relation to such beneficiary. Furthermore, any connected person in relation to a trust is a connected person in relation to every other connecter person of that trust. (Olivier & Honiball, 2009:100).

The term ‘connected person’ is used extensively throughout the legislation for both income tax and capital gains tax purposes, where it serves, in most cases, as an anti-avoidance mechanism (Olivier & Honiball, 2009:99). For example, in terms of paragraph 38 of the Eighth Schedule, where an asset vests in a beneficiary, the proceeds on the disposal of the asset will be deemed to be the market value as a result of the fact that the beneficiary and the trust are connected persons (Stiglingh *et al*, 2017:847).

4.2.6. Capital Gains Tax

As a person, a trust is subject to capital gains tax on the disposal of any asset and will include any taxable capital gain determined in accordance with the Eighth Schedule in its taxable income in terms of section 26A (Olivier & Honiball, 2009:122). In terms of paragraph 10 of the Eighth Schedule, the inclusion rate for the net capital gain of a trust (other than a

special trust) is 80%, whereas the inclusion rate for a natural person is 40% for the 2017 year of assessment. The fact that the inclusion rate applicable to trusts is so much higher than that of natural persons is an example of how trusts have been singled out by the legislature for harsher tax treatment (Olivier & Honiball, 2009:123).

In the context of a trust, a disposal of an asset includes, for example, the sale of a capital asset by the trustees, as well as the vesting of an interest in a trust asset in a beneficiary. A disposal will also take place where a beneficiary exchanges a vested right to claim assets from the trustees for a real right to the asset when the beneficiary takes actual ownership of the asset. (Geach & Yeats, 2007:253).

In addition to the general capital gains tax provisions, several provisions contained in the Eighth Schedule apply specifically to trusts and trust distributions (Olivier & Honiball, 2009:122).

Paragraph 80(1) applies where an asset of a trust vests in a resident beneficiary (Olivier & Honiball, 2009:128). The paragraph provides that any resulting capital gain must be disregarded from the trust's perspective and instead taken into account in determining the aggregate capital gain or capital loss of the beneficiary (Olivier & Honiball, 2009:128). As mentioned in the section on connected persons, the proceeds on the disposal of the asset will be deemed to be the market value of the asset, as a result of the fact that the beneficiary and the trust are connected persons (Stiglingh *et al*, 2017:847).

None of the provisions of the Eighth Schedule, including Paragraph 80(1), provide for the attribution of any capital losses to trust beneficiaries (Olivier & Honiball, 2009:129). Any resulting capital losses therefore remain attributable to the trust (Olivier & Honiball, 2009:129). Because a trust and its beneficiaries are connected persons, paragraph 39 provides that any loss which arises when a trust vests an asset in a beneficiary must be disregarded (Olivier & Honiball, 2009:138). Where a subsequent disposal takes place between the same two parties at a time when those parties are still connected persons in

relation to one another, the disregarded loss may be deducted from any resulting capital gain (Olivier & Honiball, 2009:138). Paragraph 39 contains certain special exceptions to the definition of connected persons and in relation to share schemes (Olivier & Honiball, 2009:139).

Where a capital gain, as opposed to a capital asset, vests in a resident trust beneficiary, the capital gain is once again disregarded in the hands of the trust and taken into account in determining the aggregate capital gain or capital loss of the beneficiary in terms of paragraph 80(2) (Olivier & Honiball, 2009:132). Paragraph 80(2) does not apply if the gain vests in a tax-exempt entity referenced in paragraph 62(a) to (e) (Haupt, 2017:736). Where a section 8C equity instrument is transferred to a beneficiary, the gain is also taxed in the trust in terms of paragraph 80(2A) (Haupt, 2017:736). The provisions of paragraph 80(1) and 80(2) are subject to the attribution rules found in paragraphs 68, 69, 71 and 72, which are discussed below (Haupt, 2017:735).

A South African resident beneficiary will be taxed on any amount to which that beneficiary acquired a vested right from a non-resident trust, if that amount would have constituted a capital gain had that trust been a resident, provided that the amount has not already been subject to tax in South Africa (Haupt, 2017:737). If the amount has already been subject to tax in a foreign jurisdiction, the resident will be entitled to a section 6*quat* rebate against the resulting South African tax (Haupt, 2017:737). A resident trust will be taxed on a capital gain distributed to a non-resident beneficiary, provided that the attribution rule in paragraph 72 does not apply (Haupt, 2017:737).

Where a beneficiary disposes of a contingent interest in a discretionary trust, the base cost of that interest is deemed to be nil in terms of paragraph 81. This applies despite the fact that paragraph 38(1)(b) provides that an asset acquired from a connected person is deemed to have a base cost equal to its market value (Olivier & Honiball, 2009:142).

4.2.7. Attribution of Capital Gains

As the deeming provisions of section 7 do not apply to capital gains, the Eighth Schedule contains its own attributions rules which are contained in paragraphs 68 to 73 which apply specifically to capital gains (Haupt, 2017:813). These provisions are the equivalent of the provisions contained in section 7, which applies for normal income tax purposes (Olivier & Honiball, 2009:143).

Paragraph 68 applies where a capital gain made by one spouse arose as a result of any donation, settlement or other disposition or a transaction, operation or scheme entered into by the other spouse, mainly for the reason of reducing, postponing or avoiding the latter spouse's liability for tax (Haupt, 2017:746). As a result, where one spouse acquires a vested interest in a capital gain of a trust as a result of a donation made by the other spouse, the capital gain will be taxed in the hands of the donor spouse and not in the hands of the spouse who acquired such a vested interest (Geach & Yeats, 2007:269).

In dealing with capital gains attributable to minor children, paragraph 69 mirrors the application of section 7(3) in the context of capital gains. Where a minor child acquires a vested interest in a capital gain of a trust as a result of a donation made by the parent, the capital gain will be taxed in the hands of the parent. (Geach & Yeats, 2007:270).

The provisions of paragraph 70 are similar to those of section 7(5). Where a person has made a donation, settlement or other disposition which is subject to a stipulation or condition in terms of which a capital gain shall not vest in the beneficiaries of that donation until the happening of some contingent or fixed future event, that capital gain must be taken into account in calculating the donor's tax liability. Paragraph 70 will only apply where the donor was a resident throughout the year of assessment in which the capital gain arose and if the capital gain has not vested in any resident beneficiary during that year of assessment. (Olivier & Honiball, 2009:143).

Similar to section 7(6), paragraph 71 seeks to ensure that where a right to a capital gain has been awarded to a beneficiary during a particular year of assessment as a result of a donation settlement or other disposition made by a donor, and that donor may revoke that right or confer it upon another, the capital gain will be taxed in the hands of the donor and not in that of the beneficiary (Geach & Yeats, 2007:271). Paragraph 71 will only apply where the donor was a resident throughout the year of assessment in which the capital gain arose (Olivier & Honiball, 2009:145).

Where a resident has made any donation, settlement or other disposition to any person who is not a resident, and a capital gain attributable to that donation, settlement or other disposition has, during that year, vested in a person who is not a resident, paragraph 72 provides that the capital gain must be taxed in the hands of the donor and not in the hands of the person in whom that capital gain vests. The term 'any person who is not a resident' includes any offshore trust (Olivier & Honiball, 2009:145).

Paragraph 73 is a limiting provision and provides that where both income and capital gains are derived by reason of a donation, settlement or other disposition, the total amount attributed to another person in terms of either section 7 or paragraph 68 to 72 shall not exceed the amount of the benefit derived from that donation, settlement or other disposition (Olivier & Honiball, 2009:148).

4.2.8. Section 7C

In the 2016 National Budget Review, National Treasury expressed concern over the granting of low-interest rate loans to trusts as consideration for the transfer of assets in order to avoid estate duty and donations tax (National Treasury, 2016a:49). In response to this concern, section 7C was introduced and came into operation on 1 March 2017 (Stiglingh *et al*, 2017:843).

Section 7C is an anti-avoidance provision, which deals with the tax treatment of low-interest rate and interest-free loans granted to trusts. Initially, National Treasury proposed that the

difference between the interest charged on the loan to the trust and interest calculated at the official rate of interest be included in the taxable income of the person who granted the loan. The proposal was, however, amended following public hearings, so that the foregone interest is instead treated as a continuing, annual donation for purposes of donations tax. (Stiglingh *et al*, 2017:843).

The section applies to any loan, advance or credit granted by a natural person, or at the instance of that natural person by a company that is a connected person in relation to that natural person, to any trust in relation to which that person or company or any person in relation to which that person or company is a connected person (Stiglingh *et al*, 2017:843).

As mentioned above, the difference between the interest calculated at the official rate of interest and the actual interest charged on the loan, advance or credit, will be deemed to be a donation made by the lender on the last day of the trust's year of assessment in terms of section 7C(3). If the lender is a natural person, that person is entitled to utilise the annual donations tax exemption of R100 000 against the deemed donation amount for donations tax purposes. (Stiglingh *et al*, 2017:843). Donations tax will be discussed in more detail later in this chapter.

The official rate of interest is defined in paragraph 1 of the Seventh Schedule to the Income Tax Act as an interest rate equal to the South African repurchase rate plus 100 basis points, in the case of a debt which is denominated in the currency of the Republic. In the case of a debt denominated in any other currency, the official interest rate is defined as being a rate of interest that is the equivalent of the South African repurchase rate applicable in that currency plus 100 basis points.

Section 7C(2) prohibits the lender from claiming any deduction, loss, allowance or capital loss in respect of the disposal, including by way of reduction or waiver, or by way of failure to claim payment, of such a low-interest rate or interest-free loan (Stiglingh *et al*, 2017:843).

Section 7C(5) provides for a number of instances in which the provisions of section 7C(2) and (3) will not apply, including, among others, a loan, advance or credit granted to certain vesting trusts, to a special trust created solely for the benefit of minors with a disability, or to a trust that is classified as a public benefit organisation (Stiglingh *et al*, 2017:843).

4.2.9. Special Trusts

Two types of special trusts are defined in section 1 (Geach & Yeats, 2007:237). Paragraph (a) of the definition defines a special trusts as a trust which has been set up solely for the benefit of an individual or individuals with a disability as defined in section 6B(1), where such disability renders such an individual incapable of earning sufficient income for their maintenance or from managing their own financial affairs, provided that where more than one person is a beneficiary of such a trust, such persons must be relatives in relation to one another, and such a trust shall cease to be a special trust in respect of years of assessment ending on or after the date on which all such persons, for whose benefit the trust was created, are deceased.

A 'disability' is defined in section 6B(1) as a moderate to severe limitation of a person's ability to function or perform daily activities as a result of a physical, sensory, communication, intellectual or mental impairment, which has lasted or has a prognosis of lasting more than one year and is diagnosed by a duly registered medical practitioner in accordance with criteria prescribed by the Commissioner.

Paragraph (b) of the definition of 'special trust' in section 1 defines a special trust as a testamentary trust created solely for the benefit of relatives of the testator, where the youngest of such relatives is under the age of 18 on the last day of the tax year.

The above definitions of a special trust apply for income tax purposes. In terms of capital gains tax, the definition of a special trust is, however, more restrictive and only the paragraph (a) definition of a special trust qualifies as a special trust for capital gains tax purposes. (Geach & Yeats, 2007:238).

A special trust, as opposed to a normal trust, has the advantage of being taxed in the same manner as a natural person (Geach & Yeats, 2007:238). Instead of being taxed at a flat rate equal to the maximum marginal rate applicable to individuals, as is the case for a normal trust, a special trust is taxed in accordance with the sliding-scale rates applicable to natural persons (Geach & Yeats, 2007:238).

From a capital gains tax perspective, the inclusion rate applicable to a special trust (as defined in section 1) is the same as that of a natural person, whereas the inclusion rate applicable to normal trusts is much higher (Olivier & Honiball, 2009:235). In terms of paragraph 10 of the Eighth Schedule, the inclusion rate applicable to a special trust is 40%, whereas a normal trust is subject to an inclusion rate of 80% for the 2017 year of assessment. A special trust in terms of paragraph (a) of the section 1 definition also qualifies for the annual exclusion, as well as the primary residence exclusion applicable to natural persons (Olivier & Honiball, 2009:236). For the 2017 year of assessment the annual exclusion applicable to natural persons and special trusts, in terms of paragraph 5 of the Eighth Schedule, is R40 000, whereas the primary residence exclusion in terms of paragraph 45 is R2 000 000. Such a special trust also qualifies for the personal-use asset exclusion in terms of paragraph 45, as well as the exclusion in respect of compensation for personal injury, illness or defamation in terms of paragraph 59 (Olivier & Honiball, 2009:236).

If a qualifying beneficiary of a special trust dies, paragraph 82 provides that a trust will only cease to be a special trust for capital gains tax purposes at the earlier of two years after the death of that beneficiary or the date at which all the assets of that trust have been disposed of (Olivier & Honiball, 2009:236).

4.2.10. Donations Tax

In South Africa, donations tax is levied on the value of any property disposed of under a donation by a resident. Donations tax is levied at a rate of 20% for the 2017 year of assessment. (Olivier & Honiball, 2009:176).

‘Property disposed of’ is widely interpreted and includes any direct or indirect disposal, whether in trust or not. As a result, any contribution by a founder in trust to be administered for the benefit of a beneficiary will be a donation if it meets the definition of a ‘donation’ in section 55. (Olivier & Honiball, 2009:176).

Where property has been donated to a trustee in order to be administered by him for the benefit of a beneficiary, such a trustee is included in the definition of a ‘donee’ in section 55(1). (Du Toit, 2007:152).

Several exemptions from donations tax are provided for in terms of section 56 (Olivier & Honiball, 2009:177). With regards to trusts, section 56(1)(l) provides for an exemption in respect of property disposed of under and in pursuance of a trust (Olivier & Honiball, 2009:183). As a result, any distributions made by the trustees in accordance with the relevant will or trust deed to the beneficiaries will be exempt from donations tax (Olivier & Honiball, 2009:183). This exemption does not extend to donations made to other persons, or to an amount which the settlor settles to found the trust (Olivier & Honiball, 2009:183).

Any bona fide contributions made for the maintenance of a person is also exempt from donations tax. This exemption also applies to trusts. (Olivier & Honiball, 2009:178).

In addition, provision is made for an annual exemption to the value of R100 000 which applies to natural persons, and R10 000 which applies to casual gifts made by donors other than natural persons, including trusts. (Olivier & Honiball, 2009:178).

4.2.11. Estate Duty

In South Africa, natural persons who are ordinarily resident are subject to estate duty on the value of their worldwide property upon death. Like donations tax, the rate at which estate duty is levied in 2017 is 20%. (Olivier & Honiball, 2009:188). This rate is applied to the dutiable amount of the estate (Stiglingh *et al*, 2017:87. Estate duty is only payable on the net value of the estate exceeding R3 500 000 (Stiglingh *et al*, 2017:995).

In contrast to the treatment of a trust for income tax purposes, a trust is not regarded as a person for estate duty purposes and is therefore not subject to estate duty. Subject to certain exceptions provided for in the Estate Duty Act, trust assets will also not form part of the estate of the founder. As a result, trusts are often used as an estate-duty planning vehicle, in order to minimise estate duty or to avoid it altogether. (Olivier & Honiball, 2009:189).

4.3. Conclusion

In South Africa trusts are defined as a person for income tax purposes and are therefore treated as taxable entities in their own right (Olivier & Honiball, 2009:65). The trust will therefore be taxable on any gross income which accrues to it (Olivier & Honiball, 2009:66). If section 7 or section 25B applies, trust income is not taxed in the hands of the trust but rather in that of another person (Olivier & Honiball, 2009:66).

Trust beneficiaries could be taxed on trust income if the income is distributed to the beneficiaries or if the beneficiaries obtain a vested right to the income. The founder or donor of a trust may become taxable on the income of the trust where a causal link exists between the receipt or accrual of trust income and a donation, settlement or other disposal to a trust. (Olivier & Honiball, 2009:66).

As a person, a trust is subject to capital gains tax on the disposal of any asset and will include any taxable capital gain in its taxable income (Olivier & Honiball, 2009:122).

Subject to the attribution rules, where a trust asset is vested in a beneficiary, any resulting capital gain must be disregarded from the trust's perspective and instead taken into account in determining the aggregate capital gain of the beneficiary (Olivier & Honiball, 2009:128). Where a capital gain, as opposed to a capital asset, vests in a trust beneficiary, the capital gain is once again disregarded in the hands of the trust and taken into account in determining the aggregate capital gain of the beneficiary, provided none of the attribution rules apply (Olivier & Honiball, 2009:132).

The Eighth Schedule contains its own attributions rules which are contained in paragraphs 68 to 73 which apply specifically to capital gains (Haupt, 2017:813). These provisions are the equivalent of the provisions contained in section 7, which applies for normal income tax purposes (Olivier & Honiball, 2009:143).

In South Africa, donations tax is levied on the value of any property disposed of under a donation by a resident (Olivier & Honiball, 2009:176). Any distributions made by the trustees in accordance with the relevant will or trust deed to the beneficiaries will be exempt from donations tax (Olivier & Honiball, 2009:183). The transfer of assets to a trust by the founder is not exempt from donations tax (Olivier & Honiball, 2009:183).

A trust is not regarded as a person for estate duty purposes and is therefore not subject to estate duty (Olivier & Honiball, 2009:189).

Chapter 5: A comparison of the taxation of trusts in the United Kingdom and South Africa

5.1. Introduction

In this chapter, a comparison will be drawn between the taxation of trusts in the United Kingdom and South Africa. The comparison will be drawn with reference to each type of tax applicable to the transactions relating to trusts. First, general aspects relating to trusts will be compared. Then, the tax treatment of trusts under income tax, capital gains tax, as well as inheritance tax, donations tax and estate duty, as they apply in each jurisdiction, will be compared. The questions addressed in the comparison below were compiled by the author.

5.2. General aspects regarding the taxation of trusts

General aspects regarding the taxation of trusts	United Kingdom	South Africa
1. Is the trust a 'person' for tax purposes?	No. The trustees are, however, treated as a single, distinct person for tax purposes.	Yes
2. Is the trust regarded as a natural person/individual for income tax purposes?	No	No (In certain respect, a special trust is, however, treated as a natural person.)
3. What is the relevant tax year/ year of assessment?	6 April to 5 April the following year.	1 March to last day of February the following year

5.2.1. United Kingdom

A trust is not regarded as a separate legal person in its own right. Instead, the trustees of a trust are treated as a single and separate person for income tax purposes. (Garton, 2015:98). The person represented by the trustees is not regarded as an individual for income tax purposes and therefore does not qualify for any personal or other allowances (Garton, 2015:99). The tax year starts on 6 April each year and ends on 5 April the following year (Her Majesty's Revenue and Customs, 2017d).

5.2.2. South Africa

In South Africa trusts are treated as taxable entities in their own right (Olivier & Honiball, 2009:65). As a person, a trust may become liable for both income tax and capital gains tax (Geach & Yeats, 2007:234). The year of assessment of a trust ends on the last day of February each year (Olivier & Honiball, 2009:67).

The rate of tax for a trust other than a special trust is 41% for the 2017 year of assessment. Trusts do not qualify for either the rebates granted to individuals in terms of Section 6 of the SA Income Tax Act, or the interest exemption in terms of Section 10(1)(i) of the same Act (Olivier & Honiball, 2009:67). A special trust is taxed in accordance with the sliding-scale rates applicable to natural persons (Geach & Yeats, 2007:238).

5.3. Income tax

Income tax on trust income	United Kingdom	South Africa
1. Who is taxed on trust income?	The trustees are taxed on trust income, unless the income has been mandated to a beneficiary.	Where the provisions of section 7 apply, the donor will be taxed on trust income.
	In addition to the trustees, trust beneficiaries are taxed on	Where the provisions of section 7 do not apply

	income which has been distributed to them, or to which they are entitled. Beneficiaries are entitled to a credit for tax already paid by the trustees on the distributed income.	and a beneficiary has a vested right to trust income, the beneficiary will be taxed.
	In addition to the trustees, the settlor is taxed on income which is deemed to be that of the settlor in terms of sections 624 to 629. The settlor is entitled to a credit for tax already paid by the trustees on the deemed income.	The trust is taxed on any remaining undistributed income.
2. What are the relevant income tax rates for the 2017 tax year?	a) Accumulated or discretionary income above £1 000: - Dividend Income: 38.1% - Other Income: 45%	Normal trust: 41% Special trust: The sliding scale rates applicable to natural persons.
	b) Income other than income in part (a): - Dividend income: 7.5% - Other Income: 20%	

5.3.1. United Kingdom

Initially, trust income is taxed in the hands of the trustees. The trustees are treated together as a single and distinct person for income tax purposes. (Garton, 2015:98). Where trust income is mandated to the beneficiaries of an interest in possession trust, such income is not included in the income of the trustees, but is taxed directly in the hands of the beneficiary (Her Majesty's Revenue and Customs, 2017f).

Any accumulated or discretionary income which arises to the trustees must be taxed at the trust rate of 45% on income other than dividend income and at the dividend trust rate of 38.1% in the case of dividend income (Garton, 2015:99). The first £1 000 of accumulated or discretionary trust income must be taxed at the basic rate (Inland Revenue, 2004:9). Where no accumulated or discretionary income arises to the trust, trust income, other than dividend income, is taxed at the basic rate of tax of 20% (Maston, 2016:42). Dividend income is taxed at the basic dividend rate of 7.5% (Her Majesty's Revenue and Customs, 2017d). Where income has been subject to tax at source, the trustees are only required to pay an amount equal to the difference between the tax charged at the applicable rate and the amount of tax paid at source (Maston, 2016:72).

Trust beneficiaries are subsequently subject to tax on any trust income which has been distributed to them, or to which they are entitled (Garton, 2015:100). The beneficiary will be liable for tax on the gross amount of trust income by applying the marginal tax rate applicable to that beneficiary and is subsequently entitled to a credit for the tax already paid by the trustees on the trust income attributable to that beneficiary. (Garton, 2015:100).

Anti-avoidance provisions apply where the settlor, their spouse or civil partner retains an interest in the settlement, where an unmarried minor child of the settlor receives a benefit from the settlement and where the settlor, their spouse or civil partner or minor child receives a capital payment from the accumulated income of the settlement. In order for these anti-

avoidance provisions to apply, some element of 'bounty' must be present. (Garton, 2015:101).

Subject to certain exceptions, any income arising under a settlement in which the settlor, their spouse or civil partner retains an interest is deemed to be that of the settlor (Garton, 2015:102). Where an unmarried minor child of a settlor receives a benefit from a settlement, that income is also deemed to be that of the settlor. This provision does not apply where the amount paid to the minor child of the settlor is below £100. (Garton, 2015:102). Where a capital sum is paid to the settlor, their spouse or civil partner, that amount is deemed to be income of the settlor. (Garton, 2015:103).

In terms of section 646 of the Trading and Other Income Act, the settlor is entitled to claim a credit for the amount of tax paid by the trustees on income which has been deemed to be that of the settlor under sections 624 to 629 of the Trading and Other Income Act.

5.3.2. South Africa

Where gross income accrues to or is received by a trust, the trust itself will be taxable as a separate person. Where the provisions of section 25B or section 7 of the SA Income Tax Act apply, however, income is not taxed in the hands of the trust. (Olivier & Honiball, 2009:66).

Where trust income arises as a result of a donation made by the founder, section 7 of the SA Income Tax Act provides that any income resulting from the donation is deemed to accrue to the founder. The income will therefore be taxed in the hands of the founder and not in the hands of the person who received the income. (Geach & Yeats, 2007:243).

Income to which the beneficiaries have a vested right, or which has been distributed to them, will be taxed in the hands of the beneficiaries (Olivier & Honiball, 2011:136). The trust will be taxed on any undistributed trust income. (Olivier & Honiball, 2011:136). Income which has been distributed to a beneficiary during the same year that it arises will retain its nature

(Olivier & Honiball, 2009:72). The provisions of section 25B of the SA Income Tax Act are subject to the provisions of section 7 of the same Act (Olivier & Honiball, 2011:136).

The rate of tax for a trust other than a special trust is 41% for the 2017 year of assessment (45% for the 2018 year of assessment). A special trust is taxed in accordance with the sliding-scale rates applicable to natural persons (Geach & Yeats, 2007:238).

5.4. Capital Gains Tax

Capital Gains Tax	United Kingdom	South Africa
Taxable event		
1. Creation of a settlement / founding of a trust	Deemed disposal of assets by settlor at market value. Settlor liable for capital gains tax. Hold-over relief could be available on the transfer of business assets or assets subject to the relevant property inheritance tax regime.	Actual disposal of assets by founder. Founder liable for tax on the capital gain. Disposal deemed to take place at market value if founder and beneficiary are connected persons.
2. Disposal of trust asset by trustees.	Trustees liable for capital gains tax. Capital gain calculated in same manner as that of an individual.	Trust liable for tax on the capital gain. Where a capital gain is vested in a beneficiary, that capital gain is disregarded in the hands of the trust and taxed in the hands of the beneficiary.
3. Beneficiary becomes entitled to trust asset /	A deemed disposal takes place at market value. The assets are	An actual disposal takes place at market value.

vesting of trust asset in beneficiary.	deemed to have been disposed of and reacquired by the trustees at market value and any resulting capital gain will be chargeable to capital gains tax. No capital gains tax arises where assets are transferred to a beneficiary of a bare trust.	Any resulting capital gain must be disregarded from the trust's perspective and instead taken into account in determining the aggregate capital gain or capital loss of the beneficiary.
4. Deemed disposal at death of beneficiary.	A deemed disposal takes place at the termination of a life-interest in possession on the death of the life tenant where the property continues to be settled property. Trust assets are deemed to be disposed of and reacquired at market value with no resulting chargeable gain.	None
6. Attribution rules	None	Capital gains could be taxed in the hands of the founder of any of the attributions rules apply.
7. Capital gains tax rates / taxable capital gain inclusion rates.	Ranges from 10% to 28% depending on the taxpayer's level of income, the type of taxpayer and the type of asset	Inclusion rate for normal trusts: 80%. Inclusion rate for special trusts: 40%.

	disposed of.	
8. Annual exempt amount / annual exclusion.	Individuals and trustees for disabled persons: £11 100 Other trustees: £5 550	Normal trusts: None Special trusts: R40 000

5.4.1. United Kingdom

The rate of capital gains tax ranges from 10% to 28% for the 2016 - 2017 tax year, depending on the type of taxpayer, the taxpayer's level of income, as well as the type of asset disposed of (Her Majesty's Revenue and Customs, 2017c). Individuals, personal representatives and trustees for disabled persons are entitled to an annual exempt amount of £11 100 for the 2017 tax year (Maston, 2016:93). The trustees of a trust other than a trust for disabled persons are entitled to an annual exempt amount of £5 550 (Her Majesty's Revenue and Customs, 2017c).

The settlor of a trust is liable for capital gains tax that arises as a result of the deemed disposal at the creation of a trust (Garton, 2015:105). Where business assets are transferred to a trust, or where the assets are transferred to a trust subject to the 'relevant property' inheritance tax regime, hold-over relief is available on the disposal (Maston, 2016:101;103).

Where chargeable assets are disposed of by trustees in the course of administering the trust, the trustees are liable for capital gains tax on the disposal. The capital gains tax on these gains are calculated using the same method applicable to individuals, but apply the lower annual exemption amount (Garton, 2015:106).

A deemed disposal of trust property at market value takes place at the termination of a life-interest in possession on the death of the life tenant where the property continues to be settled property (Garton, 2015:106). Consequently, no chargeable gain arises and the result is merely an increase in the base value of the property (Maston, 2016:91).

A deemed disposal also takes place once a beneficiary becomes absolutely entitled to any portion of the settled property (Maston, 2016:86). When this occurs, the assets are deemed to have been disposed of and reacquired by the trustees at market value and any resulting capital gain will be chargeable to capital gains tax (Garton, 2015:106). Once again, where the disposal resulted from the death of a life tenant, no chargeable gain will arise and the result is merely an increase in the base value of the asset. (Garton, 2015:106).

Where the trustees of a bare trust transfer trust assets to a beneficiary, no liability for capital gains tax arises (Her Majesty's Revenue and Customs, 2017d).

In terms of section 17 of the Taxation of Chargeable Gains Act, the disposal of an asset shall be deemed to take place at market value where the asset is not disposed of by way of a bargain made at arm's length, and in particular where the asset is disposed of by way of a gift or on a transfer to a settlement by a settlor.

5.4.2. South Africa

As a person, a trust is subject to capital gains tax on the disposal of any asset and will include any taxable capital gain in its taxable income (Olivier & Honiball, 2009:122). The inclusion rate for the net capital gain of a trust (other than a special trust) is 80%, whereas the inclusion rate for a special trust is 40% for the 2017 year of assessment. A special trust in terms of paragraph (a) of the section 1 definition of the SA Income Tax Act also qualifies for the annual exclusion, as well as the primary residence exclusion applicable to natural persons (Olivier & Honiball, 2009:236). For the 2017 year of assessment the annual exclusion applicable to natural persons and special trusts, in terms of paragraph 5 of the Eighth Schedule to the SA Income Tax Act, is R40 000, whereas the primary residence exclusion in terms of paragraph 45 of the Eighth Schedule to the SA Income Tax Act is R2 000 000. Such a special trust also qualifies for the personal-use asset exclusion in terms of paragraph 45 of the Eighth Schedule to the SA Income Tax Act, as well as the exclusion

in respect of compensation for personal injury, illness or defamation in terms of paragraph 59 of the Eighth Schedule to the SA Income Tax Act (Olivier & Honiball, 2009:236).

Where a trust asset is vested in a beneficiary any resulting capital gain must be disregarded from the trust's perspective and instead taken into account in determining the aggregate capital gain or capital loss of the beneficiary (Olivier & Honiball, 2009:128). The proceeds on the disposal of the asset will be deemed to be the market value of the asset, as a result of the fact that the beneficiary and the trust are connected persons (Stiglingh *et al*, 2017:847). Where a capital gain, as opposed to a capital asset, vests in a resident trust beneficiary, the capital gain is once again disregarded in the hands of the trust and taken into account in determining the aggregate capital gain or capital loss of the beneficiary (Olivier & Honiball, 2009:132). These provisions are subject to the attribution rules found in paragraphs 68, 69, 71 and 72 to the Eighth Schedule of the SA Income Tax Act (Haupt, 2017:735).

5.5. Inheritance tax, estate duty and donations tax

Inheritance Tax, Estate Duty and Donations Tax	United Kingdom (Only trusts created after 22 March 2006)	South Africa
1. Is tax levied on the transfer of assets to a trust?	Yes. A chargeable transfer for inheritance tax purposes arises on the transfer of relevant property to a trust.	Yes. Where the transfer of property to a trust meets the definition of a donation, donations tax will be levied on the transfer.
	Secondly, a periodic charge is levied at 30% of the normal charge at lifetime rates every ten years on settled property.	
	Lastly, inheritance tax is	

	charged when settled property ceases to be relevant property.	
2. Is tax charged on the transfer of an asset out of a trust?	Yes. An inheritance tax exit charge is levied of up to 6% on the value of relevant property transferred.	No. Donations made in pursuance of a trust are exempt from donations tax.
3. Is tax charged at the death of a person?	Yes. Inheritance tax is charged as a transfer of value is deemed to have taken place immediately before a person's death.	Yes. Estate duty is charged on the value of a person's estate at death. A trust is not a person for estate duty purposes and therefore no estate duty is levied on trust assets where the founder of a trust dies.
4. What is the value of the transfer, donation or the estate?	The value transferred is the amount by which the estate of the person has been diminished as a result of the transfer.	Donations tax: In most cases, the fair market value of the property donated at the date of donation. Estate duty: The value of worldwide property and deemed property at the date of death.
5. Exempt transfers, exemptions and abatements.	Only transfers to interest in possession trusts in favour of a vulnerable beneficiary can	Donations tax: Includes amounts contributed for the maintenance of a

	qualify as a potentially exempt transfer. Transfers from such a trust to a vulnerable beneficiary are not subject to inheritance tax. General exemptions include gifts of up to £3 000 per year, transfers between spouses and gifts to charities.	person as well as property disposed of in pursuance of a trust. General exemption: R100 000 per annum for natural persons. R10 000 per annum for other persons on casual gifts. Estate Duty: Abatement of R3 500 000.
6. Rate of tax	20% of the amount above £325 000. An additional 20% is levied if the transferor dies within seven years of making the transfer.	Donations tax: 20% Estate Duty: 20%.

5.5.1. United Kingdom

Inheritance tax must be charged on the value transferred by a chargeable transfer. Where value is transferred by an individual, provided the transfer is not an exempt transfer, a chargeable transfer arises. Exempt transfers include gifts of up to £3 000 per year, transfers between spouses and gifts to charities. (Garton, 2015:110).

The standard rate of inheritance tax is 40% of the amount above the threshold of £325 000 (Her Majesty's Revenue and Customs, 2017a). A different threshold applies where, for example, a taxpayer gives his or her home to their children, and a reduced rate of 36% applies to certain assets where a taxpayer leaves more than 10% of the net value of their

estate to charity at death (Her Majesty's Revenue and Customs, 2017a). Where the trustees of a trust pay inheritance tax on transfers into a trust, inheritance tax is levied at a reduced rate of 20% (Her Majesty's Revenue and Customs, 2017f). If the person who made the transfer dies within seven years of making the transfer, an additional 20% inheritance tax charge is levied (Her Majesty's Revenue and Customs, 2017f).

Where an *inter vivos* transfer of value by an individual constitutes a gift or is made to certain trusts, such a transfer is classified as a potentially exempt transfer. If the transferor of a potentially exempt transfer dies within seven years of the transfer, it becomes a chargeable transfer. Otherwise, the potentially exempt transfer becomes an exempt transfer. (Garton, 2015:110).

At the date of a person's death, a transfer of value is deemed to have taken place immediately before the person's death. The value transferred is the amount by which the estate of the person has been diminished as a result of the disposal. (Garton, 2015:110).

From 22 March 2006 only transfers to interest in possession trusts in favour of a disabled person or a bereaved minor can qualify as potentially exempt transfers. As a result, the creation of any other trust during the settlor's lifetime will be a chargeable transfer subject to inheritance tax. (Garton, 2015:120). In addition, any trust created on or after 22 March 2016, other than a few exceptions, including a trust in favour of a disabled person and a trust for a bereaved minor, will be subject to the relevant property regime. (Garton, 2015:120).

In terms of the relevant property regime, inheritance tax is firstly charged on the settlor when property is initially settled. Secondly, a periodic charge at 30% of the normal charge at lifetime rates is levied every ten years on settled property. Lastly, inheritance tax is charged when settled property ceases to be relevant property. (Garton, 2015:117).

Where assets are transferred out of a trust an inheritance tax exit charge of up to 6% is levied on the transfer of all relevant property. Transfers out of a trust include where trust

assets are distributed to beneficiaries or where a beneficiary becomes absolutely entitled to a trust asset. (Her Majesty's Revenue and Customs, 2017g).

5.5.2 South Africa

In South Africa, donations tax is levied on the value of any property disposed of under a donation by a resident. Donations tax is levied at a rate of 20%. Any contribution by a founder in trust to be administered for the benefit of a beneficiary will be a donation if it meets the definition of a 'donation' in section 55 of the SA Income Tax Act. (Olivier & Honiball, 2009:176).

With regards to trusts, an exemption is provided for in respect of property disposed of under and in pursuance of a trust. As a result, any distributions made by the trustees in accordance with the relevant will or trust deed to the beneficiaries will be exempt from donations tax. (Olivier & Honiball, 2009:183).

In addition, provision is made for an annual exemption to the value of R100 000 which applies to natural persons, and R10 000 which applies to casual gifts made by donors other than natural persons, including trusts. (Olivier & Honiball, 2009:178).

In South Africa, natural persons who are ordinarily resident are subject to estate duty on the value of their worldwide property upon death. Like donations tax, the rate at which estate duty is levied is 20%. (Olivier & Honiball, 2009:188)

In contrast to the treatment of a trust for income tax purposes, a trust is not regarded as a person for estate duty purposes and is therefore not subject to estate duty. Subject to certain exceptions provided for in the Estate Duty Act, trust assets will also not form part of the estate of the founder. (Olivier & Honiball, 2009:189)

Chapter 6: Conclusion

The objective of this report is to compare the tax treatment of trusts under South African law to that of the United Kingdom.

What has been found is that South Africa and the United Kingdom follow significantly different approaches to the taxation of trusts. Despite the difference in mechanisms used, similar results are, however, often achieved for the same types of transactions in both jurisdictions.

In South Africa trusts are defined as a person for income tax purposes and are therefore treated as taxable entities in their own right (Olivier & Honiball, 2009:65). In the United Kingdom, the trustees of a trust are treated as a single and separate person for income tax purposes, distinct from the persons who are the trustees of the trust (Garton, 2015:98). Therefore, despite the fact that a trust is not defined as a person in the United Kingdom, both jurisdictions effectively treat the trust as a separate person for tax purposes

In South Africa trust beneficiaries are taxed on trust income if the income is distributed to the beneficiaries or if a vested right to the income is obtained (Olivier & Honiball, 2009:66). The trust is only taxed on income which is retained in the trust after the application of section 7 and 25B of the SA Income Tax Act (Olivier & Honiball, 2009:66). In the United Kingdom trust income is firstly taxed in the hands of the trustees. (Garton, 2015:98). Secondly, trust beneficiaries are subject to tax on any trust income which has been distributed to them and are subsequently entitled to a credit for the tax already paid by the trustees (Garton, 2015:100). Where the beneficiary is subject to tax at the higher rate than the trust, the beneficiary will be liable for the additional tax above the amount already paid by the trustees (Garton, 2015:100). Whereas in South Africa the trust is only liable for tax on undistributed income, the liability for tax in the United Kingdom falls on the trust, with the beneficiary only liable for any excess tax payable.

In South Africa the founder of a trust may become taxable on the income of the trust where a donation, settlement or other disposition was made to a trust (Olivier & Honiball, 2009:66). In the United Kingdom income arising under a settlement in which the settlor retains an interest, or income paid to an unmarried minor child of the settlor is deemed to be that of the settlor. (Garton, 2015:102). Both jurisdictions therefore apply certain anti-avoidance provisions which result in tax on the founder or settlor where certain rights are retained or where children benefit from the trust.

In South Africa the trust is subject to capital gains tax on the disposal of any asset and will include any taxable capital gain in its taxable income (Olivier & Honiball, 2009:122). Where a trust asset or capital gain is vested in a beneficiary, the capital gain must be disregarded from the trust's perspective and instead taken into account in determining the aggregate capital gain of the beneficiary (Olivier & Honiball, 2009:128, 132). These rules apply provided the attributions rules contained in paragraphs 68 to 73 do not apply (Haupt, 2017:813).

In the United Kingdom, the trustees are liable for capital gains tax on the disposal of a trust asset and for the capital gains tax that arises when a beneficiary becomes absolutely entitled to settled property (Garton, 2015:106).

Whereas a trust will only be liable for tax on capital gains in South Africa where none of the attribution rules apply and the beneficiary has no vested right to the capital gain, the trustees of a United Kingdom trust will be liable for capital gains tax in most cases.

Although the United Kingdom has no estate duty or donations tax as such, the inheritance tax regime fulfils the same function as these taxes in many respects.

In the United Kingdom, where assets are transferred to a settlement during the settlor's lifetime a chargeable transfer will arise (Garton, 2015:120). Most trusts created after 22 March 2006 are subject to the relevant property regime (Garton, 2015:120). In terms of this regime, inheritance tax is firstly charged on the settlor when property is initially settled.

Secondly, a periodic charge at 30% of the normal charge at lifetime rates is levied every ten years on settled property. Lastly, inheritance tax is charged when settled property ceases to be relevant property. (Garton, 2015:117). In South Africa donations tax is levied on the transfer of assets to a trust if the transfer meets the definition of a donation (Olivier & Honiball, 2009:176). No periodic charge is levied in South Africa.

Where relevant property is transferred out of a United Kingdom trust, an inheritance tax exit charge is levied on the transfer. (Her Majesty's Revenue and Customs, 2017g). In South Africa, any distribution of assets by the trustees in accordance with the relevant will or trust deed to the beneficiaries will be exempt from donations tax (Olivier & Honiball, 2009:183).

At the date of a person's death, a transfer of value is deemed to have taken place for inheritance tax purposes in the United Kingdom (Garton, 2015:110). Where the trustees of a trust pay inheritance tax on transfers into a trust, inheritance tax is levied at a reduced rate of 20% (Her Majesty's Revenue and Customs, 2017f). If the person who made the transfer dies within seven years of making the transfer, an additional 20% inheritance tax charge is levied (Her Majesty's Revenue and Customs, 2017f). In South Africa a trust is not regarded as a person for estate duty purposes and is therefore not subject to estate duty at the death of the founder (Olivier & Honiball, 2009:189).

In South Africa, National Treasury has expressed concern over the use of trusts to avoid tax through income-splitting, as well as the avoidance of estate duty and donations tax through the transfer of assets to trusts by way of interest-free loans (National Treasury, 2013b:54). In order to address these concerns, the South African government has proposed to implement measures to ensure that assets transferred by way of loans to trusts are included in the estate of the founder at death and that interest-free loans advanced to trusts are categorised as donations (National Treasury, 2016a:49). Section 7C of the SA Income Tax Act has been implemented to give effect to some of these proposals. The Davis Tax Committee has also made a number of recommendations regarding required changes to the taxation of trusts,

including repealing the deeming provisions of sections 7 and 25B of the SA Income Tax Act for resident trusts and taxing trusts as separate taxpayers (Davis Tax Committee, 2015:7).

The system of taxation in the United Kingdom effectively prevents the use of trusts for income-splitting in that the liability for tax on income ultimately falls on the trust. The beneficiaries are, in effect, only liable for any additional tax that might arise in their hands as a result of using a higher marginal tax rate which applies to them in their personal capacity.

The use of trusts to avoid inheritance tax in the United Kingdom is reduced by the application of the ten-year periodic charge on settled property. The risk is further reduced by the fact that an additional 20% inheritance is levied on settled property if the person who made the transfer dies within seven years of making the transfer.

In designing tax legislation on trusts which minimises the avoidance of tax, especially regarding income-splitting and the avoidance of estate duty and donations tax, National Treasury could consider implementing provisions similar to those applied by the United Kingdom, including primarily taxing the trust on income, rather than the beneficiaries, as well as applying a periodic tax charge to trust assets and taxing trust assets in the hands of the founder at death.

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