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South African trusts: eroding the tax base

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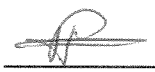
University of the Witwatersrand, Johannesburg

WITS Research Report

South African Trusts:

Eroding the Tax Base?

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

Johannesburg - March, 2015

Declaration

I hereby declare this research report to be my own unaided work. It is submitted for the degree of Master of Commerce in the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination in any other university.



Pravir Jeaven

31 March 2015

Contents

Abstract 5

1 Introduction 6

1.1 General 6

1.2 Research Problem 10

2 Taxation of Trusts 11

2.1 General 11

2.2 Income Tax 12

2.2.1 Charging and roll up provisions 12

2.2.2 Conduit Pipe Principle 13

2.2.3 Section 25B 14

2.3 Capital Gains Tax 15

2.4 Transfer Duty 16

2.5 Estate Duty 17

2.6 Donations Tax 18

2.7 Conclusion 19

3 Anti-Avoidance Provisions 20

3.1 General 20

3.2 Tax Evasion versus Tax Avoidance 20

3.3 General Anti-Avoidance Provisions 21

3.3.1 Arrangement 21

3.3.2 Tax Benefit 21

3.3.3 Sole or Main Purpose Test 22

3.3.4 Objective Requirements 24

3.3.5 Substance over Form 26

3.3.6 Application to Trusts 28

3.4 Specific Anti-Avoidance Provisions 29

3.4.1 General 29

3.4.2 Donation, settlement or other disposition 29

3.4.3 Income Tax – Reattribution Rules 30

3.4.4 Capital Gains Tax – Reattribution Rules 32

3.5 Invalidity of Trusts 35

3.5.1 *Essentialia* of a Valid Trust 35

3.5.2 The Independence Issue 36
3.5.3 Application to Trusts 38
3.6 Conclusion 39
4 Proposed Amendments 40
4.1 National Budget Speech 40
4.2 Summary of the meeting between STEP and National Treasury 41
4.3 ITR12TR 43
4.4 Conclusion 43
5 Conclusion 45

Abstract

The South African Revenue Service ('SARS') and National Treasury has in the recent past identified various areas of tax in which taxpayers have been avoiding tax by arranging their affairs in a certain way. An area which SARS and National Treasury sees as being a danger to the South African tax base is the utilisation of trusts by individuals. This was made evident in the 2013 National Budget Speech by way of a passing high-level comment on how SARS proposes to mitigate the risk that trusts pose to the South African tax base. This research evaluates whether trusts do in fact pose a valid risk to erode the tax base and whether they are as 'deadly' as they are made out to be. A discussion of the taxation of local trusts is included in this paper and it continues by analysing the various anti-avoidance provisions contained in the Income Tax Act. In addition, this paper discusses the proposed amendments to be made to the current tax regime as well as the revised tax return format for trusts and the supposed purpose thereof. The paper concludes on the validity of the concern raised by both SARS and National Treasury in respect of trusts being used as vehicles to erode the South African tax base.

Key words: anti-avoidance, conduit pipe principle, ITR12T, National Treasury, SARS, tax avoidance, tax evasion, trusts.

1 Introduction

1.1 General

Recently the utilisation of trusts has been more prevalent with many individuals utilising such a vehicle as an estate planning tool. Trusts are also treated differently from other investment vehicles from an income tax (including capital gains tax) perspective which has resulted in many tax advisors flagging trusts as being an effective vehicle to 'avoid' tax. In addition, to the aforementioned the perceived lack of regulatory requirements of trusts also provides individuals with a relatively easier administrative vehicle than other options (e.g. companies and partnerships) which may appeal to a wider group of individuals.[1] Such lack of regulatory requirements include that the financial statements of the trust does not need to be audited.

In the 2013 Budget Speech delivered by the previous Minister of Finance, Pravin Gordan, on 27 February 2013, specific reference was made to government's proposed intention to modify the current regime of the taxation of trusts in an attempt to preserve the tax base of South Africa. In terms of the 2013 Budget Speech, the previous Minister of Finance indicated that a large number of taxpayers in South Africa were utilising trust structures to avoid tax. Specific mention was made to the 'conduit pipe principle' and the shielding benefit provided by trusts from estate duty as possible mechanisms that could be eroding the tax base of South Africa.

At the time of writing this dissertation the information made available as to what the changes to the taxing system of trusts could entail was limited and appeared to be the proposed abolishment of the conduit pipe principle housed in section 25B of the Income Tax Act 58 of 1962, as amended (hereafter referred to as the 'Income Tax Act') (which taxing mechanism is unique to trusts) and the replacement by the following taxing mechanism:

- The taxable income of the trust (prior to any distributions) being subject to tax at the trust level; and
- Additional deductions to the taxable income in the instance whereby any of the taxable income mentioned in the first bullet point is distributed to a beneficiary.[2]

Based on the above, it would appear that the only effect of the proposed change to the taxing mechanism is to 'denature' the income flowing from discretionary trusts (i.e. if interest income flows

[1] The main piece of legislation that governs trusts is the Trust Property Control Act 57 of 1988, as amended

[2] Please refer to chapter 5 that discusses the proposed changes to the taxing system of trusts as indicated in the 2013 Budget Speech

from a discretionary trust then the income in the hands of the respectively beneficiary would be seen to be 'income' and not interest).

The question that the above 'simple' proposed amendment may pose to many tax advisors and individuals that utilise trusts, is whether SARS and National Treasury will be provided with the comfort they require to view trusts as vehicles that do not put the South African tax base at risk of erosion and if so, whether in fact the trust vehicle (and the reasons why a trust vehicle would be used) is properly understood by SARS and National Treasury.

As mentioned above, trusts have become very popular as a result of trusts being used as a tool in estate planning; however without the trust being properly administered by the trustees there is a significant chance that the trust would be ineffective in fulfilling the purpose it was designed for.

Trusts are specifically regulated by the Trust Property Control Act No. 57 of 1988 (hereafter referred to as the 'Trust Property Control Act'), in addition to other several Acts such as the Income Tax Act. In addition to this case law has also developed the area of trust tax law quite substantially.

Features of a Trust

In essence a trust is a contract between the donor and the trustees for the benefit of third persons, in other words the beneficiaries. This concept is similar to the *stipulatio alteri* which arose under Roman Dutch Law and is translated to meaning a contract for the benefit of others.[3]

In accordance with this contract the trustees should administer the trust's assets with the necessary care in order to benefit the beneficiaries of the trust. The duties are based on common law as well as in the trust instrument or trust deed. In the judgement in the case of *Estate Kemp v McDonald's Trustee*[4] it was established that the trustees will have no beneficial interest in the property, but are bound to hold and apply the property for the benefit of the beneficiaries.[5]

The principle of a trust can be dated back to the middle ages, where the landlord would leave his possessions - assets and servants – to a trusted person when he was away. The trusted person had complete control over the landlord's possessions until he returned. The legal device of a trust is derived from the English law, and via usage has become a part of South African law.[6]

The South African Income Tax legislation was amended after the courts decided in the case that a trust is seen as a separate legal entity and is therefore a separate taxpayer. All undistributed income that is retained in the trust is subject to tax at a flat rate of 40%, whilst the effective Capital Gains Tax rate is

[3] Notes on South African Income Tax, Huxham and Haupt, 2011 (page 721)

[4] Estate Kemp and Others v McDonald's Trustee 1915 AD 49

[5] Supra 1

[6] Supra 3

20% for a trust. Transfer duty is charged at a flat rate of 8% for a trust, and a trust is seen as being continuous dependent on the trust deed.

Categories of Trusts

In South Africa there are various types of trusts that can be sub-divided into two main categories namely testamentary trusts *(mortis causa)* and living trusts *(inter vivos).*

- ***Testamentary Trusts (mortis causa)***

  Testamentary trusts are a very popular form of trusts and their main purpose is to protect the interests of minors and/or other dependents that are unable to look after their own affairs. The trust itself only comes into existence upon the death of the testator or testatrix and remains in existence for either a predetermined period or up until a certain event such as the minor turning 18.[7] The creation of these trusts is done via a bequest in terms of the deceased individual's will. The testator or testatrix appoints the trustees in a will by having a trust clause in his will. The trustees administer the trust and any assets that form part of the deceased estate may be moved to the trust.

  As a result of the donor being deceased the provisions of section 7 would not apply to a testamentary trust and hence the only parties that could be taxed are the trust itself or the beneficiaries if the income was distributed to them.

  The value of the property that would be bequeathed to the trust would be valued at market value and would form part of the deceased estate and hence be subject to estate duty. There is also a possibility that there could also be capital gains tax consequences with respect to the property bequeathed to the trust.

- ***Living Trusts (inter vivos)***

  These trusts are created in the lifetime of the founder with the main purpose of eliminating estate duty consequences upon death of the founder but may with proper use also have significant income tax benefits as well. Usually in the formation of an *inter vivos* trust, a donation would be involved in order to transfer an asset to the trust as a result the provisions of section 7 would be applicable.

[7] SILKE: South African Income Tax, Stiglingh et al, 2011 (page 754)

Types of Trusts

Once divided into the two categories of trusts, these trusts can be further sub-divided to suit a particular need or function of an individual.

- ***Discretionary Trust***

  In this type of trust the distribution of amounts that are either income or capital to the beneficiaries of the trust is subject to the trustees' approval. As a result either the beneficiary will be taxed if amounts were distributed or the trust will be taxed on amounts not distributed. This trust assists in minimising income tax consequences by splitting the income to several individuals resulting in a less onerous burden on each beneficiary.

- ***Vested Trust*** [8]

  In this type of trust the capital and income beneficiaries are already determined and illustrated. In this situation the income would be taxable in the hands of the beneficiary even if no payment was actually made from the trust to the trustee.

- ***Special Trust***

  These types of trusts are created for the sole purpose to benefit a person who suffers from a serious mental illness or serious physical deformity. These trusts are taxed at the same rate as a natural person, in other words on the sliding scale.

Other example of type of trusts includes the following:

- Public Benefit Trusts
- Family Trusts
- Umbrella Trusts
- Guardian Trusts

Why One Would Have a Trust

There are several reasons why trusts are utilised by individuals. The first reason is to hold or protect assets on behalf of minor or incapacitated dependents. This could be applicable in the case where the children are still minors and the parents are deceased.

[8] Notes on South African Income Tax, Huxham and Haupt, 2009 (page 715)

By placing assets in a trust one also protects the assets in the case of insolvency as a trust is seen as a separate person in terms of tax. Therefore even if the trustee becomes insolvent the relevant creditors would not be able to claim from the trust as it would be seen as being a separate legal entity.

Another benefit of a trust is the ability to freeze the value of assets in an estate. This is beneficial for the taxpayer as this would reduce the amount of estate duty payable and hence the trust is an important vehicle in estate planning.

In addition to the above benefits, it is possible that if administered properly a trust could assist in minimising income tax consequences on an individual by sharing the income tax consequence amongst several people for example the beneficiaries.

For the majority of trusts there is no requirement for audited annual financial statements to be produced unless specifically requested by the Master of a High Court; however accounting records are to be kept for the purposes of completing tax returns. From an administration point of view there are less onerous requirements compared to other types of entities such as companies and close corporations.

Another benefit of a trust is that it does not dissolve upon the death of a trustee or if a trustee is added or removed from a trust. A trust enjoys perpetual succession, dependent on a trust deed, unless the trust is terminated by way of dissolution or sequestration.

1.2 Research Problem

The purpose of this dissertation is to determine whether the utilisation of South African trusts do erode the tax base of South Africa. In order to provide an answer to the aforementioned question one would need to address the following:

- What is the current taxation principles applicable to trusts?
- What is the difference between tax evasion and tax avoidance?
- Does any of the anti-avoidance provisions contained in the Income Tax Act find application to trusts?
- Can a trust be invalid?
- What are the proposed amendments that SARS and National Treasury aim to make in order to mitigate the risk that South African trusts pose to the South African tax base?

By answering the above questions, it would be able to determine whether trusts are as lethal as they appear to the tax base of South Africa or alternatively whether these vehicles are misunderstood by National Treasury and SARS.

2 Taxation of Trusts

2.1 General

The Trust Property Control Act is the piece of legislation that directly applies to the regulation of trusts. In addition to this there are several sections in the Income Tax Act that directly applies to trusts.

In order to determine who should be taxed there are various factors that one has to consider in order to ascertain who would be the relevant person to tax. These factors are as follows:[9]

- The terms of a trust deed
- Whether the beneficiaries are older than 18 making them a major person
- Whether the beneficiaries have a vested right
- Whether or not the trust has distributed the income to the beneficiaries

2.1.1 Definitions – Section 1

Looking at section 1 of the Income Tax Act there are several words relating to trusts that are defined in this section.

Beneficiary [10]

A beneficiary is defined as a person who has a vested or a contingent interest in all or part of the receipts or accruals or assets of that trust.

Person[11]

The definition of a person was amended in 1991 by Act No. 129 to specifically include a trust after the *CIR v Friedman and Other*[12]. In this case the court decided that a trust was not a 'taxable entity' liable as a person for tax as a result of this SARS issued the amendment to the definition of a person that reads as follows:

> *"person" includes –*
>
> *(a) an insolvent estate;*
> *(b) the estate of a deceased person;*
> *(c) any trust; and*
> *(d) any portfolio of a collective investment scheme other than a portfolio of a collective scheme in property,*

[9] Notes on South African Income Tax, Huxham and Haupt, 2009 (page 717)
[10] Professional Tax Handbook Volume 1 2010/2011, LexisNexis (page 13)
[11] Professional Tax Handbook Volume 1 2010/2011, LexisNexis (page 28)
[12] CIR v Friedman and Others NNO 55 SATC 39, 1991

but does not include a foreign partnership[9]

Resident

A trust is seen as being a resident of South Africa if it is either

- Established or formed in the republic; or
- If it has a place of effective management in the republic

For trusts the place of effective management is seen as being the place where the trustees fulfil their fiduciary duties as trustees.[13]

Trust

A trust is defined as follows in the Income Tax Act:

> *"Means any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such a person is appointed under a deed of trust or by agreement or under the will of a deceased person"*[14]

Trustee

The word trustee is defined as follows in the Income Tax Act:

> *"in addition to every person appointed or constituted as such by act of parties, by will , by order or declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interest or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability"* [12]

2.2 Income Tax

2.2.1 Charging and roll up provisions

Section 25B of the Income Tax Act is the principal taxing section relating to trusts. This section provides that, subject to section 7 of the Income Tax Act, trust income is taxed either in the hands of the trust or the beneficiaries. In essence, if the trust income vests in the beneficiaries, the beneficiaries are taxed on it. However, if the income does not vest in the hands of the beneficiaries, the trust is taxed on it. This section is often referred to as the 'conduit pipe principle'.

[13] Professional Tax Handbook Volume 1 2010/2011, LexisNexis (page 32)
[14] Professional Tax Handbook Volume 1 2010/2011, LexisNexis (page 38)

2.2.2 Conduit Pipe Principle

An important principle relating to trusts that section 25B confirms is the principle of a conduit pipe which was initially discussed in the case of *Trustees of the Hull Trust Fund v CIR*[15]. In this case the court decided that if income was paid out to a beneficiary in the same year of assessment in which the amount was received by the trust, the amount would be seen to have been received by the beneficiary only and not the trust for tax purposes.

In *Armstrong v CIR*[16], it was held that income of a trust retains its nature / identity until it reaches the parties in whose hands it is taxable, e.g. the beneficiaries. The trust would be seen as being the intermediary object through which income flows. This was confirmed by the court in *SIR v Rosen*[17] where the court stated that the income flowing through a trust to a beneficiary will retain its identity, whether it is paid by way of annuity or in some other way. However, the income will only retain its nature if it accrued to the beneficiary in the same tax year as it accrued to the trust. Any accumulated income in the trust will lose its identity.

A trust is a mere conduit or channel through which the income flows, and the income will retain its identity in the hands of the beneficiary. When the accrual of the income is to a beneficiary, any exemption from tax provided by the Income Tax Act applying to the income will be available to that beneficiary. It should be borne in mind in this context that certain exemptions are only allowable to natural persons (and therefore not to trusts or companies), for example the dividend and interest exemptions. The various provisions of section 10 of the Income Tax Act should therefore be examined carefully in this regard in order to effectively utilise any available exemptions.

Making use of the example where the trust receives local dividends from various investments that the trusts hold and then distributes the local dividends to the beneficiaries, by making use of the conduit principle the amounts received by the beneficiaries would still be seen as being dividends. Hence, if the beneficiaries are natural persons that are resident of South Africa they are entitled to apply section 10(1)(k) - which is the local dividend exemption section - to the amount that they received from the trust to minimise their tax liability. Another facet of the conduit pipe principle is that the distribution of income to the beneficiaries is deemed to be a *pro rata* of the various types of income that is earned by the trust, however a trust deed may give the power to the trustees to determine what type of income the distributions compose of.

[15] Trustees of the Hull Trust Fund v CIR 5 SATC 201, 1931
[16] 1938 AD 343
[17] 1971 (SA) 1 (A)

2.2.3 Section 25B

Section 25B(1) and 25B(2) of the Income Tax Act are viewed as being the charging sections. In addition, the abovementioned charging provisions would be subject to the attribution rules contained in section 7 of the Income Tax Act (please refer to paragraph 3.2 below for a discussion on this section). The purpose of this section is to set out the conduit pipe principle in the tax legislation as opposed to relying on the decisions relating to trusts in the court.[18]

Essentially, section 25B(1) of the Income Tax Act comprises of two elements:

- The income vests in the beneficiaries then the beneficiaries would be taxed on the income, provided that section 7 does not find application; else if
- The income does not vest in the beneficiaries and remains in the trust then the trust would be taxed on the income, provided that section 7 does not find application.

To the extent that section 7 finds application, then section 7 overrules section 25B and the person to be taxed will be taxed in accordance with the provisions of section 7 of the Income Tax Act (please see discussion in paragraph 3 below).

Section 25B(2) of the Income Tax Act deals with the instance whereby a beneficiary of a trust acquires a vested right from a trust by way of the trustees discretion. Accordingly, the tax liability will rest on the beneficiary in respect of such amounts. Section 25B(2A) deals with the accumulated income from foreign trusts that were distributed to a South African resident.

Section 25B(3) of the Income Tax Act determines that allowable deductions and allowances must follow the amount to which they relate. To the extent to which an amount is deemed to belong to a beneficiary or a trust, any associated deduction or allowance will be deemed to be a deduction or allowance that may be made in the determination of the taxable income derived by the respective beneficiary or trust. In other words, if no income is allocated or distributed to a beneficiary, all expenses incurred in the production of the income, provided that these expenses are tax allowable, are deductible in determining the taxable income of the trust.

Section 25B(4) of the Income Tax Act provides that any tax deductions that are claimed by a beneficiary are limited to the income that accrues to the beneficiary. Accordingly, no tax losses are allowed to accrue to the beneficiary through a trust and consequently all tax losses will remain in the trust to be set off against any future taxable income retained in the trust.

[18] Income Tax Act No. 58 of 1962, Section 25B was brought into effect by Income Tax Act No. 129 of 1962, Section 27(1).

2.3 Capital Gains Tax

Capital Gains Tax was introduced on 1 October 2001 and applies to the "disposal" of an "asset" for "proceeds" after 1 October 2001. A trust, which is a South African tax resident, would be subject to capital gains tax on any net capital gain realised on the "disposal" of an "asset" subject to various provisions contained in the Eighth Schedule to the Act.

A capital gain on the disposal of an asset arises when the proceeds received on the disposal exceeds the base cost of the asset, whereas a capital loss will typically arise when the base cost of the asset exceeds the proceeds received.

Essentially, in terms of the Eighth Schedule to the Income Tax Act, a capital gain or loss will be calculated with reference to the following basic formula:

Proceeds – Base Cost = Capital Gain / (Loss)

A trust is required to include a portion (66.6% in respect of years of assessment commencing after 1 March 2013, prior to this only 50% of the gain was included in taxable income) of the net capital gain realised by it during the year of assessment in its taxable income, by virtue of the provisions of paragraph 10 of the Eighth Schedule to the Income Tax Act read together with section 26A of the Income Tax Act. The effective capital gains tax rate applicable to trusts is accordingly 26.7% (66.6% x 40%). There are various specific capital distributions rules pertaining to trusts contained in the Income Tax Act (similar to those that govern the income distribution rules pertaining to trusts refer to paragraph 3.2 below).

Paragraph 80 of the Eighth Schedule to the Income Tax Act includes charging and roll-up provisions whereas paragraphs 68, 69, 71 and 72 contains the attribution provisions similar to those provisions that govern the taxing of income derived by trusts (i.e. section 7 and 25B of the Income Tax Act), whereas paragraph 81 and 82 of the Eighth Schedule to the Income Tax Act deal with the base cost of the interest in a discretionary trust and the death of a beneficiary in special trust respectively.

Paragraph 80(1) and paragraph 80(2) of the Eighth Schedule to the Income Tax Act are viewed as being the charging sections contained in the capital gains tax schedule similar to section 25B(1) and 25B(2) contained in the Income Tax Act. In addition, the abovementioned charging provisions would be subject to the attribution rules contained in paragraphs 68, 69, 71 and 72 of the Eighth Schedule to the Income Tax Act (please refer to paragraph 3.2 below for a discussion on these provisions).

Disposals by a trust for capital gains tax purposes can be effected in two ways, namely:

- The vesting of an interest in an asset to a beneficiary of a trust; or
- A sale transaction with a third party (i.e. a normal sale transaction).

The purpose of these paragraphs would be in essence to shift the capital gains tax liability from the trust to the beneficiary in certain instances whereby either the beneficiary acquires an interest in the asset in question (i.e. paragraph 80(1) of the Eighth Schedule) or alternatively where the beneficiary receives the capital gain (i.e. paragraph 80(2) of the Eighth Schedule). With regard to the latter provision in order for such a provision to find application, the capital gain arising from the disposal of an asset would be required to be vested in the hands of a beneficiary of the trust.

It is important to note that a trust is unable to distribute a capital loss to a beneficiary (similarly to those provisions that prohibit the distribution of an assessed loss to a beneficiary). Both of these provisions provide that the capital gain should be disregarded for the trust provided that the provisions contained in paragraphs 68, 69, 71 and 72 do not find application and that the capital gain should rather be accounted for in the hands of the beneficiary which benefited from the vesting of such asset.

Similarly to section 25B(3) of the Income Tax Act, paragraph 80(3) of the Eighth Schedule to the Income Tax Act applies to non-resident trusts where such trusts have resident beneficiaries. In this regard, the Eighth Schedule generally applies in respect of non-residents where such persons dispose of immovable property situated in the Republic of South Africa or where there is an interest in immovable property in the Republic of South Africa (as provided for in paragraph 2 of the Eighth Schedule to the Income Tax Act).

Paragraph 80(3) of the Eighth Schedule applies in instances whereby a non-resident trust disposes of an asset to a beneficiary receiving an interest in the disposed asset in the subsequent year of assessment which would have been subject to capital gains tax if the trust was a tax resident in South Africa. This provision would only find application where the capital gain was not subject to tax in South Africa.

2.4 Transfer Duty

In the past the trust structure was used by many informed individuals as a means of completely avoiding transfer duty on the sale of immovable property. Prior to the amendments to the Transfer Duty Act 40 of 1949, (hereafter referred to as the 'Transfer Duty Act'), by way of the Revenue Laws Amendment Act No. 72 of 2002, transfer duty was effectively only levied on the transfer of property from one person[19] to another. The historical result is that for a change of ownership in property, held by a trust, could be effected by way of changing the stipulated beneficiaries without triggering transfer duty

[19] Including companies, close corporations and trusts.

implications due to the registered owner not changing. This "non-trigger" of transfer duty was not only unique to trusts but companies and close corporations could also historically benefit by merely selling the shares in a company that held the property in question from the seller to the purchaser without triggering any transfer duty.

As mentioned above, this loophole was effectively closed by the amendment made to the Transfer Duty Act, which amended the definitions of 'transaction' and 'property' which resulted in the acquisition of a contingent right in a trust that holds either a residential property or a share in a property-owning company being subjected to transfer duty. Although the amendment to the transfer duty resulted in the imposition of transfer duty when a beneficiary of a trust acquired a "contingent right" to property, the Transfer Duty Act does make provision for certain exemptions such as the inclusion of a new born child as a beneficiary. Similarly, the amendments made closed the loophole for companies and close corporations to impose transfer duty in similar transactions where the shares are disposed of from the purchaser to the seller to avoid the imposition of transfer duty.

2.5 Estate Duty

Section 2 of the Estate Duty Act currently imposes a levy of twenty per cent on any estate valued over three and a half million rand (i.e. one fifth of a person's estate is paid over to SARS).[20] In addition, to this duty are also the usual other estate costs such as executor's fees, administration costs and funeral expenses which results in death being very costly. At the time of the death, the value of the deceased's estate is calculated by pooling together all of the assets and deducting any liabilities, including the costs of any administration. In addition, the Estate Duty Act specifically includes other deemed assets and liabilities in the deceased's estate. The net effect of such a transaction could be significant for wealthy individuals.

As a result of the costly nature of dying, it is quite common that an individual would utilise a trust structure to shield certain or all of the assets from the deceased's estate resulting in the estate duty tax implications of the deceased's estate being reduced. Generally this process would be facilitated by way of either a disposal or a bequeath which can facilitate the transfer of assets from a person's estate to a trust. The effect is that the assets so disposed of or bequeathed will no longer constitute a part of that person's estate and consequently will not be subject to the calculation of estate duty.

The above principle is echoed in the Trust Property Control Act by stipulating that the trust assets constitute a separate estate, both in the event of the trustee's death or insolvency. In support of this, in the case of *CIR v MacNeillie's Estate*,[21] Steyn CJ held that a trust does not on its own possess legal personality and therefore cannot constitute a 'person' for the purposes of the Estate Duty Act. Therefore,

[20] From 1 March 2007.
[21] *CIR v MacNeillie's Estate* 1961 (4) All SA 27 (A) 32.

any assets legitimately vested in a registered trust, despite being the previous ownership of the deceased, cannot be subject to estate duty.

Practically, most estate planners would suggest that you sell any assets that have the potential to grow to the trust and facilitate such by an interest-free loan account. The current value of the asset (i.e. the loan) is frozen, for estate duty purposes and accordingly only the current value of the asset will be captured in the estate duty calculation.

Notwithstanding the above, SARS has through the implementation of section 3(3)(*d*) of the Estate Duty Act, created a deeming provision which in effect includes any property controlled by the deceased prior to his death to form part of the estate for the purposes of determining estate duty thereby eliminating the effectiveness of the strategy above.

It is important to note that the provision of section 3(3)(*d*) of the Estate Duty Act does not apply to a situation where a person has disposed of assets to an *inter vivos* trust for due consideration. The rationale for the provision not finding application is due to the fact that the transaction is viewed as being legitimately commercial and the proceeds would be included in his estate upon death. In other words, even though the asset disposed of would not be subject to the imposition of estate duty the proceeds being either the cash or the loan would form part of the deceased's estate and be subject to estate duty. Accordingly, based on the aforementioned, for estate duty purposes, the trust structure would be the most beneficial if the trust acquired the asset in question from the initial date of acquisition.

2.6 Donations Tax

Donations are a transfer of wealth and therefore subject to Donations Tax (sections 54 to 64 of the Income Tax Act). Donations Tax is payable by the donor at a rate of 20% but does not apply to South African non-residents (regardless if the assets in question are South African or not). Spouses married in community of property are deemed to donate property jointly if the property is from the joint estate.

In order for a donation to exist the donation in question must be seen as being "any gratuitous disposal of property or any gratuitous waiver or renunciation of a right." In the Welch's Estate case, the court held that a donation requires a motive of sheer liberality or disinterested benevolence. Based on the aforementioned, a sale at a discount may therefore be a donation (section 58 specifically deems this to be a donation at the Commissioner's discretion). In terms of section 56(1)(l) of the Income Tax Act, trusts are exempt from donations tax when the trust vests or distributes assets to the beneficiaries of the Trusts.

For a natural person, the first R100 000 of donations per year of assessment is free from Donations Tax whereas a trust gets an annual exemption of R10 000.

2.7 Conclusion

Based, on the above analysis contained in Chapter 2, it is quite evident that trusts have their own unique taxing regime. In this regard, it would appear that the sections governing the taxing of trusts are quite specific. In addition, at least with respect to transfer duty and estate duty, it would appear that National Treasury and SARS have closed some loopholes that were present in the legislation. It is however, important to note that the loopholes in some instances were not only applicable to trusts. The purpose of the next chapter is to further delve into what 'weapons' of defence SARS has in relation to the potential misuse of trusts.

3 Anti-Avoidance Provisions

3.1 General

The Income Tax Act contains both specific and general anti-avoidance provisions. The specific anti-avoidance provisions in respect of trusts are contained in section 7 of the Income Tax Act. The main purpose of these sections is to reattribute income to beneficiaries in instances in which "a donation, settlement or other disposition" has occurred. This chapter begins by analysing the concepts of 'tax evasion' and 'tax avoidance' and thereafter looks at the General Anti-Avoidance Rules ('GAAR') provisions and the Specific Anti-Avoidance Rules (including the 'redistribution rules'). Lastly, this chapter looks at what makes a trust an 'invalid trust'.

3.2 Tax Evasion versus Tax Avoidance

Legally the distinction between 'tax avoidance' and 'tax evasion' is quite simple – tax avoidance is legal whereas tax evasion is illegal. Tax avoidance does generally not fall foul of the GAAR provisions, whereas 'tax evasion' does fall foul of the GAAR provisions and may result in additional penalties being imposed as well as potentially leading to criminal charges being imposed.

There is a plethora of case law that provides support that every person is entitled to arrange the affairs to pay the minimum tax. In *IRC v Duke v Westminster* [1936] AC 1 at 19:

> *'Every man is entitled, if he can, to order his affairs so that tax attaching under the appropriate Act is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however, unappreciative the Commissioners for Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax'*

The above principal was also referred to in *CIR v Conhage (Pty) Ltd,* where it was said:

> *"Within the bounds of any anti-avoidance provision in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner if eg the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax".*[22]

On the other hand with regard to tax evasion, this is a clear intention of the taxpayer to either escape tax liabilities by either fraudulent or other illegal measures. An example of this may be the overstating of expenditure, or artificially increasing expenditure to decrease taxable income or alternatively the non-disclosure of income in order to once again decrease the taxable income of a taxpayer and therefore decrease the tax bill to be paid to SARS.

[22] *CIR v Conhage (Pty) Ltd, 61 SATC 391*

Anti-avoidance was previously governed in terms of section 103 of the Income Tax Act and much of the case law was established on the provisions contained therein. The new GAAR provisions (contained in section 80A to 80L of the Income Tax Act) replaced section 103(2) of the Income Tax Act and are effective in respect of transactions entered into after 2 November 2006. Based on the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006 the purpose of the new GAAR provisions was to combat various weaknesses in the old provisions.

3.3 General Anti-Avoidance Provisions

The GAAR provisions, set out on sections 80A to 80L, serve to curb practices whereby transactions take place with a sole or main motive of avoiding tax. These provisions apply to any arrangement (or to any steps therein or parts thereof), where an 'impermissible tax avoidance arrangement' has been entered into by a taxpayer in order to avoid incurring a tax liability. If the GAAR provisions apply, SARS has wide powers, which include the power to disregard, combine or re-characterise transactions.

The GAAR provisions apply where all the following requirements are met:

- There must be an ***arrangement*** (being a transaction, operation, scheme, agreement or understanding, including a step or part thereof);
- The arrangement must ***result in a tax benefit*** (which includes any avoidance, postponement or reduction of any liability for tax);
- The taxpayer must have entered into the arrangement with the ***sole or main purpose to obtain a tax benefit***; and
- At least ***one of the 'objective requirements'*** described below should be met.

3.3.1 Arrangement

An 'arrangement' is broadly defined as 'any transaction, operation, scheme, agreement or understanding (whether enforceable or not), ***including all steps therein or parts thereof***'. (***Emphasis added***). The emphasised portion of the definition makes it clear that SARS may attack (should it wish to do so) the proposed transaction as a whole or any constituent part of the proposed transaction.

3.3.2 Tax Benefit

'Tax benefit' is defined as including '*any avoidance, postponement or reduction of any liability for tax*[23]'. The definition of 'tax benefit' is substantially similar to the provision in the former GAAR of section 103(1) of the Income Tax Act. This view is supported in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2006, on page 62, where it is stated in discussing section 80L that the defined terms (specifically including 'tax benefit' and 'tax') '*draw heavily on the provisions and*

[23] 'Tax' is, in turn, defined to include any tax, levy or duty imposed by the Act or any other Act administered by SARS.

interpretation of the current GAAR'. Accordingly, any case authority relating to the interpretation of 'tax benefit' under the previous section 103(1) will prove to have a strong influence when it comes to interpreting the same term under the new section 80A.

In *CIR v Smith* 1964 (1) SA 324 (A) the court held that avoiding a liability for tax in terms of section 103(1) means 'to get out of the way of, to escape or prevent an anticipated liability'. An anticipated liability for tax may vary from an imminent, certain prospect to a vague, or remote possibility. [24] In *CIR v King*[25], the court stated that what may be more appropriate is to consider whether an arrangement resulted in a reduction of tax as opposed to avoiding a liability for tax.

3.3.3 Sole or Main Purpose Test

Accordingly, if the above two elements contained in the GAAR provisions are met, the predominant test is whether the transaction, operation or scheme was concluded or entered into with the sole or main purpose of obtaining a tax benefit. If the aforementioned question is answered in the affirmative, there would be a strong possibility that the taxpayer would fall foul of the GAAR provisions. Alternatively, if a transaction was entered into by a taxpayer and it was not the sole or main purpose to obtain a tax benefit, then the GAAR provisions would not find application.

It is thus necessary as a first step to determine whether the sole or main purpose of the transaction (or any part thereof) is to obtain a tax benefit and if not, no further enquiry is necessary and the GAAR will not apply. This requirement is considered below.

The burden of proving that the taxpayer did not enter into a transaction for the sole or main purpose of obtaining a tax benefit rests on the taxpayer in terms of section 80G of the Income Tax Act. Based on the ordinary meaning of the words '*sole purpose*' and '*main purpose*' the former term refers to the exclusive or only purpose whereas the latter term refers to a dominant purpose.

Moreover, it is noted that the legislator chose to use similar wording to that used in section 103, namely '*sole or main purpose*'. Therefore, as the requirement of section 80A – 80L seems largely the same as the sole or main purpose requirement of section 103, the findings of our courts in the past should apply *mutatis mutuandis* to an enquiry as to the sole or main purpose of an arrangement in terms of section 80A – 80L .

The body of case law dealing with a taxpayer's sole or main purpose under section 103 would thus remain relevant and should assist in a similar inquiry of purpose, pursuant to the provisions of the GAAR. In order to establish whether the sole or main purpose of a transaction is the avoidance of tax, the purpose of the transaction should be considered resulting in this test being a purely subjective test.

[24] See also *CIR v King, 14 SATC 184*
[25] *CIR v King, 14 SATC 184*

In light of the subjectivity of the test to be applied, it is possible that one taxpayer may enter into a transaction driven mainly by tax considerations, whilst another taxpayer may enter into a similar transaction motivated mainly by business considerations. What is of paramount importance is the stated intention of the taxpayer in each particular factual circumstance. The taxpayer's stated intention will, however, be tested against objective circumstantial facts.

In applying the 'purpose' test a court will no doubt take cognisance of the case of *CIR v Conhage (Pty) Ltd*, 61 SATC 391. In this case, the taxpayer entered into sale and leaseback arrangements with a financier utilising some of its manufacturing plant and equipment. The sale and leaseback arrangements were considered to be more efficient from a tax perspective than an ordinary loan. In this regard, the court held that:

> *"…although the agreements of sale and leaseback had served the dual purpose of providing the taxpayer with capital and to take advantage of the tax benefits to be derived from that type of transaction, the raising of finance was the fons et origo of the transactions and it remained the underlying and basic purpose thereof."*

It was also held that:

> *"…even if the particular type of transaction was chosen solely for the tax benefits, it would be wrong to ignore the fact that, had the respondent not needed capital, there would not have been any transaction at all…"*

Accordingly, in the abovementioned case, the court found that the relevant transactions served a dual purpose of providing a taxpayer with capital and also of taking advantage of the tax benefits to be derived from the type of transaction. It was held in that case that the requirement of sections 103 (the previous GAAR provisions in the Income Tax Act), were not satisfied, as the obtaining of the tax benefit was not the main purpose of the taxpayer.

In addition, the court found in the Zimbabwean case of *R Ltd and K Ltd v COT*, 45 SATC 148 that, in considering whether the merger of two farming operations on a particular basis amounted to an operation, scheme or transaction in which the main or one of the main purposes was to avoid tax:

> *"…there is compelling authority, both in the United Kingdom and in Australia that when a genuine commercial transaction is considered and there are two ways of carrying it out, one that involves paying more tax than the other, it is quite wrong to draw the inference, as a necessary consequence, that in adopting the course which involves paying less tax, one of the main objects is to avoid tax"*

The same principle was applied in *CSARS v Knuth and Industrial Mouldings (Pty) Ltd*, 62 SATC 65, where the acquisition of a business in a particular manner, motivated by commercial reasons, also achieved certain tax efficiencies.

From the above court cases, it is clear that, should a taxpayer enter into a particular transaction motivated by normal commercial considerations or objectives and, in doing so, choose to structure the transaction in a manner that will attract the least amount of tax, it would not necessarily result in a finding that the 'sole or main purpose' for entering into the transaction was one of tax avoidance (also see *CIR v Bobat and Others*, 67 SATC 47).

Moreover, notwithstanding the inconsistency in judgements pronounced worldwide in relation to tax avoidance, a bedrock attitude has emerged in that the courts will probably uphold a transaction, if it is satisfied that the transaction is rationally related to a useful non-tax business purpose that is plausible in light of the taxpayer's circumstances. In the absence of such a plausible non-tax business purpose, the courts will most probably rule in favour of the *fiscus*, if the transaction is attacked in terms of GAAR.

3.3.4 Objective Requirements

If all of the other elements of the GAAR provisions are met, SARS would be required to prove, in the context of a business situation, that the arrangement meets one of the following objective requirements. If, for example, the sole or main purpose of the transaction is not to obtain a tax benefit, the enquiry should end there and no further consideration of this element of the GAAR is required.

It is important to note at the outset that the meaning and ambit of these objective requirements is not clear and is to date is relatively untested by our courts. In about 2010 SARS issued a draft guide on the interpretation of the GAAR, however, this guide appears to have been subsequently withdrawn. These provisions have largely been drawn from foreign GAAR provisions such as the Canadian GAAR. Thus, in interpreting these provisions the ordinary meaning of the relevant terms must be applied and recourse may also be had to foreign authorities where the provisions are unclear. A summary of the provisions have been set out below for the sake of completeness:

- *Abnormality as to manner or means* – If the arrangement was entered into in a manner or by means which would not normally be employed for *bona fide* business purposes, other than for obtaining a tax benefit. Silke[26] is of the view that what is meant by "*bona fide* business purpose" is not purpose (either subjective or objective) but method, that is to say, the overt means or manner by which the taxpayer has entered into or carried out the arrangement in question. If that means or manner was such as would not normally be employed in the context of business, then this component of an impermissible avoidance arrangement is present.

[26] *Silke on South African Income Tax*, electronic version at paragraph 19.39

- *The arrangement lacks commercial substance* - Section 80C(1) of the Income Tax Act deals with 'in-principle' lack of commercial substance whereas section 80C(2) of the Income Tax Act lists certain factors which could indicate that an arrangement lacks commercial substance.

  The provisions of section 80C(1) of the Income Tax Act provide that an arrangement, which results in a significant tax benefit for a party, but does not have a significant effect upon either the 'business risk' or 'net cash flows' of that party (apart from any effect attributable to the tax benefit obtained), lacks commercial substance.

  As mentioned above, section 80C(2) of the Income Tax Act lists and codifies in considerable detail a number of events which will be seen as indicators of an absence of commercial substance. It is important to note that these indicators are of no fiscal consequence and become consequential only if the arrangement in question had a sole or main purpose of obtaining a tax benefit. These indicators are:

  - The legal substance of the avoidance arrangement as a whole is inconsistent with, or differs from, the legal form of its individual steps;
  - Round trip financing, as described in section 80D. Round trip financing is defined in section 80D of the Income Tax Act and it includes any avoidance arrangement in which funds ("any cash, cash equivalents or any right or obligation to receive or pay the same") are transferred among parties, and the transfer of the funds result directly or indirectly, in a tax benefit and significantly reduces, offsets or eliminates any business risk incurred by any party in connection with the avoidance arrangement.
  - An accommodating or tax indifferent party, as described in section 80E. In broad terms, this provision largely contemplates the inclusion of a particular party in a transaction, purely to impact the tax treatment of income or expenses incurred. For example, where an amount would be non-deductible in the hands of one party but deductible in the hands of another and the expense is thus flowed through the latter party, such party could be an accommodating or tax indifferent party; or
  - Elements that have the effect of offsetting or cancelling each other.

- *Abnormality as to rights and obligations* - The arrangement creates rights or obligations that would not normally be created between persons dealing at arm's length. In *CIR v Louw,* 1983 (3) SA 551 (A), it was decided that where parties to a transaction are not strangers but are in a 'special relationship', the question of the abnormality of their rights and obligations in terms of s 103(1)(b)(ii) must be ascertained by asking whether – in the context of that type of special relationship – each of the parties was seeking 'to extract from the transaction the best possible

advantage for himself'. On the facts of the case at hand, the court held that the answer was in the affirmative; hence there was no abnormality. The intrinsic logic in the decision in Louw applies with equal force in the context of the new 80A(c)(i), despite the omission of the key phrase appearing in section 103, which requires a consideration of the surrounding circumstances or context within which the parties are transacting; or

- *Misuse or abuse of tax legislation* - The arrangement results directly or indirectly in the misuse or abuse of the provisions of the Income Tax Act. As to the meaning of this provision we note that in *Canada Trustco Mortgage Co v Canada*, [2005] 2 SCR 601, 2005 SCC 54, the Supreme Court of Canada held that - '*The GAAR may be applied to deny a tax benefit only after it is determined that it was not reasonable to consider the tax benefit to be within the object, spirit or purpose of the provisions relied upon by the taxpayer ... [T]his means that a finding of abuse is only warranted where the opposite conclusion – that the avoidance transaction was consistent with the object, spirit or purpose of the provisions of the Act that are relied on by the taxpayer – cannot be reasonably entertained*'. In other words, the abusive nature of the transaction must be clear. The GAAR will not apply to deny a tax benefit where it may reasonably be considered that the transactions were carried out in a manner consistent with the object, spirit or purpose of the provisions of the Act, as interpreted textually, contextually and purposively.

3.3.5 Substance over Form

Based on the objective requirements set out above, a recent area in which the courts seem to be more fairly active in the recent past, is determining what is the true intention of a transaction (i.e. the substance) rather than that of the form set out in the agreements (i.e. substance over form). In other words the substance over form test always entails a factual enquiry.

From a South African common law perspective, the court may regard the legal substance of a transaction over the form in which it is presented, if the nature of such a transaction is in dispute. The legal maxim *plus valet quod agitur quam quod simulate concipitur* – "what is actually done is more important than that which seems to have been done" would apply in such a case[27]. The resultant consequence of the aforementioned may be drastic and result in the substance of the transaction taking precedence over the actual legal form resulting in the tax consequences arising from the true substance of the transaction in question.

One of the most earliest South African case on the subject of substance over form is that of *Zandberg v Van Zyl* 1910 AD 302 where Innes J stated at page 309 as follows:

[27] See also De Rebus, High Court challenges SARS interpretation of simulated transactions.

> *"Now as a general rule, the parties to a contract express themselves in language calculated without subterfuge or concealment to embody the agreement at which they have arrived. They intend the contract to be exactly what it purports; and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a Court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be. The maxim then applies plus valet quod agitur quam quod simulate concipitur. But the words of the rule indicate its limitations. The Court must be satisfied that there is a real intention, definitely ascertainable which differs from a simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The inquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down." (Emphasis Added)*

Furthermore, in the case of *Commissioner of Customs and Exercise v Randles Brothers and Hudson Limited CCE* 1941 AD the court also had to decide whether a transaction was in *fraudem legis*. In interpreting the above quotation in the *Zandburg v Van Zyl* case (supra) the court in the Randles Brothers case (supra) stated as follows:

> *'A disguised transaction in the sense in which the words are used above is something different. In essence it is a dishonest transaction: dishonest, in as much as the parties do not really intend it to have, inter partes, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that the real agreement or transaction falls within the prohibition or is subject to the tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition are not subject to the tax. Such a transaction is said to be in fraudem legis, and is interpreted by the Courts in accordance with what is found to be the real agreement or transaction between the parties.' (Emphasis Added)*

The discussions in *Commissioner of Customs and Excise v Randles Brothers and Hudson Ltd* appear to highlight that the agreements entered into should give effect to the true intentions of the parties and where the intentions of the parties differ to the structure set out in the agreements then such transaction could be said to be simulated.

Hefer JA in *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR* stated that:

> "*one must distinguish between the principle that one may arrange ones affairs so as to remain outside the provisions of a particular statute*[28] *and the principle that a court will not be deceived by the form of a transaction, it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance*".[29]

Based on the above, it is evident that the courts do not dispute this decision that they recognise that the true nature and substance of a transaction will still be examined and it should not deviate from the form of a transaction. Recently, the courts have gone in detail as to the tests that should be applied in determining whether a transaction is simulated.

In *CSARS v NWK Ltd* it was held that:

> "*the test to determine simulation cannot simply be whether there is an intention to give effect to contract in accordance with its terms. Invariably where parties' structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction, of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated and the mere fact that parties do perform in terms of the contract does not show that it is simulated, the charade of performance is generally meant to give credence to their simulation*".[30]

This judgment, takes the above cases a step further, as it provides that it is not enough to consider whether the intentions of the taxpayers are considered in the respective agreements, but rather as to whether the commercial rationale for the transaction would give insight into the true purpose and substance of the transaction in question.

3.3.6 Application to Trusts

In this regard, it is quite evident that SARS has some form of recourse if the taxpayer falls foul of the GAAR provisions in either the establishment of the trust or the operating of the trust thereafter. If for example, the taxpayer merely sets up a trust structure for the sole reason of avoiding tax, there would be a strong chance (if SARS was aware) that SARS would utilise the provisions of GAAR in order to ignore the trust structure and levy the appropriate tax consequences. Furthermore, to the extent that the trust is not in substance a trust but rather an extension of one person, SARS could also use the substance over form principle to have the trust structured ignored. Notwithstanding the aforementioned, it would

[28] See also *IRC v Duke of Westminster 1936 AC 1*
[29] *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR 1996, 58 SATC 229*
[30] *CSARS v NWK Ltd, 73 SATC 55*

be difficult for SARS to argue that a trust was solely set up for purposes of avoiding tax or that the trust has no substance. The next few sub-chapters delve in further, analysing the specific anti-avoidance provisions that SARS may have as protection against trusts as well as what makes a trust invalid (i.e. have no substance).

3.4 Specific Anti-Avoidance Provisions

3.4.1 General

It is important to remember that trusts are often created to alienate assets, that is, to separate a person from his property (in form if not always in substance). Accordingly, the legislator has decided that persons who alienate their assets in this way must, in certain circumstances, continue to pay the income tax on income generated by those assets (even if the assets are now owned, controlled and enjoyed by others) to prevent trusts from being used for tax avoidance.

Section 7 of the Income Tax Act is a specific anti-avoidance section and seeks to ensure that if a person gratuitously divests himself of an asset, any income generated from that asset will be taxed in the hands of that donor, in certain circumstances. The provisions of Section 7 of Income Tax Act provide that the income of the trust or beneficiaries is taxable in the hands of another person (i.e. a trust donor) in certain circumstances, even in the case where a beneficiary may have a vested right to an amount or has actually received it. The trust donor will be deemed to have earned the income accruing to the trust or beneficiary that arises from "a donation, settlement or other disposition" of the donor's capital in the following situations.

3.4.2 Donation, settlement or other disposition

It is important to note that where there is no donation or gratuitous settlement present, this would make section 7 being ineffective. A donation is a disposal that is liberal or generous in nature, and the gratuitous nature of the disposal can be either wholly or partly.

The phrase other disposition is the most contentious issue in this phrase as a result of the fact that there is much uncertainty around its meaning. It is important to note that based on the laws of interpretation that the principle of *sui generis* would find application to such term and that all words should be read in the same context (i.e. as donation indicates a gratuitous nature, the settlement or other disposition would also need to be of a gratuitous nature). The courts decided in Ovenstone v SIR[31], that one should read the section as being:

> "excludes any disposal of property that is a wholly commercial or business one, ie. made for due consideration; it covers any disposal of property made wholly gratuitously out of liberality or generosity; it also covers any disposal of property made

[31] Ovenstone v SIR 42 SATC 55, 1980

under a settlement or other disposition for some consideration but in which there is an appreciable element of gratuitousness and liberality or generosity.[32]"

Hence disposition can be seen as meaning any disposal where the motivation behind the disposal was either wholly or partially liberal or generous. If the dispositions are made at full value or alternatively if the settlements are made for full consideration then section 7 would not apply. If the consideration made is seen as being appreciable then the resulting income would be apportioned however, if the whole consideration is seen as being minimal then the whole disposal will be seen as being gratuitous.

A practical, example of such a transaction can be found in the case of *CSARS v Woulidge*[33], in which the taxpayer disposed of shares owned to two trusts on loan account which was subject to interest at the discretion of the taxpayer. The court held that his failure to exercise his discretion to charge any interest amounted to a 'disposition' of a gratuitous nature and accordingly triggered the provision of section 7 of the Income Tax Act.[34] Similarly, in *CIR v Berold*[35] it was determined that an interest free loan would be considered to be a continuing donation.

Accordingly, based on the above, further examples of a 'donation, settlement or other disposition' can include instances whereby assets are disposed of for a consideration less than market value or where interest-free loans or alternatively low-interest loans are provided to a trust.

The portion that is less than the market value in question (i.e. the difference between the market related interest rate and the interest rate charged or alternatively the difference between the market value of an asset and the consideration received) could be viewed as being a donation and subject to the anti-avoidance provisions contained in section 7 of the Income Tax Act.

3.4.3 Income Tax – Reattribution Rules

Section 7(3)

Section 7(3) of the Income Tax Act states the following:[36]

> *"Income shall be deemed to have been received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child:*
>
> *(a) It has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child; or*
> *(b) It has been accumulated for the benefit of that child."*

[32] *Ovenstone v SIR* 1980 (2) SA 721 (A) 76.
[33] *C:SARS v Woulidge* 2002 (1) SA 68 (SCA).
[34] *C:SARS v Woulidge* 2002 (1) SA 68 (SCA) 204.
[35] CIR v Berold 24 SATC 729, 1962
[36] Professional Tax Handbook Volume 1 2010/2011, LexisNexis (page 49)

As can be seen by this section the phrase by reason of is an important phrase. Looking at the judgement that was passed in the *Kohler v CIR*[37], it was decided that by reason of refers to the immediate cause and not the remote cause. Therefore making use of this principle one can see that income that was received by reason of a donation, and then if such income was reinvested to produce income, this final income would not accrue according to section 7(3) as the cause is too remote.

Section 7(5)

This section deals with a donation that has an attached stipulation or condition that results in the beneficiaries being unable to receive either the entire income or some portion of it until the condition or stipulation occurs.

For this section to be applicable income has to be retained in the trust and such income has to have arose from the donated asset. To determine whether or not the donor is liable for tax for the amounts that was retained in the trust one has to determine why they were retained.

If the payment to the beneficiary is only delayed and the beneficiary has a vested right in the income then the beneficiary will be liable for tax. If the reason for the non-distribution is the result of a stipulation or condition not being met and there is a chance that the beneficiary might never receive the income then it would be taxed in the hands of the donor.

Section 7(6)

This section results in the donor being liable for tax once again if there does indeed exist a revocable vesting mechanism. What this means is that even though income may have been paid to a beneficiary the donor may revoke the beneficiary's right to the income or alternatively confer this right. This section is applicable if the donor has this right and it is not a requirement of this section that this right needs to be exercised.

Section 7(7)

This section is applicable when a taxpayer cedes the right to receive income generated by an asset, but however still either retains the ownership or the right to regain ownership of the asset. The taxpayer would be taxed on the income generated by the asset.

Section 7(8)

This section deals with income that is received by a non-resident by reason of a donation that was made by a resident. This section deems that the amount should be taxed in the hands of the resident.

[37] Kohler v CIR, 16 SATC 312, 1949

Section 7(9) and Section 7(10)

Section 7(9) deals with the case where an asset is sold for less than the full market value and states that this would be deemed to be a donation. Thus this event would be specifically included into the ambit of section 7 of the Income Tax Act. This provision can be seen to being excessive as a result of the fact that this event would have been included into the category of other disposition.

Section 7(10) states that if a resident makes a donation, settlement or any other disposition as contemplated in section 7 of the Income Tax Act, then the taxpayer is required to disclose this fact to the Commissioner when submitting his return.

3.4.4 Capital Gains Tax – Reattribution Rules

As mentioned above, paragraph 80(1) and 80(2) of the Eighth Schedule to the Income Tax Act is subject to the provisions contained in paragraphs 68, 69, 71 and 72 of the Eighth Schedule to the Income Tax Act and essentially shifts the capital gains tax liability to the person where a 'donation, settlement or disposition' is made (please refer to the earlier discussion in chapter 3.4.2 where a detailed analysis of this term is conducted). The capital gains tax implications for each of the abovementioned paragraphs are set out below as well as a discussion of paragraphs 70 and 73 of the Eighth Schedule to the Income Tax Act which deals with other attribution rules pertaining to trusts.

Paragraph 68 of the Eighth Schedule to the Income Tax Act

In the instance in which a capital gain arises as a result of a 'donation, settlement or disposition' made by a person and the capital gain is vested in the hands of the spouse of the aforementioned person the gain would be deemed to have vested in the hands of the person and not the spouse. The purpose of this provision is to curtail any tax avoidance schemes in which a person tries to vest such a gain in the hands of a person who has a lower marginal tax rate who happens to be their spouse.

Paragraph 69 of the Eighth Schedule to the Income Tax Act

Once again, this paragraph will only find application if a capital gains tax event arose as a result of a 'donation, settlement or other disposition'. In this instance the mischief that SARS is hoping to curtail is the event in which a 'donation, settlement or other disposition' is made by a parent of a minor and thereafter the capital gains tax event is vested in the hands of such minor. The purpose of such a transaction is to shift the capital gains tax to the minor which should have a lower tax rate than the parent.

Paragraph 71 of the Eighth Schedule to the Income Tax Act

This paragraph is worded in a similar manner as to section 7(5) of the Income Tax Act and deals with instances whereby the capital gain is retained in the trust. In this regard, if a capital gain arises as a result of a 'donation, settlement or other disposition' made by a resident, then such capital gains tax liability would be shifted to the aforementioned resident.

Paragraph 72 of the Eighth Schedule to the Income Tax Act

This paragraph applies in the instance in which a capital gain arises as a result of a 'donation, settlement or other disposition' made by a person and the capital gain is vested in the hands of a beneficiary which is a non-resident. To the extent that the gain would have been subject to tax if the beneficiary was a resident, then the capital gain would have been deemed to have been vested in the hands of the person who provided the 'donation, settlement or disposition' (i.e. the donor).

The mischief being curtailed by this paragraph is the use of vesting any capital gains to non-resident beneficiaries to avoid tax in instances whereby the donor has provided a 'donation, settlement or other disposition' to the trust.

Paragraph 70 of the Eighth Schedule to the Income Tax Act

The vesting of an interest in an asset would be an unconditional event. Accordingly, as this provision relates to a conditional vesting (i.e. subject to a Trustee's discretion), paragraphs 80(1) and 80(2) of the Eighth Schedule to the Income Tax Act would not find application. As a result, the capital gain that arises as a result of a 'disposition, settlement or other disposition' and is contingent will be taxed in the hands of the donor.

Paragraph 73 of the Eighth Schedule to the Income Tax Act

The purpose of this paragraph is to limit the attribution of a capital gain to the benefit derived from the 'donation, settlement, or other disposition'. If the income that is deemed to be attributed in terms of section 7 of the Income Tax Act and the capital gain that is attributable in terms of paragraphs 68 – 72 of the Eighth Schedule of the Income Tax Act exceeds the benefit that is derived from the 'donation, settlement, or other disposition', the attribution that exceeds such benefit would be retained and taxed in the hands of the trust and consequently will not be attributed out of the trust.[38]

[38] Woulidge principle

Other relevant provisions in the Eighth Schedule to the Income Tax Act

Paragraph 11 of the Eighth Schedule to the Income Tax Act sets out what events would be deemed to be a disposal for tax purposes. Paragraph 11(1)(*d*) of the Eighth Schedule to the Income Tax Act specifically includes the vesting of an interest in an asset of a trust in a beneficiary as being a disposal event.

Furthermore, paragraph 13(1)(a)(iiA) of the Eighth Schedule to the Income Tax Act provides that the disposal event would occur on the date that the interest vests in the beneficiary, regardless of whether the asset in question has been delivered etc.

Paragraphs 38 and 39 of the Eighth Schedule aims to ensure that transactions between connected persons are effected at market value to ensure that no artificial tax losses are created. In terms of section 1 of the Income Tax Act a beneficiary of a trust and the related trust would be connected persons and as such any transactions between the two parties would be effected at market value from a tax perspective. In addition, any capital losses that are created between any transactions involving the beneficiary of a trust and the related trust would be ring-fenced and can only be off-set against any future capital gains derived from transactions between the aforementioned parties.

Paragraph 81[39] of the Eighth Schedule to the Income Tax Act sets out the manner in which the base cost of an interest in a discretionary trust should be determined. This provision provides that the base cost of an interest in a discretionary trust should be deemed to be nil despite paragraph 38(1)(b) of the Eighth Schedule to the Income Tax Act. Paragraph 38(1)(b) is the provision that deems disposal transactions to be at market value between connected persons in the following instances:

- The price is not at arms length;
- Disposals by way of donations; or
- Consideration is not measurable in money.

Accordingly, even in the instance whereby the transaction falls within the ambit of paragraph 38(1)(b) of the Eighth Schedule to the Income Tax Act or where an actual consideration is paid and a base cost would arise in terms of paragraph 20 of the Eighth Schedule, the base cost of the interest in a discretionary trust would still be deemed to be nil and the full proceeds for such interest would be subject to capital gains tax.

[39] paragraph 81 of the Eighth Schedule to the Income Tax Act provides that:

> *'despite paragraph 38 (1) (b), a person's interest in a discretionary trust must be treated as having a base cost of nil'.*

The purpose behind such a provision is that an interest in a discretionary trust is merely 'a *spes*' (i.e. a hope) as there can be no guarantee that future economic benefits would be derived from the acquisition of such an interest as the trustees of such trust would determine the manner and quantum in which future economic benefits would be distributed. Accordingly, from a valuation perspective, utilising a discount cash flow methodology[40] for example, the value of such an interest would be close to nil as there would be no definite future cash flows.

3.5 Invalidity of Trusts

3.5.1 *Essentialia* of a Valid Trust

A trust is a contract for the benefit of a third person (i.e. a *stipulatio alteri*). In this regard, a trust is effectively a legal relationship flowing from a contract. In order for a valid trust to be created all of the following *essentialia*[41] needs to be met:

- ***Intention to create a trust***

  This is probably the most important element of a trust and the most often ignored. There must be an intention by the founder to divest himself of assets and hand over ownership and control to the trustees. A failure to give up control is the most common reason that a trust is deemed to be invalid.

  The failure to relinquish sufficient control of the property in question or grant an adequate amount of independence, by the founder to the trustees will be a failure of intention to create a valid trust. Consequently the intention to transfer ownership and vest property in the trustees, or beneficiaries, is essential for a trust to be created. As a trust *inter vivos* is a *stipulatio alteri*, the founder and the trustee must both intend to create the trust, as they are parties to a contract. In reality, this contract is often unilateral, with the founder deciding the terms and selecting a trustee to agree to them and carry them out.

- ***The expression by the founder of that intention in mode apt to create an obligation***

  It is not enough for the founder to create the possibility of a trust, or grant someone the discretion or power to create a trust over his property. For a valid trust to be created, the founder should direct that a trust must be created, for example, by contracting for a legal obligation to transfer ownership of the intended trust property to the trustees or, less commonly, to the beneficiaries.

[40] the discount cash flow methodology, basis its valuation on future cash flows and discounting such values on a time value basis.
[41] See Cameron and Honoré South African Law of Trusts 4th edition.

The obligation devolves upon the trustee, in respect of an ownership trust, to take control of the assets in trust. Consequently, the intention is most usually expressed as an agreement or contract with the trustee, which in the instance of an *inter vivos* trust the trustee accepts.

- ***Trust property must be identifiable***

  The term 'property' is defined in the Trust Property Control Act as being 'moveable or immovable property, and includes contingent interests in property'. What can be property for trust purposes is therefore widely defined, including both real property and contingent rights to property. The trust property need not necessarily be defined or identifiable (i.e. with absolute certainty) and as such reasonably certainty will suffice (i.e. must be capable of being determined). If, the property is not adequately identified, the trust will be deemed to be invalid.[42]

- ***The definition with reasonable certainty of the trust object***

  A trust instrument generally places restrictions on the trust property. For example, a trust deed can provide that the trustees must use the trust property for the benefit of certain persons and distribute income generated by the property to certain persons. Without an object for this arrangement, it is a *nudum praeceptum* and therefore invalid.[43]

- ***A lawful trust object***

  A trust must not only have an ascertainable object, but that object must be lawful. This would seem to flow from the general principle of contract law that a contract concluded for an unlawful purpose is either invalid or unenforceable.[44]

In addition, to the above another issue, which has started many a debate in the tax fraternity, with respect to the validity of a trust is whether it is a requirement for a trust to have an independent trustee. There have been several cases recently that have shown that having an independent trustee minimises the chance that the courts would deem a trust to be an extension of one's estate. Several judgments of cases have also attempted to define what an independent trustee is.

3.5.2 The Independence Issue

Recently there have been a vast number of cases that are appearing before the courts relating to trusts, with specific reference to the manner in which the trustees acted.

[42] *Ex Parte Executors Estate Kemp* 1940 WLD 26
[43] *Ex Parte Executors Estate Kemp* 1940 WLD 26
[44] see Thomas, Ph. J., Van Der Merwe, C. G. and Stoop, B. C. (1998) *Historical Foundations of South African*

The decision that the court came to in Land and Agricultural Bank of South Africa v Parker and Others[45] is a vital cornerstone in the South African Law of Trusts and has many tax consequences that were not suspected by many tax practitioners.

The trust in this case was a family trust, and was founded by Mr Parker and one of the requirements of the trust deed was that there would always be at least three trustees in office. When the trust was initially founded the trustees of the trust where Mr Parker and his wife as well as their attorney, whilst the beneficiaries of the trust included Mrs Parker – the wife – as well as their descendents. The family attorney resigned as a trustee in 1996, leaving only two trustees remaining in office. A third trustee was appointed at a later stage and this trustee was the son of Mr Parker. The trust lent money from the appellant to which effect it subsequently defaulted resulting in the appellant attempting to sequestrate the trust and trustees.

The trustees attempted to make use of the argument that the requirement of having three trustees in office at time of concluding the loan agreements with the appellant as per the trust deed was not met and as a result the loans were seen to be invalid. Initially the courts found in favour of the trust but upon the appeal the appellant was successful in his appeal.

Due to the manner in which the trustees acted, the principle of an independent trustee was suggested by the courts to ensure that such a circumstance is avoided in the future. It was decided in the case that for the period that a trust has a fewer number of trustees than what is laid out in the trust deed, the trust would lack legal capacity and hence would not be able to enter into any juristic acts. The trust would lack capacity and the trustees themselves would lack the authority to enter into any contracts on behalf of the trust.

It is important to note that a trust is not a legal person except for the purposes of the Income Tax Act and this case was the first time that a court has held that a trust has lacked capacity and as a result the act of the trust was seen to be invalid. The above case demonstrates that one should be cautious when transacting with a trust and that one should familiarise themselves with the trust deed in order to ensure that the requirements of the trust deed are met.

The Supreme Court of Appeal pointed out the fact that especially with family trusts, many trusts are not formally ensuring that there is an adequate separation of enjoyment and control of the trust. In other words having the same persons as the trustees and beneficiaries will undermine the trust as the purpose of the trust is for the benefit of a third party.

[45] Land and Agricultural Bank of South Africa v Parker and Others 2005 (2) SA 77 SCA

The court made a recommendation that the master of the high court should ensure that there is an appointment of an independent trustee where the trustees are all the beneficiaries and the beneficiaries are all related to one another. Furthermore the court stated that the independent trustee does not have to be a professional person.

In another case namely *Badenhorst v Badenhorst*[46] the concept of an independent trustee cropped up in the judgement of the case. The case was a divorce case and made reference to *Braun v Blann and Botha NNO*[47] and stated that one should look at the manner in which the trust was administered. The trust itself should not be seen as being an alter ego for a taxpayer as this would mean that the trust is essentially an extension of the taxpayer and hence would form part of the taxpayer's assets. This case also made mention of the fact that an independent trustee should not be someone that is of a blood relation to any of the trustees or beneficiaries or alternatively an individual that could be influenced by the same parties concerned.

In the case of *Thorpe and Others v Trittenwein and Another*[48,] the courts again made reference to the fact that with respect to modern day family trusts there is a blurring of the separation between the enjoyment and ownership of the assets. Furthermore the court stated that this separation is the very core idea of a trust. Once again the manner in which the trust was administered by the trustees was seen as being in fault. This was probably due to the fact that Thorpe was not only the founder of the trust but also the dominant trustee as well as with members of his family a beneficiary of the trust.

3.5.3 Application to Trusts

From the above, it is clear that many individuals that utilise trusts may not necessarily be aware of the requirements of creating a valid trust. In addition, although the independence issue is fairly recent, one can see that the courts are already starting to implement various procedures to ensure that vital components of a trust are maintained. The courts believe that by having an independent trustee, it would be probable that the trust would be administered in the appropriate manner and the trust would operate in the best possible interest of the beneficiaries. Although the requirement of having an independent trustee is not part of the legislation relating to trusts, many tax practitioners are suggesting that one makes use of independent trustees to ensure that the courts and SARS do not deem the trust to be an extension of the taxpayer's estate and thereby effect the substances over form principle.

[46] Badenhorst v Badenhorst 2006 (2) SA 225 SCA
[47] Braun V Blann and Botha NNO 1984 (2) SA 850 (A)
[48] Thorpe and Others v Trittenwein and Another 2007 (2) SA 172 (SCA)

3.6 Conclusion

It is important to note that SARS does not generally utilise the GAAR provisions as often as they would like (probably due to the difficulty of proving that the GAAR provisions find application) and rather make use of the Specific Anti-Avoidance Provisions scattered throughout the Income Tax Act. These Specific Anti-Avoidance Provisions generally do not have such a high level of difficulty in enacting and generally apply to 'common' transactions that SARS and National Treasury may not entirely be in favour of (e.g. Hybrid Debt Instruments). Based on the analysis above, it would appear that enacting the Specific Anti-Avoidance Provisions (i.e. the re-attribution rules) would be a lot easier for SARS to effect and thereby result in a more favourable taxing event for SARS. In addition to its arsenal, the substance over form principle could also be used by SARS in the event that a taxpayer is treating the trust as an extension of themselves. In this regard, the tax consequences would probably be treated as if the taxpayer held all of the assets in their personal capacity and the income would accrue to the taxpayer in question.

Notwithstanding the above, it appears that the above ammunition that SARS has at their disposal may still not be enough to counteract the mischief and abuse that the trust structures may cause to the tax base of South Africa. In this regard, the next chapter analyses the proposed changes that SARS and National Treasury wishes to make in respect of the trust taxing regime.

4 Proposed Amendments

4.1 National Budget Speech

As part of the 2013 Budget Review, reference was made to various aspects of the current taxation of trusts which are areas of concern which were initially intended to be amended by legislation during 2013/ 2014[49]. The areas of concern are as follows:

- Distributions from offshore foundations;
- The utilisation of trusts to avoid estate duty; and
- The abolishment of the conduit pipe principle in respect of Discretionary Trusts and Trading Trusts.

For purposes of this dissertation the proposed change to treat distributions from offshore foundations as ordinary income is outside the scope of this dissertation. With regard to the proposed changes to be made in respect of the estate duty implications in respect of trusts, neither National Treasury nor SARS has indicated the manner in which they will "remedy" this. Based on the 2013/2014 National Budget, it was estimated that estate duty would only bring in 0.1% of the total estimated tax revenue[50].

As previously mentioned, SARS is likely to recommend that the conduit pipe principle (see chapter 2 for a detailed discussion) be abolished and replaced with a new taxing regime. It is proposed that the new taxing regime would find application to only Discretionary Trusts and Trading Trusts.

A discretionary trust is a trust in which the trustees has a discretion on how to distribute profits, if at all, to the beneficiaries with regard to either quantum or timing. The "opposite" of this would be a Vesting Trust. A vesting trust sets out the proportion of the distribution to be distributed to each beneficiary in the trust deed. It is important to note that a trust could be a hybrid of the above, as a trust deed could make provision for either capital profits or revenue profits (i.e. normal income) to be discretionary or vesting. The commentary provided in the 2013 National Budget Speech does not provide clarity as to whether a trust that provides a discretionary right to only capital or income would fall within the new tax regime.

The main change proposed (although the proposal is very informal and no further detail has been provided by either SARS or National Treasury) is that the conduit pipe principle will be abolished and replaced with a similar taxing regime whereby the trust would still be allowed to flow through income and expenditure in a similar way as before, but the income "flowed" to the beneficiaries would lose its identity. For example, in respect of interest distributions made by a trust, the current "conduit pipe

[49] Chapter 4: Revenue trends and tax proposals of the 2013 Budget Speech

[50] Based on the Table 4.9 of Chapter 4 of the National Budget Speech 2013 and an article by Dr Beric Croome, The Future Taxation of Trusts, http://www.bericcroome.com/2013_06_01_archive.html (Accessed 20 August 2014)

principle" contained in section 25B of the Income Tax Act would allow the income to retain its nature and potentially be subject to the interest exemption contained in the Income Tax Act. With the new proposed taxing regime the interest distribution would be seen to be taxable income and not be subject to any potential exemptions contained in the Income Tax Act.

In the run up to the 2015 Budget speech, there were several 'rumours' or 'predictions' made of potential changes to the Income Tax Act. Those included the following:

- Increase in marginal tax rates;
- Increase in Value-Added Tax rates;
- Increase in Capital Gains Tax rates (the inclusion rates for trusts were rumoured to increase from the current 66.6%); and
- The imposition of Estate Duty on trusts every 20 years (which eluded to the change in estate duty mentioned in 2013 / 2014).

Although none of the above, barring the increase in marginal rates which has seen the tax rates for trusts being increased to 41% from 40%, there is a possibility that the other 'rumours' or predictions could come through in the near future. Many individuals in the tax fraternity were of the view that because it was the inaugural Budget Speech of the new Finance Minister Nhlanhla Nene, that the budget speech for the 2015 / 2016 year did not include any 'surprises' and that the budget speech in the subsequent year may provide for more of an insight of where National Treasury and SARS hope to go with regard to trusts.

At the time of writing this paper, neither National Treasury nor SARS has provided any further clarity as to what changes will be made to the trust tax regime.

4.2 Summary of the meeting between STEP and National Treasury[51]

During the course of June 2013, National Treasury met with STEP (the Society of Trust and Estate Practitioners) to discuss their perception of trusts as well as to gain any input from STEP. The summary of the report disclosed by STEP, specifically makes reference to the fact that National Treasury has not made up their mind with regard to the new taxing regime of trusts (this is quite evident due to the fact that as at the date of writing this report (almost two years later), National treasury still has not provided an indication of the proposed changes). National Treasury gave an indication of the plans in respect of both offshore and made recommendations for both local and offshore trusts and foundations. Once again it is noted that the proposed changes for offshore trusts and foundations are outside the scope of this research paper.

[51] Report Back Received from STEP Cape Town, 23 June 2013, http://sentineltrust.co.za/Advisory/report-back-received-from-step-cape-town/, (Accessed 20 June 2014)

Based on the report it would appear that National Treasury's view of local trusts is that of suspicion, similar to that of SARS, and National Treasury is under pressure to stamp out the 'tax avoidance' created by the utilisation of trust structures. The new taxing regime for trusts is to do away with the conduit pipe principle and to rather tax trusts as companies as according to National Treasury's view, a trust is very similar to a company. This statement, had Gordon Stuart, Chief Operating Officer of Sentinel International, up in arms as it shows National Treasury's lack of understanding of what a trust is and the reasons for a trust being utilised.

Gordon Stuart goes on further to state his 'confusion' as to why National Treasury is getting upset with individuals that utilise trusts and follows the taxing guidelines set out in the Income Tax Act and the principles set out by our court. In his view, these sections were not created by a 'clever tax advisor' but was rather rules set out by SARS. He goes on further to state that "*I can only assume that the relevant sections were introduced by SARS and now they are getting sulky because it doesn't suit them anymore*'.

The example that National Treasury utilises as their area of concern, is when fully taxable income is distributed to a non-resident beneficiary (thereby avoiding a tax liability in South Africa) whilst tax exempt income is distributed to a resident beneficiary. In this regard, one can understand why National Treasury does view trusts with suspicion, however the question is the frequency of this type of transaction and furthermore, does it make sense to collapse the whole trust taxing regime to target a specific circumstance? (This situation could be remedied by way of a specific anti-avoidance provision inserted into the Income Tax Act dealing with this specific circumstance).

National Treasury proposes that the following tax regime for trusts would occur. Trusts would be taxed on all income and gains made at the punitive rate (i.e. 40% or 41% rate for years of assessment commencing on or after 1 March 2015). Notwithstanding the aforementioned, any distributions, limited to the income generated by the trust, will be deductible in the hands of the trust (i.e. reducing the taxable income for the trust) and be taxed in the hands of the beneficiaries, to the extent that the distribution lead to a tax deduction in the hands of the trust. The aforementioned will reduce the risk of double taxation occurring (i.e. both the trust and the beneficiary being taxed). In essence the effect of the proposed taxing regime essentially seems to mirror the 'conduit pipe principle' barring the fact that any income received from the trust would be 'denatured' (i.e. not retain its income nature). Notwithstanding the aforementioned it would appear that exempt income (i.e. such as dividends) flowing through the trust would still be exempt income in the hands of the beneficiary if distributed in the same year of assessment. National Treasury had also indicated that they would offer a window period to allow individuals to collapse their trust structure in a tax neutral manner.

Based on the above, it is unsure how the new trust taxing regime will stop the so called mischief that is created by a trust structure, however on the face of it, it seems that the situation which National Treasury is targeting is a specific situation dealing with taxable income flowing offshore and not being taxed in

South Africa. Once again the utilisation of a provision that specifically targets this event should potentially be considered to be inserted into the Income Tax Act.

4.3 ITR12TR

The new ITR12TR, which was effective from the 3rd of October 2014, is more complex and detailed than its predecessor being the ITR12. In this regard, the format of the new tax return requires the following transactions to be disclosed (for the 2014 year of assessment only distributions are required to be disclosed, thereafter from the 2015 year of assessment all of the below transactions would need to be disclosed to SARS):

- Capital or revenue distributed or vested in beneficiaries;
- Distributions or vesting of non-taxable income;
- Distribution or vesting of capital or assets;
- Loan(s) granted and received;
- Donation(s) or contribution(s) made or received;
- Distributions received from other trusts or foundations;
- Refund(s) received on contribution(s) made to this trust; and
- The right of use of asset(s) granted.

The above transactions are required to be disclosed individually in the instance that there are 50 or less individuals to which the above transactions apply. To the extent that there are more than 50 individuals then the disclosure of the above transactions can be done on a consolidated basis, provided that the transactional amount per individual does not exceed R500 000, in which case the transactional detail would need to be disclosed per individual.

Other notable changes to the trust tax return is the fact that discretionary / vesting rights can be disclosed to SARS in respect of both capital and normal income separately. Another interesting question asked in the new income tax return is whether the trust is a beneficiary of another trust (the double trust structure is not liked by SARS and does lead to adverse tax consequences depending how structured – this is unfortunately not discussed in this paper).

4.4 Conclusion

Based on the above, it is quite evident that neither SARS nor National Treasury has made up their mind as to what the proposed change to the trust taxing regime should be. Notwithstanding the aforementioned, it would also appear that SARS' and National Treasury's understanding of trusts and why such vehicles are used (barring for the perceived use of avoiding tax) is limited at this stage. The proposed indication of the change at this stage, seems to be targeting a specific instance with the abolishment of the 'conduit pipe principle' that has been formalised by both the court and the Income Tax Act. This proposed change by SARS and National Treasury may be seen to be 'excessive' and

potentially the use of inserting another specific anti-avoidance provision may be a better mechanism of protecting the tax base. In addition, the new ITR12TR, appears on the face of it, to be an interesting return which may serve SARS the purpose of acting as an 'informal' survey. The results of the tax returns completed can be used to assist both SARS and National Treasury in creating a better mechanism to protect the tax base of South Africa.

5 Conclusion

The purpose of this dissertation is to determine whether the utilisation of South African trusts do erode the tax base of South Africa.

In chapter 1, an analysis was provided which included *inter alia*, the types of trust that are in existence as well as the possible reasons why a taxpayer would have a trust structure. In this regard, there are several commercial reasons as to why a trust would be utilised (which are not tax driven) such as the protection of assets from insolvency as well as perpetual succession. The obvious question that follows from here is why not use a company or a close corporation to serve the same purpose. The answer to this in most cases is due to the fact that trusts do not have as stringent regulatory requirements as a company or a close corporation (e.g. financial statements are not required to be audited) and this makes it easier to manage for the average man in the street.

Following the determination of why trusts could be potentially used by taxpayers in general, a deep analysis was conducted in determining the current taxation principles attributable to trusts. Provided that the trust is a vesting trust or a discretionary trust in which distributions was made in the same year of assessment, the trust itself would be a 'conduit' and the taxing implications would flow to the beneficiaries whom received the distributions, provided that there was no 'donation, settlement or other disposition'. To the extent that there was a 'donation, settlement or other disposition' the taxing implication of the distribution made to the respective beneficiary could be re-attributed to someone else. These principles have been set out in the Income Tax Act as well as laid out by our courts. From an income tax perspective the most important aspect of the 'conduit pipe principle' is that the income still retains it nature.

In addition Chapter 2, further went on to analyse the impact of Estate Duty and Transfer Duty implications in respect of trusts. As part of this exercise it was evident that historically there may have been some 'tax loopholes' which taxpayers could benefit from by utilising a trust structure, however this was not necessarily unique to trusts. Notwithstanding the aforementioned, SARS and National Treasury did amend the relevant pieces of legislation to close the 'tax loopholes'.

Chapter 3, went on to analyse the 'weapons' that SARS have at their disposal to combat the misuse or mischief created by trusts. A brief analysis was conducted with regard to the difference between 'tax evasion' and 'tax avoidance'. Thereafter an analysis of the GAAR provisions was conducted whereby the concept of 'substance over form' was also analysed. Thereafter the specific anti-avoidance provisions were also analysed which dealt with the re-attribution from one beneficiary to another person provided that there was a 'donation, settlement or other disposition'. Lastly, an analysis of potential aspects that could make a trust invalid was also investigated, including a look at the issue of independence.

Finally, in chapter 4 an analysis of the proposed amendments was conducted. In this regard, due to the inactivity from SARS and National Treasury on this aspect this discussion was limited to representations made in the National Budget Speech as well as the meeting between STEP and National Treasury. As mentioned it would appear at this stage that the proposed change involves the abolishment of the 'conduit pipe principle' and the replacement thereof of a similar taxing regime which fundamental difference relates to the fact that the income distributed would generally not retain its nature (i.e. denature of income) barring that of exempt income such as dividends.

It would appear that the rationale behind this proposed change is due to the fact that National Treasury and SARS are 'unhappy' with the fact that trusts are distributing taxable income to non-residents and missing out on the opportunity to tax such income. The entire abolishment of an elementary taxing principle in respect of trusts to negate the aforementioned example, seems to be both excessive and harsh. On the face of it, it might serve all parties better if a piece of legislation that specifically deals with the aforementioned example is inserted into the Income Tax Act as a specific anti-avoidance provision. This would limit the complexity of drafting the new trust taxing regime which on the face of it will have many nuances that would require a lot of thought and clever drafting and would probably be subject to various amendments until the legislation is working effectively for both SARS and the taxpayer. In addition, a brief analysis was conducted if the new ITR12TR which at this stage seems to be a source of information gathering for SARS and requires a lot more disclosure than its predecessor.

In summary, as with most things, depending on how the trust vehicle is used it should not lead to an erosion of the tax base of South Africa provided that it is used legitimately. To the extent that the trust is being misused by the taxpayer, SARS does have 'weapons' which it can enact to safeguard the tax base, ranging from GAAR, Specific Anti-Avoidance provisions and substance over form. It would appear that at this stage both SARS and National Treasury needs to delve deeper to determine why and for what purpose trusts are being used.

Hopefully through this process the perceived suspicion of these vehicles would be negated and SARS and National Treasury can find some positive aspects that the trust vehicles provide to the *fiscus* thereby leaving this unique creature in our tax law with its distinctive taxing regime.

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