Tax Guide

Taxation of Trusts and Parties to a Trust

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In South Africa a trust has not always been a taxpayer. In fact, it was only in the late 1990's that a trust became an entity that could be taxed. It has always been commonly understood that a trust is a conduit, and the expectation was that the beneficiaries of a trust should be taxed on any income, and not the trust itself. But the tax consequences of income derived by a trust for the beneficiaries of the trust, was never a straightforward matter; in fact, it always has been quite a complex matter.

The trust law in South Africa developed over time and is still developing. From a normal tax point of view, income tax can currently be assessed on (or be payable by) the trust itself, or the beneficiaries of the trust, or the donor (in relation to a trust), or all of them.

A trustee of a trust, *qua* trustee[1], should not be taxed on income accruing to the trust, but would of course, if entitled to trustees' fees, be taxed thereon.

This guide will explain when tax will be payable by the donor, the beneficiaries, or the trust. It will also show how tax must be declared in returns of income that must be submitted as required by the Income Tax Act, No, 58 of 1962 (the Act or the Income Tax Act) and the Tax Administration Act, No. 28 of 2011 (the Tax Administration Act).

It is necessary, in the first instance, to explain what a trust is.

1.2 A trust defined
1.2.1 General

The single most authoritative text available on trust law in South Africa, is the book "The South African Law on Trusts", by Tony Honoré. In the second edition of this book, Honoré made the following general comments with regard to the creation of a trust:

> *"It has sometimes been said that a trust inter vivos 'is' a contract for the benefit of third person or stipulatio alteri or fiducia com amico. But on reflection it is plain that the starting point being made is simply that the <u>method of creation of a trust inter vivos is by way of contract</u> and that the contract usually contains a stipulation in favour of the beneficiary, who by accepting acquires an indefeasible right under the trust."*

Judge Cameron, in a majority judgement in *Genesis Medical Scheme v Registrar of Medical Schemes and Another* [2017] ZACC 16, explained a trust (or a trust relationship) in general terms as follows:

> *"The fundamental tenet of the trust relationship in our law is that a trustee, though generally the legal owner of the trust assets, holds them not in the trustee's own interest, but for or on behalf of another person, the trust beneficiary.*
>
> *A further tenet is that the trust relationship must be deliberately constituted. It cannot arise unintentionally. Constructive and resulting trusts are unknown to South African law. A trust can therefore come into existence only by testamentary disposition, by statute or by contract between living persons."*

[1] The term "*qua trustee*" is a Latin phrase that means "in the character or capacity of a trustee".

The most important point that follows from the above is that a trust comes into existence, by way of a contract agreement, statute, or testamentary disposition. Whilst a contract does not have to be in writing, all of the other formats will require an agreement or some document, such as the last will and testament, or an Act of Parliament. The Trust Property Control Act uses the term “trust instrument”, and in section 1 defines it as follows:

> *“In terms of the definitions section of the Act, a “trust instrument” is “a written agreement or a testamentary writing or a court order according to which a trust was created”.”*

Judge Bester[2] said:

> *“A trust instrument must therefore be in writing. However, that does not mean that a trust cannot be created by oral agreement.”*

And then, with respect to *“a trust ... created by oral agreement”*, Judge Bester said

> *“But that oral agreement only becomes a “trust instrument” when it is reduced to writing: in terms of 2 of the Act, “(i)f a document represents the reduction to writing of an oral agreement by which a trust was created or varied, such document shall for the purposes of this Act be deemed to be a trust instrument”.”*

What the Trust Property Control Act does, is to add (to what Tony Honoré and Judge Cameron said), that a trust can also be created by court order. In practice, a court will often order that a trust be created where a person was successful in a claim for compensation to be paid by the road accident fund or resulting from medical negligence. Judge (Dr) E van der Schyff[3] said

> *“Trusts are often created by order of Court where awards are made in claims for damages arising out of motor vehicle accidents where plaintiffs are minors or mentally incapacitated persons to protect the awards. In In Re Protection of Certain Personal Injury Awards (Pretoria Society of Advocates and Others, Amici Curiae), a Full Court of this Division confirmed that creating a trust as a protective mechanism is tenable in law. Trusts so created are, in essence, sui generis as they are solely created to protect awards and are referred to as protective trusts.”*

As is said in the Fundamentals of South African Trust Law 2019[4]:

> *“A trust in the strict sense is governed by both the common law and the Trust Property Control Act.*
>
> *The South African Trust is premised on a functional separation between a trustee’s control of a trust and the property subject to that trust on the one hand, and the trust beneficiaries’ enjoyment of the benefits yielded by the trustee’s control, on the other hand.”*

Is the nature of a trust any different for purposes of income tax in South Africa?
The Appellate Division, of the Supreme Court of South Africa (as it was then known), with respect to the Phillip Frame Will Trust[5], had opportunity to consider the nature of a trust from a taxation point of view. With respect to whether “a trust is a legal person”, Judge Joubert, writing for the majority, said that:

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2 In *Groeschke v Trustee for the Time Being of the Groeschke Family Trust and Others* (44105/2011) [2012] ZAGPJHC 228; 2013 (3) SA254 (GSJ) (31 October 2012)
3 In *Sandenbergh and Another v Master of the High Court and Another* (087032-2023) [2024] ZAGPPHC 436 (29 April 2024)
4 By F Du Toit, B Smith and A van der Linde
5 In *The Commissioner for Inland Revenue v Friedman and Others N N 0*

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

I can find nothing in the 1962 Act which manifests an intention of the Legislature to regard a trust as a "taxable entity".”

Having considered this and with respect to the question, whether a trust is a person, the judge then concluded that the answer “is therefore No.”
With respect to a second issue before the court, namely

“Is the Trust despite its lack of legal personality nonetheless for purposes of the 1962 Act a "taxable entity" that is liable as a “person” for income tax in regard to its undistributed trust income which does not accrue to any potential income beneficiary?

Judge Joubert simply concluded; “The answer to the Second Issue is accordingly No.””

Inland Revenue, as SARS was known at the time, as one would expect, responded by amending the Income Tax Act, and since then, a trust is a person for taxation purposes (or a taxable entity). In order to do so, they had to amend certain tax Acts, in order to include a trust (as a person). This of course was primarily done for purposes of the Act.

The Trust Property Control Act[6], repealed the Trust Moneys Protection Act, 1934, and then codified, but not in its entirety, the common law relating to a trust into South African law. The commencement date of the Trust Property Control Act was 31 March 1989 and therefore before the first amendments were made to the Income Tax Act. It is necessary, for purposes of completeness, to also read the definition, of a trust the in the Trust Property Control Act.

The Trust Property Control Act defines a “**trust**” as *“the arrangement through which the ownership in property of one person* (the founder of the trust or the donor) *is by virtue of a trust instrument made over or bequeathed to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument* (trust deed) *for the benefit of the person*(s) (the beneficiary or beneficiaries) *designated in the trust instrument* (the trust deed)*”*.

Judge Marais, for the majority, in Estate R F Welch v Commissioner for the South African Revenue Service, said the following:

“There is nothing in South African law which prohibits a citizen from establishing an inter vivos trust for any lawful reason.”

This raises the question of whether the definition of a trust, as found in the Income Tax Act, differs from the above definition, which is a trust in the strict sense.

1.2.2 A trust defined for income tax purposes

As was mentioned in the previous paragraph, at common law, a trust is not a person[7], and a trust was also not always a person for purposes of the normal (or income) tax.

[6] Act No. 57 of 1988
[7] A trust is also not included as a person in the definition in section 1 of the Interpretation Act (Act No. 33 of 1957)

From an income tax point of view, historically, a trust (or the trustees of the trust) was seen as a flow through entity (at least until the early 1990's). In principle then, to the extent that income "flowed through" to the beneficiaries of the trust (or was vested in the beneficiaries), the trust itself should be tax neutral. Where the income was retained in the trust, the trustees as representative taxpayers, were taxed on the income of the trust (historically).

This practice (of the tax being imposed on the trustees) was successfully challenged[8] and it resulted in no tax payable on income retained in a discretionary trust. This prompted Inland Revenue, as was said above, to amend the Act, to allow for this income (the income retained in the trust) to be taxed. And for this tax to be imposed on the trust itself. Other than the amendment to the definition of a person, other definitions were added to the Act, and they are:

> *"In this Act, unless the context otherwise indicates -*
>
> > *"**beneficiary**[9]" in relation to a trust means a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust;*
> >
> > *"**trust**" means any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person*.
> >
> > "***trustee**", 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 … 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."*

Simply put, for income tax purposes, a trust is an arrangement whereby property[10] is held by the trustees of the trust for the benefit of the beneficiaries of the trust. The arrangement can then be by way of an agreement, a trust deed, or a will of a deceased person. From the definition of a trust above, it can be seen that there are, in essence, three persons (or parties) to a trust.

The meaning of the word "beneficiary", for purposes of the Income Tax Act, was only added to the Act in the 2005 year. The purpose for introducing this "wider definition of "beneficiary", was "to clarify that the word includes contingent beneficiaries."[11] Section 25B was added to the Act at the same time as the trust became a person for purposes of the Act.

The right of a beneficiary, to income or capital of a trust, is determined from the trust instrument (agreement, trust deed or will), and this right of the beneficiary is fundamental to determine the tax consequences of the amount (or property) that a beneficiary may be entitled to. Section 25B, since its introduction, used the terms "*has a vested right*", or "*acquired a vested right to*", whilst the definition of "beneficiary", refers to a "*vested right*", or a "*contingent right*".

The guide will deal with the tax event, or vesting, in more detail later on. Suffice to say that vesting is fundamental to trusts and the beneficiaries of trusts, as far as income tax is concerned. Whilst it is common, colloquially really, to refer to a trust as a vested trust or a discretionary trust, it would be more correct to refer to the beneficiaries as having either vested rights, or contingent rights (or both). Whether

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[8] Commissioner for Inland Revenue v Friedman and Others NNO (14/91) [1992] ZASCA 190; 1993 (1) SA 353 (AD); [1993] 1 All SA 306 (A) (5 November 1992)

[9] The definition of "beneficiary" was added to the Act in a later year.

[10] Property, for income tax purposes, is cash or other assets.

[11] See the Memorandum on the Revenue Laws Second Amendment Bill, 2005

the right of beneficiaries of a trust is one or the other, does not define the kind of trust. However, it is a very important distinction for purposes of income tax.

From an income tax point of view, the difference in the "taxing" of the beneficiaries to the trust, arises from the nature of their rights. And the rights of a beneficiary must be determined, from no other source than from the trust deed itself.

It is appropriate to start with some comments relating to the interpretation of trust deeds.

1.2.3 Interpreting trust deeds:

It is necessary to interpret the trust deed in order to determine the nature of, or the kind of trust one is dealing with.

According to Judge Wallis[12], with reference to the interpretation legislation, said that it was *"necessary to say something about the current state of our law in regard to the interpretation of statutes and statutory instruments and documents generally*". And then said that the "present state of the law" relating to interpretation can be expressed as follows:

> *"Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective not subjective."*

Important to note the reference to "documents generally", and "whatever the nature of the document" – the above is therefore also applicable to trust deeds.

Judge Mhlantla, *Wilkinson and Another v Crawford N.O. and Others* [2021] ZACC 8, writing for the majority, and with respect to the interpretation of the trust deed, said the following:

> *"The golden rule of interpretation of testamentary instruments is to "ascertain the wishes of the testator from the language used". As a general rule, words and phrases must be given the meaning they had at the time the testamentary instrument was made. It is thus imperative to consider what the words used by the testator mean or what the testator meant by using the words."*

It is submitted that the above is also relevant to the interpretation of a trust deed (or instrument). Judge Dlodlo, with respect to a trust deed, said[13] the following:

> *"Essentially, in interpreting a Trust Deed, the point of departure is the grammatical or ordinary meaning of the words used. Those words must be read within the context of the Trust Deed as a whole. In Moosa v Jhavery 1958 (4) SA 165 (N) at 169 D-F the then Natal bench held that the*

[12] *Natal Joint Municipal Pension Fund v Endumeni Municipality* (920/2010) [2012] ZASCA 13 (15 March 2012)

[13] Harper and Others v Crawford NO and Others (9581/2015) [2017] ZAWCHC 78; 2018 (1) SA 589 (WCC) (30 June 2017)

trust speaks from the time of its execution and that it must be interpreted as at that time. The court held further that:

> *'It is the settlor's intention at that time that must be ascertained from the language he used in the circumstances then existing. Subsequent events (and in these are included statutes) cannot, I consider, be used to alter that intention.'*

The above remains the legal position when it comes to testamentary trusts despite the passage of time."

From a tax point of view, but not only for that purpose, it is important to always refer to the trust deed, or trust instrument (or will), and to interpret that document in order to determine whether the trust is a trust *inter vivo*, or a trust *mortis causa*, and then to determine what the nature of the rights of the beneficiaries are and when a beneficiary becomes entitled to benefit from the trust income or property.

What are the different trusts (essentially for purposes of income tax)?

2. The nature of a trust

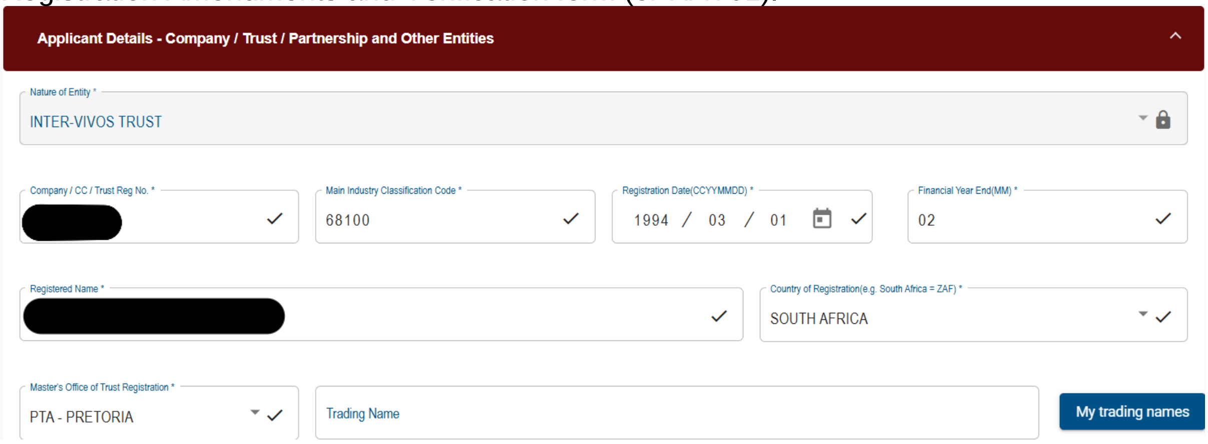
2.1 The different kinds of trusts

SARS requires, in the tax return of income (or the ITR12T[14]) for a trust, that the following must be indicated:


Trust Type
Trust Type
INTER VIVOS
Income Rights
Vesting
Discretionary
Capital Rights
Vesting
Discretionary

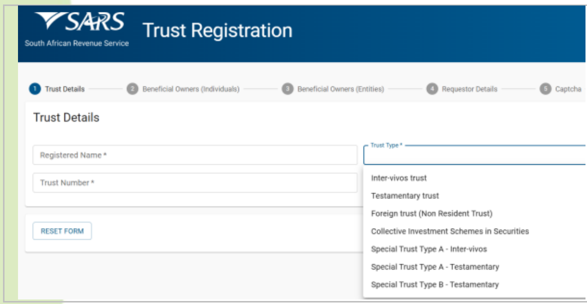
With respect to the type of trust, this is auto populated to the trust return and the detail thereof is obtained from the detail provided to SARS when the trust was registered.

Registration Amendments and Verification form (or RAV01).


Applicant Details - Company / Trust / Partnership and Other Entities
Nature of Entity *
INTER-VIVOS TRUST
Company / CC / Trust Reg No. *
[redacted]
Main Industry Classification Code *
68100
Registration Date(CCYYMMDD) *
1994 / 03 / 01
Financial Year End(MM) *
02
Registered Name *
[redacted]
Country of Registration(e.g. South Africa = ZAF) *
SOUTH AFRICA
Master's Office of Trust Registration *
PTA - PRETORIA
Trading Name
My trading names

The nature of the entity, the trust in this instance, follows from the request to register as a taxpayer.

[14] The version that became available on eFiling on 16 September 2024

<table>
<tr>
<td>
</td>
<td>The trust type allows for the following to be selected (sic):
• Inter vivos trust
• Testamentary trust
• Foreign trust (Non-resident trust)
• Special Trust Type A – Inter vivos
• Special Trust Type A – Testamentary
• Special Trust Type B – Testamentary</td>
</tr>
</table>

Note: the registered name follows from the trust deed itself, which always will state the name of the trust. And the trust number, is a number allocated by the Master when the deed is submitted to the Master and the letter of authority is obtained (for the trustees).

As was said above, from a tax point of view, the kind of trust will be determined with reference to the rights of the beneficiaries to the income or capital of, or capital gains arising in the trust. On this basis there could essentially be two kinds of trusts, namely a trust where the beneficiaries have a vested right (then referred to as a vested trust), or a conditional right (the discretionary trust). But in reality, that may be irrelevant because a beneficiary in a trust may have rights both to capital or income of the trust, and then it is colloquially referred to as a hybrid trust. The ITR12T does not make provision for the hybrid option. If one were to mark the trust as "vested", it cannot also be marked as hybrid, under income rights or capital rights. The return only recognises a trust *inter vivo and* a trust *mortis causa*.

As will be seen later in this guide, from an income tax point of view, the nature of the rights of the beneficiaries would also determine the timing of the tax event (or kind of trust).

Because the definition of a trust in section 1(1) of the Act, refers to the method of creation of a trust, namely "*by agreement or under the will of a deceased*", it would be appropriate to start the discussion of the kinds of trusts in South Africa, with the trust *inter vivo* and the trust *mortis causa*.

2.1.1 Registration of a trust as a taxpayer

2.1.1.1 A trust is a person required to register as a taxpayer

In terms of section 22(1) of the Tax Administration Act, it is the person '*obliged to apply to … register with SARS under a tax Act*' who must do so. One must therefore look to the Income Tax Act to determine if a trust is obliged to register with SARS.

For purposes of the Tax Administration Act, see section 15(a), and *"taxpayer means -*
(a) a person who is or may be chargeable to tax or with a tax offence;
(b) a representative taxpayer ..."

In terms of the definition, in section 1(1) of the Income Tax Act, "**taxpayer**" means *"any person chargeable with any tax leviable under this Act*'. This Act is of course the Income Tax Act, and it levies the normal tax (on income) and the withholding taxes, such as on dividends and donations tax.

In terms of section 67(1), of the Income Tax Act, *"Every person who at any time becomes liable for any normal tax or who becomes liable to submit any return contemplated in section 66 must apply to the Commissioner to be registered as a taxpayer in accordance with Chapter 3 of the Tax Administration Act*."

According to section 66(1), of the Income Tax Act, the Commissioner must annually give public notice of the persons who are required by the Commissioner to furnish returns for the assessment of normal tax. No reference is made to the tax chargeable. It follows that a trust, which is not liable for any normal tax, may well have to submit *"returns for the assessment of normal tax"*.

The following appears in the annual notice (Notice number 4918), which was published in Government Gazette No. 50741, on 31 May 2024.

> 2. Persons who must submit an income tax return
> The following persons must submit an income tax return ...
>
> (a) **Every trust** that was a resident during the 2024 year of assessment;
> (b) Every ... trust ... which was **not a resident** during the 2024 year of assessment, that—
>
> (i) carried on a trade through a permanent establishment in the Republic;
> (ii) derived income from a source in the Republic; or
> (iii) derived any capital gain or capital loss from the disposal of an asset to which the Eighth Schedule to the Income Tax Act applies;

It follows from the above that a trust, being a resident of the RSA, and being liable to furnish a return, will have to register with SARS as a taxpayer in terms of section 66 of the Income Tax Act, even if the trust is not liable to the normal tax.

When is a trust a resident of South Africa for purposes of the Act (or income tax)?

2.1.1.2 Resident

In the Act, unless the context otherwise indicates, "***resident[15]"*** *means*

"any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic,

but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation;"

If a trust was formed in South Africa, when the trust deed is submitted to the Master, it would be formed or established in South Africa and will consequently also be a resident for purposes of income tax in South Africa.

If the trust is not a resident of the RSA, for purposes of income tax, the trust must also have to register as a taxpayer with SARS. With respect to a foreign trust, the obligations to file a return is based on the fact that the trust derives income (not taxable income) from a source in the RSA or disposed of an asset, the capital gain of which has a source in the RSA or carried on a trade through a permanent establishment in the RSA. It is not based on the fact that the trust may be liable to the normal tax.

[15] Paragraph (b) of the definition of "resident" in section 1(1) and the words following paragraph (b),

A foreign trust will become a resident South Africa if the place of effective management of the trust is in South Africa.

And a trust that was formed in South Africa will cease being a tax resident of the RSA, if in terms of a double taxation agreement, it is deemed to be exclusively a resident of another country (that the RSA has a treaty with). The wording is typically found in paragraph 4(3) of Article 4 of the treaty and reads as follows:

> *"Whereby reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated."*

Paragraph 1 of Article 4 of the treaty would indicate when dual residency applies – typically it is liable to tax.

The trust (formed in South Africa) then ceases to be a resident of the RSA when it is exclusively deemed to be a resident of the other country.

Section 9H(2) of the Act applies to a person (other than a company) and will then result in a capital gain in respect of the assets of the trust, other than immovable property in the RSA – see section 9H(4) for the specific detail.

2.1.1.3 Other taxes

If a trust, which is a tax resident in the RSA, pays an amount of interest or a royalty to a foreigner, it will have to register for the relevant withholding tax.

It is now clear when a trust must register as a taxpayer for purposes of the normal tax. When will a trust be a trust *inter vivo*, or a trust *mortis causa*?

And that discussion starts with some general comments, relating to the difference between the two kinds of trusts.

2.2 The trust *inter vivo* or the trust *mortis causa*

2.2.1 General comments

Judge MH Rampai[16] said the following:

> *"As regards a trust mortis causa, it can be created in the will of a testator. It is also commonly known as testamentary trust. It essentially constitutes a testamentary disposition. As such the testamentary instrument whereby a trust mortis causa is created has to be validly executed in accordance with the requisite prescripts and formalities prescribed by sec 2 Act No 7 of 1953, the Wills Act.*
>
> *Since a trust mortis causa is provided for and embodied in the will, it is a voluntary and a unilateral minute of a testator's final wishes and directions concerning the ultimate disposal and distribution of his assets after his death. It follows, therefore, that being a mode of testamentary disposition,*

[16] in Hamilton and Another v Badenhorst and Others (5348/2017) [2018] ZAFSHC 33 (29 March 2018)

the creation of a trust mortis causa is a purely unilateral act by the testator based on the doctrine of freedom of testation. Put differently, it is not a bilateral legal act or contract."

Trust *inter vivo:*

"As regards a trust inter vivo, it is created by means of a bilateral act[17]. It essentially constitutes a contractual mode of disposition. As such the contractual instrument whereby, a trust inter vivo is created has to be validly executed in accordance with the requisites and prescripts of the Trust Property Act in particular and the law of contracts in general.

Because a trust inter vivo is a bilateral agreement, it is provided for in a separate document outside a will. It was described by the court as something akin to stipulation alteri in other words a contract for the benefit of a third party."

Judge Chaskalson, writing for the majority on 2 October 2024[18], explained it as follows:

"An inter vivos trust is a trust created during the lifetime of the founder of the trust through a contract between that founder and the trustee(s) of the trust who will administer the trust for the benefit of the beneficiaries. It is distinguished from a testamentary trust which is created in terms of the will of a testator who wants their estate, or a part thereof, to be administered in trust for beneficiaries identified in the will."

In summary, a trust *inter vivo*, is a trust created between living persons, whereas a trust *mortis causa*, is created by (or in terms of) the last will and testament of a person.

It is outside the scope of this guide to deal with this in more detail, but suffice to say, from an estate planning point of view, that it would be in the best interest of the parties to advise the testator (or planner) to create a trust *inter vivo*, and then make the bequest to this trust (which should preferably be in existence at the date of death). This is not only for purposes of income tax, or the normal tax on capital gains arising on death, but also primarily for purposes of estate duty or donations tax.

From an income tax point of view, there is no difference in the tax treatment of income or capital gains that vests in the beneficiaries of these two trusts. That is other than the "timing" of the vesting moment, which may be uncertain in the trust *mortis causa*. Put differently, because vesting is the tax event (or incidence of tax), it matters not, for purposes of income tax, whether the trust is a trust *inter vivo*, or *mortis causa*.

It is necessary to make mention of another kind of trust, namely the *bewind trust*.

2.2.2 The *bewind* trust

Judge Rogers[19] said:

"In the case of trusts, the trustees are sometimes said to have "bare ownership", or not to have "beneficial ownership", of the assets belonging to them, because they must administer the assets for the benefit of the trust beneficiaries. This does not mean that anyone else is the "beneficial

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17 The wording in the case report, *sic*: "it is created by means of a bilateral act"

18 *The Thistle Trust v Commissioner for the South African Revenue Service* [2024] ZACC 19 – decided on 2 October 2024

19 In *Independent Community Pharmacy Association v Clicks Group Ltd and Others* (CCT 11/22) [2023] ZACC 10; 2023 (6) BCLR 617 (CC) (28 March 2023)

owner" of the trust assets. Except in the rare case of a bewind trust, the trustees are the only "owners" of the assets, even though they do not personally enjoy the benefits of ownership. The beneficiaries of the trust are not the owners of the trust assets. In a discretionary trust, a particular beneficiary might never get a benefit from the assets. Even where a trust beneficiary becomes vested with the right to a trust asset, the beneficiary's right is a personal right to compel the trustees to perform their trust obligations by delivering the asset to the beneficiary. Only upon such delivery does the beneficiary become the owner of the asset. Although trust beneficiaries are not usually described as "beneficial owners" of trust assets, if that expression is used, it does not mean that they are in law the owners of the assets."

In a *bewind* trust the founder makes a gift or bequest to the beneficiary and vests the administration of the assets in the administrator or trustee. This structure is known as a *bewind* in Dutch law and a *bewindhebber* in Roman-Dutch law. In a *bewind* trust the ownership of the assets of the trust vests in the beneficiary, but the administration of the trust vests in the trustee or *bewindhebber*.

SARS, in their guide on special trusts, explains as follows:

> *"Although legal ownership of the trust assets vests in the trustees (other than a bewind trust), a trustee is not the beneficial owner of the trust assets. For tax purposes, however, the effect of the definitions of "person" and "trust" in section 1(1) when read together is to make the trust the owner of the assets administered by the trustees, except when the trust is a bewind trust. Assets held by a bewind trust remain the property of the trust beneficiaries and are merely administered by the trustees."*

From the above it is clear that a trust will be a *bewind* trust, if the beneficiaries actually own the assets of the trust. Put differently, there is the difference between a *bewind* trust and a trust where the beneficiaries have a vested right to the property in the trust (but owned by the trustees).

It is possible that a *bewind trust* may not constitute a trust, primarily because the property is not handed over to the trustees. It is submitted, that for tax purposes, a *bewind* will be a trust as defined. The definition is section 1(1) of the Act, refers to "*any trust fund consisting of cash or other assets which are administered and controlled by*" the trustee of the trust. It does not refer to, or have the distinction, which is found in the Trust Property Control Act, between the instance where the trustees own and the beneficiaries own or require the trustees to own the assets, for the *bewind* to be a trust.

For purposes of this guide, a *bewind* trust is essentially a trust where the beneficiaries have a vested right to the trust property and the normal tax consequences are the same as a beneficiary whose has a vested right to trust property.

Mention was made of a special trust, or that there are three kinds of special trusts, when the registration of trusts as taxpayers were discussed. What is a special trust?

2.2.3 The special trust

2.2.3.1 The different kind of special trusts

This special trust is a creature of tax legislation. Initially, or until 1999 (in Act 32 of 1999), it was defined, not in the main act, but in the annual amendment acts and just for purposes of fixing the rates of tax that applied to a special trust. This was done because *"the tax rates applicable to special trusts differ from those of other trusts"*[20].

Because the *"concept of a special trust is now also being used in the Eighth Schedule for capital gains tax purposes"*, the Act was amended to include the definition of "special trust" in section 1 of the Act."[21]

The Act defines two kinds of special trusts, and they are commonly referred to as a "Type A" or a "Type B" trust. The latter follows from the fact that the two special trusts are defined in paragraph (a) and (b) of the definition of special trust in section 1(1) of the Income Tax Act.

The SARS guide on special trusts should be consulted – it provides a decent explanation of when a trust will be a special trust, and the difference between the two types of special trusts.

It is outside the scope of this guide to go into more detail[22] about the definition of a special trust. Suffice to say the following:

The difference between the two kinds of special trusts, in the first place lies in the beneficiaries of the trust, and secondly, in how the trust is created. The following table provides the requirements for both:

	The Type A-trust Paragraph (a) of the definition of "special trust"	The Type B-Trust Paragraph (b) of the definition of "special trust"
The creator of the trust	... a trust created	... a trust created ... by or in terms of the will of a deceased person
The beneficiaries of the trust	solely for the benefit of one or more persons who is or are persons <u>with a disability</u> as defined in section 6B(1)	solely for the benefit of beneficiaries who are <u>relatives in relation to that deceased person</u> and who are alive on the date of death of that deceased person
The qualification relating to the beneficiaries of the trust.	where such disability incapacitates such person or persons from earning sufficient income for their maintenance, or from managing their own financial affairs	where the youngest of those beneficiaries is on the last day of the year of assessment of that trust <u>under the age of 18 years</u>
Tax specific	A of "special trust" (both type-A and type-B trusts), applies for the purposes of the Act as a whole.	The Eighth Schedule defines a special trust to include only a type-A trust. So, the "relief", in respect of capital gains, is not available to type-B trusts.

[20] See the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001

[21] As it was explained in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001

[22] The *Guide to the Taxation of Special Trusts* (Issue 3) should be consulted – it provides a decent explanation of when a trust will be a special trust, and the difference between the two. And is available on the SARS website.

Typically, when a trust is set up to receive road accident awards, Judges often refer to a special trust. Judge Keightley, writing for the full bench (unanimous), with respect to *"... the high number of personal injury claims for damages arising out of motor vehicle accidents, or 'RAF' claims, and, albeit a smaller number, arising from medical negligence"*, before the Gauteng Division, Pretoria, of the High Court, said the following[23]:

- These damages are awarded on the basis that the amount will compensate the plaintiff for the salary she would have earned but for their injury in an accident. In principle, therefore, the damages award should be available as an ongoing source of financial support for the remainder of the plaintiff's lifetime.
- In most cases, once a lump-sum award has been made, a court has no further legal interest in the matter.
- there are certain categories of cases in which the court retains a legal oversight role in ensuring that damages awards are protected. These are cases in which minors are recipients of damages awards, or where an adult plaintiff suffers some incapacity which inhibits his / her ability properly to manage the financial sum awarded. Many of the latter cases occur where the accident or other act of negligence caused a traumatic brain injury (TBI) to the plaintiff. TBI's vary in degree and in their neurocognitive effect. Not everyone who has suffered a TBI will require the protection of his / her damages post-award. One of the functions of the court is to make a determination as to whether such protection is necessary, and if so, what form of protection would be appropriate.
- It is against this background that the present application arises. In this Division, two legal mechanisms are generally employed to protect funds awarded as damages in cases where the plaintiff has suffered a form of cognitive incapacity as a consequence of the accident or other negligent act. The first is the appointment of a *curator bonis* following the procedures outlined in rule 57 of the Uniform Rules of Court. The second is the creation of a trust into which the damages award is paid. The formation of the trust is directed in terms of an order of court.
- Typically, both mechanisms are designed to ensure that the protected funds are used for the benefit of the plaintiff's maintenance, care and other needs. In both instances, the *curator bonis* or trustee have fiduciary duties, and they are subject to supervision by the Master of the High Court, and the court itself. The position of *curators bonis* is governed by the Administration of Estates Act, No. 66 of 1965 (the Estates Act), and that of trusts and trustees is governed by the Trust Property Control Act, No. 57 of 1988 (the Trust Act) and the common law.

Judge Marais, in Tjale N.O obo N.B v Road Accident Fund (2313/2022) [2024] ZALMPPHC 44 (12 April 2024) stated as follows:

- The only remaining question is whether the funds should be protected by way of the appointment of a *curator bonis*, or the creation of a special (protection) trust.
- In my view, appointing a *curator bonis* would be too costly and limit the minor's right to make his own decisions upon reaching the age of majority.
- A special trust, created solely for the benefit of the minor Plaintiff, would be better suited for him, to allow him to attain legal capacity upon reaching the age of majority and to enter into contracts freely. Upon reaching the age of majority, the trustee would also be able to guide the minor to make sound financial decisions. Should the trustees believe that the minor Plaintiff (upon reaching

[23] Master of the High Court v The Pretoria Society of Advocates and Others; Van Rooyen N.O. obo Ntzokhe v Road Accident Fund; Raphulu v Road Accident Fund; Raubenheimer obo Brian v Road Accident Fund; Segoba obo Sekwne v Road Accident Fund; Wentzel v Road Accident Fund (35182/2016;28304/2014;44200/2018;17258/2015;40258/2021;35182/2016) [2022] ZAGPPHC 396; 2022 (6) SA 446 (GP) (20 May 2022)

the age of majority) can make his own sound financial decisions, then upon an application to the High Court, this special trust may be terminated.

It is important to note that the above does not make the trust created by the court order, a special trust for purposes of income tax. The trustees of the trust will have to determine if the trust in fact is a type A-trust, or type B-trust and must register it accordingly with SARS as a taxpayer.

The following is an example of a special trust.

2.2.3.2 Example

The extract below is from a court order, in E.B.L v N.E.K and Another (64416/2009) [2022] ZAGPPHC 936 (25 November 2022). In this instance the action for the recovery of damages based on medical negligence, and the beneficiary clause reads as follows:

3. BENEFICIARY

The beneficiary of this Trust will be T[....] L[....], a person suffering from a mental illness as described in section 1 of the Mental Health Care Act, 17 of 2002 or a serious bodily impairment which prevents such person from generating sufficient income for his own maintenance or managing his own affairs, with regards to the income derived from the Trust assets and the capital shall also be used to the benefit of T[....] L[....] in such a way as the Trustee may deem appropriate but subject to the terms of this Deed of Trust. Should T[....] L[....] pass away, the Trust's assets will be transferred to the intestate heirs of T[....] L[....] in accordance with the provisions of the Intestate Succession Act as amended from time to time. The following expressions used in the Deed shall have the meaning hereinafter assigned to them unless the context otherwise requires.

5.1 "Beneficiary" shall mean T[....] L[....] or any other person as set out in paragraph 4 above. The Beneficiary shall be entitled to receive the income and capital of the Trust upon the terms and conditions set out in the Deed and shall be entitled to the capital of the Trust upon its termination.

It is important to remember that the fact that the trust deed contains the above provisions, does not make the trust a “special trust”, for purposes of income tax. The fact that the words, “generating sufficient income for his own maintenance or managing his own affairs”, are used, implies that a paragraph (a) special trust is envisaged. If one were to test it against the definition, it follows that:

- The trust is created solely for T L.
- TL, or the beneficiary of the trust, is a person with a disability (as defined in section 6B).

The definition of “disability” in section 6B(1) reads as follows:

> *For the purposes of* section 6B *‘**disability**’ means a moderate to severe limitation of any person’s ability to function or perform daily activities as a result of a physical, sensory, communication, intellectual or mental impairment, if the limitation –*
>
> *(a) has lasted or has a prognosis of lasting more than a year; and*
>
> *(b) is diagnosed by a duly registered medical practitioner in accordance with criteria prescribed by the Commissioner.*

The SARS guide, Guide on the Determination of Medical Tax Credits (Issue 16) states the following,

The term "physical impairment" is not defined in the Act. However, in the context of section 6B(1), it is regarded as a disability that is less restraining than a "disability" as defined.
Physical impairments will, for example, include –

- bad eyesight;
- hearing problems;
- paralysis of a portion of the body; and
- brain dysfunctions such as dyslexia, hyperactivity or lack of concentration.

Judge Davis, said the following:

"As a result of birth complications, the minor is blind, deaf and severely brain-damaged. This means that the poor child suffers from three of the above examples, or meet the section 6B requirements, and the only conclusion is that the child, as beneficiary of the trust, is a person with a disability as defined. The fact that the judge said that it is a special trust, and that from the trust deed, it is apparent that it is one, is not sufficient for purposes of income tax."

3.1.1.1 Registration of the special trust with SARS

The trustees of the trust, in order to register the trust as a taxpayer, will have to complete (and submit to SARS) the following:

- Application for registration as a Taxpayer or Changing of Registered Particulars: Trust (IT77TR). (Available on the SARS website - see later in the guide)
- The form[24] makes provision for the registration of a trust as a "special trust". A trust must be registered as from the year of assessment during which it started to exist. The following documentation, amongst others, must be provided as stipulated on the SARS website:
    - The certificate of registration from the Master's Office; or
    - The trust deed registered with the Master's Office.
- The following additional documentation must be submitted on request for a type-A trust:
    - A medical report from a medical practitioner or medical institution confirming the nature of the disability of the beneficiary of the special trust.
    - A medical report from a medical practitioner or medical institution confirming that the disability incapacitates the beneficiary from earning sufficient income for that person's maintenance or from managing that person's own financial affairs.

The trustees must indicate the type of trust on the return of income of the trust (ITR12T).

It is important to remember that, in terms of paragraph 82, of the Eighth Schedule to the Act, *"where a beneficiary of a special trust dies, that trust must continue to be treated as a special trust for the purposes of this Schedule until the earlier of the disposal of all assets held by that trust or two years after the date of death of that beneficiary"*.

3.1.1.2 The differences between a special trust and other trusts

Other than the fact that these trusts qualify for a different rate of tax, and for purposes of a capital gain a special trust is treated effectively as a natural person, the taxation of a special trust (both kinds) is no different to the taxation of any other trust.

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24 Guide to the Taxation of Special Trusts (Issue 3)

The word "taxed" or the phrase "will be taxed", is used to identify that the amounts that accrued will be income for the person, and will be reduced by allowable deductions, resulting in taxable income (or the amount that will be included in the taxable income).

3.1.2 Other trusts
3.1.2.1 Minor beneficiary trusts

It is necessary to make mention of a minor beneficiary trust, by giving the following explanation as given in an Explanatory Memorandum:

> **MINOR BENEFICIARY FUNDS**
> **Current law**
> Death benefits payable by a retirement fund with minor beneficiaries have often been paid to beneficiary trusts (vesting trusts). These benefits were taxed in the hands of the deceased upon transfer to the trust and any subsequent growth was taxed in the hands of the minor beneficiaries.
> **Reasons for change**
> With effect from 1 January 2009, vesting trusts for minor beneficiaries will be formalised as "beneficiary funds". These "beneficiary funds" will be regarded as pension funds for purposes of the Pension Funds Act and regulated as such. The Income Tax Act will automatically recognise these funds as tax exempt because of their new regulatory status.

A minor beneficiary trust is therefore not a trust in a tax sense and will not be dealt with in this guide.

3.1.2.2 REIT and other trading trusts
3.1.2.2.1 Some historical information

In South Africa, before 1 April 2013, two main types of property investment vehicles existed that operate in the same space as an international REIT – the Property Unit Trust (PUT) and Property Loan Stock (PLS). The PUT is regulated on an on-going basis by the Financial Services Board, having been the traditional stakeholder in the property investment scheme space. The PLS, the newer entrant, is regulated by the Companies Act, No. 71 of 2008 (the Companies Act). Both sets of property investment schemes are listed on the JSE so as to provide the required liquidity for investors. PUTs and PLSs are therefore also regulated by JSE rules.

The PUT falls within a unique tax regime that allows for the PUT to be effectively treated as a tax conduit. PUT distributions are treated as ordinary revenue in the hands of investors. Unlike companies, the net effect is to tax the rental income at only one level.

Property Loan Stock
As a practical matter, the PLS is a company that is not regulated by the FSB. The PLS is simply regulated by the Companies Act and the listing requirements of the JSE. Unlike the PUT, the PLS is internally managed. The unique feature of the PLS is the dual-linked nature of the units held by investors. In this dual-linked structure, the investor holds a share and a debenture with 99 per cent of the value attributable to the debenture.

The terms of the debenture are controlled by the debenture trust deed. The debenture trust deed typically requires regular interest payments from the company (quarterly, semi-annually or annually). These interest payments are available only to the extent of PLS company profits. It should also be noted that the debenture is not redeemable.

As a PLS is a registered company, the PLS is liable to pay (the normal) tax at the standard company income tax rate and the inclusion rate of its capital gains is the same as for other companies.

3.1.2.2.2 The introduction of the REIT

With effect from 1 April 2013 South Africa adopted a unified approach for property investment schemes. As was explained[25],

> *"The new entity will be called a Real Estate Investment Trusts (REIT) in line with the international norms (encompassing both the PUT and PLS regimes). The objective of the REIT is to provide investors with a steady rental stream while also providing capital growth stemming from the underlying property. If a REIT falls within the new regime, the flow-through principle will apply. Income and capital gains will normally be taxed solely in the hands of the investor and not in the hands of the REIT."*

Shareholder-level impact of REIT distributions:

- Resident shareholders
  Dividends distributed by a REIT to its resident shareholders are subject to normal tax (and exempt from dividends tax) regardless of whether the REIT makes qualifying distributions during the year of assessment. Ordinary treatment applies to any resident shareholder regardless of whether the shareholder is a company, trust or natural person. Interest forming part of a dual-linked unit is treated in similar fashion.

- Foreign shareholders
  Effective 1 January 2014, dividends distributed to foreign shareholders of a REIT will be subject to dividends tax (i.e. are not treated as ordinary revenue). This treatment also applies to deemed dividends from dual-linked units (i.e. interest on debentures forming part of a linked unit).

- Controlled property companies and associated property companies
  The tax dispensation under the REIT regime will also apply to controlled property companies.
  A controlled property company is a company that is a subsidiary of a REIT. For this purpose, subsidiary status is an IFRS definition, not a tax definition. Hence, a subsidiary can include a controlled trust. Lastly, control is an IFRS concept – not a tax concept (IFRS generally requires practical control with the default favouring a more than 50 per cent voting interest).

  Hence, a controlled property, like a REIT, can make deductible distributions of the 75 per cent rental test which is satisfied. Moreover, if a REIT receives a qualifying distribution from a controlled property company, the distribution can be treated as rental income (note: a controlled property company can also treat a qualifying distribution from another controlled property company as rental income).

  A second category of a property company is an associated property company. An associated property company is a company that is at least 20-per cent owned by a REIT or a controlled property company. Although this entity is not entitled to deduct distributions, any distributions received by a REIT (or a controlled property company) from an associated property company can

[25] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012 (10 December 2012)

qualify as a rental income if the distribution is a qualifying distribution (i.e. from an associated property company satisfying the 75-per cent rental test).

3.1.2.2.3 Normal tax considerations

3.1.2.2.3.1 CGT relief for property interests

Capital gains or losses determined in respect of the disposal by a REIT or a controlled property company of:

- immovable property;
- a share in a REIT; and
- a share in a controlled property company (but not other shares, even shares of an associated property entity),

will not be taken into account when determining the aggregate capital gain or loss of that company.

This exemption has the same impact as the capital gains rules for collective investment schemes. Capital gains is largely exempt at the entity-level with only the units being taxed with capital gains tax when disposing of units.

3.1.2.2.3.2 Other financial instrument holdings

Any amount received or accrued during a year of assessment by a REIT in respect of a financial instrument (other than a share in a REIT, a controlled property company or an associated property company) is deemed to be not of a capital nature and must be included in the income of the REIT. In effect, this ordinary treatment applies to both the disposal and the yield. The purpose of this ordinary treatment is to deter REITs from holding other forms of investments (e.g. portfolio shares), thereby coming into conflict with the mandate of a collective investment scheme in securities.

Unregulated REIT's (really entities that are not REIT's or PUT's) are typically structured as trading trusts.

3.1.3 Trading trusts

3.1.3.1 General

It was stated[26] that it is very difficult to define a business trust precisely, but that generally, a business trust is a trust where the trustees do not merely protect and manage trust assets but use the trust assets for carrying on a business for profit in order to benefit the trust beneficiary or beneficiaries, or to further the aims of the trust. The private business trust is therefore a trust with a specific aim namely to run a business with the object of making a profit in order to benefit the trust beneficiary or beneficiaries.

In practice, the beneficiaries will have vested rights to the income and capital gains of the trust, and will make contributions of capital, or fund the trust and its activities.

From a tax point of view, the taxation of the trust, and its beneficiaries, are the same as any trust where the beneficiaries have vested rights or obtain a vested right following the exercise of a discretion by the trustees.

[26] General Principles of Commercial Law; Author: Peter Havenga

Trusts can also be used to render services to clients of the trust. In order to discourage the use of entities as intermediaries to provide personal services to a client which are, in essence, services provided in terms of a contract of employment, anti-avoidance rules were introduced into the Act. These anti-avoidance rules were aimed at employees seeking to disguise their relationship by utilising a trust, primarily to avoid the withholding of employees' tax, and included the inclusion of a definition of a 'personal service trust', initially, and later 'personal service provider' in the Fourth Schedule to the Act. As part of the anti-avoidance rules brought in, section 23 was also amended to prohibit certain deductions. A trust, as a personal service provider, is really just a trading trust.

3.1.3.2 The trust as personal service provider

The phrase "personal service provider" is relevant to the withholding of employees' tax, where the trust, typically through its beneficiaries, renders services to a client of the trust.

It is defined as follows, in paragraph 1 of the Fourth Schedule to the Act (and with respect to a trust – reference to a company removed from the definition for purposes of this guide):

> *"'**personal service provider**' means any ... trust, where any service rendered on behalf of such ... trust to a client of such ... trust is rendered personally by any person who is a connected person in relation to such ... trust, and-*
>
> *(a) such person would be regarded as an employee of such client if such service was rendered by such person directly to such client, other than on behalf of such ... trust; or*
>
> *(b) where those duties must be performed mainly at the premises of the client, such person or such ... trust is subject to the control or supervision of such client as to the manner in which the duties are performed or are to be performed in rendering such service; or*
>
> *(c) where more than 80 per cent of the income of such ... trust during the year of assessment, from services rendered, consists of or is likely to consist of amounts received directly or indirectly from any one client of such ... trust, or any associated institution as defined in the Seventh Schedule to this Act, in relation to such client,*
>
> *except where such ... trust throughout the year of assessment employs three or more full-time employees who are on a full-time basis engaged in the business of such ... trust of rendering any such service, other than any employee who is a ... <u>settlor or beneficiary</u> of the trust or is a connected person in relation to such person*;"

It is important to note, with respect to a trust, that it includes the settlor of the trust as well.

The rate of tax, if income is retained in the trust, would by 45%.

The above section was introduced as an anti-avoidance provision.

To the extent that the trust, a personal service provider, acts as a mere conduit, the beneficiary will be taxed on the income, which as remuneration, will be subject to the limitations contained in section 23(m) of the Act.

However, there is another problem faced by a trust, that may be a personal service provider. It is another anti-avoidance provision and is found in the proviso (ii) to paragraph (c) of the definition of gross income. It reads as follows:

"... Provided that ... any amount received by or accrued to or for the benefit of any person in respect of services rendered or to be rendered by any other person shall for the purposes of this definition be deemed to have been received by or to have accrued to the said other person;"

In Commissioner, SA Revenue Service v Professional Contract Administration CC 2002 (1) JTLR 23 (TPD), a company contracted to render the services to a client of the company. But it may just as well have been a trust who contracted to render the services with the settlor, or a beneficiary of the trust, rendering the services.

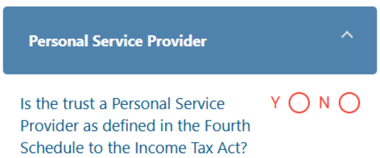
According to Judge Kirk-Cohen, the submission (by SARS) necessarily entails that the written contract between the company and its client was in substance a contract between the individual rendering the services and client and it was thus necessary to pierce the veil of corporate personality. SARS' submission was really, that *"whenever the member of a close corporation or of a company rendered a service, he rendered that service in his personal capacity and not as a member of a body corporate."*

According to the judge, this *"ignores the practicalities of modern life and the fact that a large number of people do not contract in their own name but on behalf of bodies corporate of which they are members. That is why in reply counsel added the rider that the corporate veil should be pierced in each case."*

Judge Kirk-Cohen decided that proviso (ii) does not apply in this instance, and that the income therefore accrued to the company, and not to the individual who rendered the services on behalf of the company. The judge said that:

"Paragraph (c)(ii) only applies where the substance of a contract (as opposed to its form) demonstrates that the contract concluded between a body corporate and a third party is one where the member of the body corporate, and not the body corporate itself, in fact rendered the services."

Please note that all text in blue is text taken from a SARS return or form. In completing a return of income, for a trust that is a personal service provider, the following must be observed:


Personal Service Provider

Is the trust a Personal Service Provider as defined in the Fourth Schedule to the Income Tax Act? Y ◯ N ◯

Under the heading "trust particulars", there is a heading "personal service provider", and the question under that reads as follows:

Is the trust a Personal Service Provider as defined in the Fourth Schedule to the Income Tax Act?
And requires the completer of the form to tick either "Y", or "N" (for "yes" or "no" respectively.

If "yes", the trust would then be in receipt of remuneration, so that question needs to be answered. And the person making payment to the trust, would have issued an IRP5, reflecting the remuneration and any employees' tax withheld by the client from the payment made to the trust.

In the ITR12T, the following would be captured:

Indicate the type of local amount(s) received / accrued to the trust:
Remuneration

The amount earned from the rendering of the services by the trust will then be entered there.

Note the following message that appears when the return is requested:

> Please note that you cannot alter nor delete data provided by your Employer / Service provider. If the information on this form is incorrect, please contact your employer or service provider to have the information corrected and re-submitted to SARS.

When making deductions, it must be remembered that a trust which is a personal service provider, will be prohibited from making a deduction of certain expenses, in arriving at its taxable income. This follows from section 23(k), which reads as follows:

> *"No deductions shall in any case be made in respect of ... any expense incurred by ... a personal service provider as defined in the said Schedule, other than any expense which constitutes an amount paid or payable to any employee of such labour broker or personal service provider for services rendered by such employee, which is or will be taken into account in the determination of the taxable income of such employee and, in the case of such personal service provider, any expense, deduction or contribution contemplated in paragraphs (c), (i), (l), (nA) or (nB) of section 11, expenses in respect of premises, finance charges, insurance, repairs and fuel and maintenance in respect of assets, if such premises or assets are used wholly and exclusively for purposes of trade*."

This forces the trust to pay the person rendering the service remuneration. And the recipient of this remuneration will in turn be prohibited from making certain deductions – see section 23(m) of the Act.

Should the person be a beneficiary, who has a vested right to the income accruing to the trust in respect of the services rendered by the trust or were to obtain such a right during the year of assessment, the beneficiary will also be subject to the same prohibition. And will only be able to make the deductions permitted by the Act.

3.1.4 Trusts created for a public benefit

A trust is very commonly established for purposes of the public at large. Judge Joubert[27], said that in "a private trust, i.e. a trust not for an impersonal purpose, the beneficial interests appertain to the trust beneficiaries, either as income beneficiaries or as capital beneficiaries." In a private trust the beneficiaries are normally identified by name. In a trust established for an impersonal purpose, the beneficiaries are normally not specified by name, but rather by class or some other criteria.

Such a trust would typically qualify for partial exemption from normal tax, full exemption from donations tax, and also from transfer duty. In order to enjoy that benefit, the trust will have to apply to SARS to be approved as a public benefit organisation and will enjoy partial exemption from income tax and will be taxed at the rate applicable to companies (currently at 27%) on income that does not qualify for exemption. If a trust carries on public benefit activities, and is not approved as a public benefit organisation, it will not enjoy any exemption for normal tax and will be taxed at 45% on any income retained in the trust.

[27] In Braun v Blann and Botha NNO & another 1984 (2) SA

From an income tax point of view, it would otherwise be treated the same as any other trust, and section 25B, or paragraph 80 of the Eighth Schedule would apply to the extent that income is vested in its beneficiaries.

Depending on the public benefit activities it carries on, it could apply to SARS to issue receipts for qualifying donations, which receipt will allow the donor to make a deduction against his or her (or its) taxable income.

In this guide it is not intended to deal with trusts, approved by SARS as public benefit organisations.

There essentially are three parties to a trust.

3.2 The parties to a trust

3.2.1 The founder or creator of the trust

The creator of a trust, in South Africa specifically, is mostly referred to as the founder of the trust, or as the donor to the trust. The word “settlor” is commonly found in international arrangements, and SARS, in its documents, uses the word “settlor” in connection with a *bewind* trust. The word “grantor” is also commonly used internationally. So, for instance, in the Lesotho Income Tax Act, the word “grantor” is used and is defined with specific reference to a “grantor trust”, as defined in that Act.

In this guide, the word “founder” will be used, not only because it is commonly used in South Africa in the context of trusts, but also because it is most often found in trust deeds (or can be determined therefrom).

Other than the taxes payable by the founder (or creator) of the trust, on the transfer of property to a trust, the founder will thereafter not have to pay any income tax, if the trust derives income from the property in the trust or made a capital gain on disposal of the property in the trust. However, where section 7 of the Act applies, or where there is attribution of a capital gain in terms of the Eighth Schedule to the Act, in both instances, it would apply where the income or capital gain were attributed to a donation, settlement or other disposition made by the founder of the trust, then the founder would have to pay income tax on that income or gain.

Of course, if the founder of the trust is also a beneficiary of the trust, he or she will be “taxed” as any other beneficiary. But the tax then is imposed on the individual *qua* beneficiary, and importantly not because the individual is the creator of the trust or may have been appointed as a trustee of the trust.

From an income tax point of view, other than the attribution of income or capital gains, the founder is really irrelevant. But where the founder is also a connected person, which will be discussed in detail later on in this guide, it will be very relevant in transactions between the founder and the trust, or when the taxation of beneficiaries, or the trust, itself, is concerned.

3.2.2 The beneficiaries of trusts

3.2.2.1 Beneficiaries of trust (as defined in the Income Tax Act and the Trust Property Control Act)

It is interesting that the Trust Property Control Act does not define the word "beneficiary" (but does define "beneficial owner"). The Income Tax Act, however, specifically defines a beneficiary in section 1(1), as follows:

> "*unless the context otherwise indicates, "**beneficiary**" in relation to a trust means a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust*."

As was said earlier in this guide, the purpose for introducing this "wider definition of "beneficiary", was *"to clarify that the word includes contingent beneficiaries"*. The definition emphasises, in a sense, the fact that it is the right of a person to benefit from a trust, that is relevant for purposes of income tax and that the right can be a vested or a contingent one.

And this distinction may well have led to a trust colloquially being referred to as a vested or a discretionary trust.

3.2.2.2 The trust

It is misnomer to distinguish between the different kinds of trusts, in general, on the basis of it being a "vested trust" or a "discretionary trust". As can be seen from the definition of beneficiary (above), it would be more appropriate to refer to a trust with reference to the rights of the beneficiaries of the trust.

This would then mean, that a "vested trust" would refer to a trust where all the beneficiaries of the trust only have a vested right to income or capital of the trust. A "discretionary trust", in turn, would refer to a trust where all the beneficiaries of the trust only have a contingent right to income or capital of the trust. In South Africa however, it is common for a trust to have beneficiaries who have both contingent or vested rights, or some mix thereof. Such a trust should then be referred to as a hybrid trust.
As Honoré, in paragraph 347 of his book, said:

> *"Although the types of benefit which may be given under a trust are multifarious, the main division is into capital and income beneficiaries."*

In this guide, the terms discretionary trust, hybrid trust or vested trust, will not be used. The distinction would rather be made with reference to the rights of the beneficiaries, as being either contingent or vested. And whether the rights are to income, or trust property (capital). So, for example, the phrase "discretionary beneficiary" will be used for a beneficiary of the trust who only has a contingent right to the income, capital gains, or trust capital. A "vested beneficiary", in turn, will be used for a beneficiary of a trust who has a vested right to income, capital gains, or trust capital. In both instances it would be indicated if the rights of the beneficiary are to income, or capital, or both.

3.2.2.3 The trustees

The trustees of any trust are much the same as directors of companies. As with directors of companies, who also can be a holder of shares in the company, the trustee can also be a beneficiary. In fact, in most of the so-called family trusts in South Africa, the trustees will also be beneficiaries of the trust.

The big risk here is to confuse instances where a trustee acts in his or capacity of a trustee, and then in his capacity as a connected person to the trust.

It is not intended to cover this matter in this guide. Suffice to say that there will only be normal tax consequences for a trustee, qua trustee, if he or she earns a trustee fee, or other remuneration, from the trust. From a tax point of view, if he or she benefits from the trust qua beneficiary, it would be irrelevant that the individual is also a trustee.

It is not intended to deal with the duty of trustees in this guide, but it is appropriate to make the following comments:

- Their duty is due to all the beneficiaries and equally so[28].
- Where more than one trustee has been specified in the trust deed, they share a common fiduciary obligation towards the fulfilment of the objects of the trust and must act jointly.[29]
- A person in a fiduciary position such as a trustee, on the other hand, was obliged to adopt the standard of the prudent and careful person, that is to say the standard of the bonus et diligens paterfamilias of Roman law, and was accordingly, as Kotze JA concluded at 535, *"obliged, in dealing with and investing the money of the beneficiary, to observe due care and diligence, and not to expose it in any way to any business risks".*
- The role of a trustee in administering a trust calls for the exercise of a fiduciary duty owed to all the beneficiaries of a trust, irrespective of whether they have vested rights or are contingent beneficiaries whose rights to the trust income or capital will only vest on the happening of some uncertain future event[30].
- … a trustee owes a duty of good faith akin to that owed by an agent. He or she must keep regular accounts of all his or her transactions on behalf of the beneficiary, not only of disbursements, but also the receipts, and to render such accounts to the beneficiary at all reasonable times 'without any suppression, concealment, or overcharge; keep accounts up to date and allow for the inspection of his or her books.'[31]

A trustee, or really the trustees, are representative taxpayers.

> *"In the Income Tax Act, unless the context otherwise indicates ... "representative taxpayer" means a natural person who resides in the Republic and ... in respect of income which is the subject of any trust or in respect of the income of any minor or any other person under legal disability, the trustee, guardian, curator or other person entitled to the receipt, management, disposal or control of such income or remitting or paying to or receiving moneys on behalf of such person under disability*[32]."

In practice, SARS accepts the appointment of one of the trustees as the representative taxpayer.

A representative taxpayer, in the Tax Administration Act[33], "*means a person who is responsible for paying the tax liability of another person as an agent, other than as a withholding agent, and includes a person who is a representative taxpayer in terms of the Income Tax Act*."

The liability of a representative taxpayer is set out in section 154 of the Tax Administration Act. The following extract from the SARS states the following:

10.2.2. Duties, entitlements and liabilities of representative taxpayers

[28] Judge Opperman, in Noome and Others v Botha N.O. and Others (4405/2021) [2022] ZAFSHC 108 (23 May 2022)
[29] Judge Petse, in Gowar v Gowar (149/2015) [2016] ZASCA 101 (9 June 2016)
[30] Judge Molomela, in Griessel NO and others v De Kock and another 2019 (5) SA 396 (SCA)
[31] Judge Makgoka, in Snyman v De Kooker N O and Others (400/2023) [2024] ZASCA 119 (2 August 2024)
[32] Paragraph (c) of the definition of "representative taxpayer" in section 1(1).
[33] Section 153(1)(a) of the Tax Administration Act

A representative taxpayer is in such capacity—

- subject to the duties, responsibilities and liabilities of the taxpayer represented;
- entitled to any abatement, deduction, exemption, right to set off a loss and other items that could be claimed by the person represented; and
- liable for the amount of tax specified by a tax Act.

The above duties, responsibilities, entitlements and liabilities of a representative taxpayer are, however, limited to the following:

- The income to which the representative taxpayer is entitled;
- Moneys to which the representative taxpayer is entitled or has management of or control over;
- Transactions concluded by the representative taxpayer; and
- Anything else done by the representative taxpayer in his or her capacity as a representative taxpayer.

A representative taxpayer may be assessed in respect of any tax but such assessment is regarded as made upon the representative taxpayer in such capacity only.

4. The taxation of trusts and the parties to a trust (normal tax)

4.1 General

In principle, or in terms of the Act, any one of three "persons" may be taxed on amounts that accrued to the trustees of a trust, or on capital gains made in a trust from the disposal of assets held by the trustees in the trust. And with "taxed", it means that an amount of income is deemed to have accrued to that person, or a capital gain is attributed to that person. And, after having reduced that gross income amount with exemptions, and having deducted allowable expenses, the net result is then included in the taxable income of the person, which is the amount, or what would then be the amount, that the income tax is imposed on.

When the trust is the person to be taxed, the same rules to determine taxable income, apply to the trust. Put differently, a trust is a taxpayer as any other, and in that respect:

- will have to disclose receipts and accruals (as gross income) of the trust;
- will be entitled to the exemptions provided and can make the deductions allowed in arriving at its taxable income.
- It will have to account for capital gains in respect of assets disposed of it, by including the taxable capital gain in its taxable income.

There are some differences though, the most important one is that a trust is taxed at the highest rate of tax, currently at 45% on its taxable income. This is, unless the trust is approved by SARS as a public benefit organisation, when the rate of tax is 27%, or a special trust, when the rates applicable to natural persons apply to the special trust. A special trust is also treated as if it is a natural person for purposes of determining a capital gain.

A trust does not qualify for any rebate, other than the rebate in respect of foreign taxes.

The other difference, where the trust is the person to be taxed, relates to capital gains. The trust (other than the special trust) must include a higher percentage of the capital gain (the same inclusion rate that applies to companies, applies to trusts) in its taxable income.

However, because of the conduit principle, or flow-through nature of a trust, many trusts will never be taxed. It is the beneficiaries who should be taxed, unless of course there is a donor who must be taxed, or the beneficiary is not a resident of the RSA.

The starting point, in determining the tax payable, is to determine which one of the three parties to the trust will ultimately have to bear the tax.

4.2 The framework for the taxation of trusts and the beneficiaries of trusts

Schematic overview:

	Receipt or accrual By the trustees of the trust		
Is the accrual or the capital gain deemed to be that of the donor? (donation, settlement or other disposition)			
	Not deemed to be that of the donor		
	Capital in nature		Yes
Yes			Capital gain or asset
	Vested rights	Discretionary rights	Vested
Deemed to be that of the "donor" and the donor is taxed			Resident
		Trustees decided to vest the amount	
	Beneficiary is taxed	Beneficiary is taxed	Beneficiary is taxed
			Not a resident
			Trust is taxed
In all instances where the donor or the beneficiary is not taxed, the trust is taxed.			

4.3 Steps to be followed to determine who must be taxed

It is suggested that the following steps be followed to determine which one of the three persons, mentioned above, will be taxed. In isolated instances, all three persons may well end up with a tax liability with respect to a single receipt or capital gain.

The suggested steps follow a logical process, and is premised on the principle that the trust, as a conduit, should be the last person to be taxed. And the steps will cover all trusts, and its beneficiaries, which would of course mean that not all of these steps may then apply in respect of which a tax calculation is required to be done.

Section 25B, of the Act, deals with the “taxation of trusts and beneficiaries of trusts”. The starting point, for purposes of determining taxable income (of any person) in general, is whether there was a receipt or an accrual of an amount. Whilst section 7 uses the word “*income*”, section 25B is specific in that it uses the phrase “*received by or accrued to or in favour of*”, which of course is the exact phrase used in the definition of gross income in section 1(1) of the Act. Section 25B however, qualifies the phrase – which will be discussed later on – by adding “*derived for the immediate or future benefit on any ... beneficiary*”.

The Eighth Schedule of the Act, deals with how a capital gain must be determined, and one of the four basic building blocks in determining a capital gain (or loss), is “*proceeds*”. In paragraph 35(1), where the word “*proceeds*” is defined, it refers to “*the amount received by or accrued to, or which is treated as having been <u>received by, or accrued to or in favour of</u>, that person in respect of that disposal*”.

The suggested steps will now be listed, and each of the steps will then be discussed in some detail thereafter.

<u>Step 1:</u>
Q1: did the trustees, during a year of assessment, receive an amount?
The purpose of the first step is to determine if there was:
- a receipt, the amount of which would have to be included in gross income, or
- proceeds in respect of the disposal of trust property (an asset “owned” by the trust)

by the trustees of the trust (for the immediate or future benefit of the beneficiaries of the trust).
Note: The receipt envisaged above, is not a lumpsum from a retirement fund (or insurer) in consequence of the termination of the trust. And with respect to the disposal of an asset, it is an actual disposal otherwise than by the vesting in a beneficiary and subsequent, distribution of trust assets to the beneficiaries of a trust.

<u>Step 2:</u>
Q2: Did trustees distribute cash (or money) to a beneficiary of the trust?
This question is only relevant if the answer to step 1 would be “no”, but the beneficiary benefitted from the trust. This would be where a beneficiary (or the beneficiaries) benefitted from the trust, not because there was a receipt of gross income, or proceeds in respect of the disposal of an asset, by the trustees in respect of which the beneficiaries had a vested right or obtained one.

Note: Where vesting entails a change in ownership of an asset, from the trustees to the beneficiary, it is a disposal, and paragraph 80(1) will apply, unless there was a donation. It will be a disposal of an asset.

<u>Step 3</u>:
Q3: was there a receipt of income, or a capital gain, which was derived by reason of, or in consequence of, or attributable to a donation, settlement or other disposition.
The purpose of this step is to determine if there is a donor that will have to be taxed.
In order to determine if the donor must be taxed, the starting point is to establish
- if the amount of “income” were derived by reason of, or in consequence of, a donation, settlement or other disposition; or

- whether a capital gain, arising from the disposal of an asset of the trust is attributable to a donation, settlement or other disposition.

The reason why one would do this step before the next steps, is because neither section 25B of the Act, nor paragraph 80 of the Eighth Schedule to the Act, will apply if the full receipt, or capital gain (in respect of the disposal of an asset), is to be attributed to a donor. This of course follows from section 25B being "*subject to the provisions of section 7*", and paragraph 80(1) of the Eighth Schedule, being *"subject to paragraph 68, 69 and 71*, whilst paragraph 80(2) and 80(2A), are *subject to paragraphs 64E, 68, 69 and 71"*.

If it is so, then the person who made the donation or other disposition, will bear the tax on the income (as section 7 will apply), or the capital gain (as the attribution rules in Part X of the Eighth Schedule to the Act will apply).

The word "income" is used to refer to any "*amount (other than an amount of a capital nature which is not included in gross income or an amount contemplated in paragraph 3B of the Second Schedule) received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust*".

Step 4:

Q4: did a beneficiary of the trust, who is a resident of the RSA, during the year of assessment, have a vested right to income or a capital gain of the trust, or obtain such a vested right?

This step follows from step 1, where the answers in steps 2 and 3 are "no".

The purpose of this step is to determine if the beneficiary, at the time of the receipt, or disposal of the asset, by the trustees, was entitled to the receipt (or accrual), or the capital gain. One must determine this, in the first place, from the trust deed, and then from the minutes of the meetings of the trustees during the year of assessment.

If the beneficiaries had a vested right (to income or a capital gain) or obtained a vested right in the current year (also in terms of the trust deed, but then because the trustees acted in terms of their discretionary mandate) to income or a capital gain.

Because of the changes made to section 25B (effective 1 March 2024), one must now determine whether the beneficiary, that had or obtained a vested right during the year, is a resident (ordinarily resident, or tax resident) in a country other than the RSA.

Step 5:

Q5: Is the beneficiary of the trust a person who has, or who obtained, a vested right to "income" or a "capital gain" during the year of assessment, a resident of the RSA?

If the beneficiary is a resident of the RSA (for tax purposes), the conduit pipe principle applies (colloquially speaking). The income, after making the allowable deduction, will then be taxed in the hands of the beneficiary. The trust will be a mere conduit, and to the extent that the income "flowed through" to the beneficiaries, there will not be any income tax consequences in the trust. The same applies to a capital gain.

Step 6:

Q6: was an asset vested in a beneficiary of the trust who is a resident of the RSA?

A change in ownership of the asset, which does not arise because the asset was distributed to the beneficiary.

Paragraph 80(1), of the Eighth Schedule would then apply. The relevant part reads as follows:

> "... *where a trust vests an asset in a beneficiary of that trust (other than any person contemplated in paragraph 62(a) to (e) or a person who acquires that asset as an equity instrument as contemplated in section 8C(1)) who is a resident* ...
> *the distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset, the date on which the interest vests*;"

(Paragraph 13(1)(a)(iiA) of the Eighth Schedule)

Step 7:
Any income, or capital gain not attributed to a beneficiary, or a donor, will then be taxed in the trust.

Before one can follow the above approach, it is necessary to understand the tax event, or the incidence of tax, as far as trusts and its beneficiaries are concerned. As will be explained below, vesting is the actual tax event, and it is important to start with an explanation of what vesting is.

4.4 The tax event (vesting)

4.4.1 Vesting explained

Both section 25B of, and paragraph 80 of the Eighth Schedule to, the Act, use the following phrases; "*has a vested right to*" or "*acquired a vested right to*". This concept of "a vested right" is fundamental to the taxing of the income, or capital gains, in a trust. In order to acquire a vested right, there must be a vesting event. One can therefore say that vesting is the tax event, or is what brings the trust, or the parties to the trust, within the tax net so to speak.

Of course, as was stated earlier in this guide, there must be an accrual (or receipt) of income, or a capital gain, the amount of either of which, could essentially then result in taxable income. However, in terms of determining who must bear the tax, it is the acquisition of the right to the amount, which must be a vested one, that will determine who must pay the tax. And this is colloquially referred to as vesting. This of course, unless there is a deeming provision that overrides this.

According to the Collins Dictionary, vesting[34] in British English, (noun, law), means *"the act of conferring a right upon (someone) which is immediately secured"*.

The term, "a vested right" is not defined in the Act. The *South African Concise Oxford Dictionary (2002)*, based on the *Concise Oxford Dictionary* (Tenth Edition), with respect to "vested interest", as a noun, in law, gives the following meaning to the term, "*an interest (usually in land or money held in trust) recognized as belonging to a particular person*". And for the word "interest", as a noun, "*a legal concern, title, or right in property*". With respect to the verb, "vest" (usu. be vested with), "*give (someone) the legal right to power, property, etc*."

The word "vest", or "vested", or the term "vested right", appears in a number of South African court case reports, normally in relation to deceased estates, but also in tax related ones. However, it was in *Wilkinson and Another v Crawford N.O. and Others* [2021] ZACC, that the concept of vesting had to be

[34] https://www.collinsdictionary.com/dictionary/english/vesting

considered in relating to a trust, namely the L J Druiff Trust; and where the Constitutional Court had *"to establish when vesting occurred"*. In this instance, the *"Trust Deed gave the trustees the discretion to apply the trust fund for the benefit of the beneficiaries. Upon Mr Druiff's death, this discretionary power would end and the net revenue and income was (sic) to be divided equally between his four children and paid to them."*

Judge Mhlantla (for the majority), said the following:

> *"Vesting comprises of "two sub-moments, namely dies cedit, the time when a beneficiary obtains a vested right to claim delivery of the bequeathed benefit unconditionally, and dies venit, the time at which the beneficiary's right to claim delivery of the benefit becomes enforceable." Put differently, "an inheritance or other interest in a deceased estate vests in the beneficiary when the right thereto has become unconditionally fixed and established in the beneficiary".*[35]
>
> *South African law is clear that vesting accords with dies cedit, in terms of Roman-Dutch law."*

This principle is apposite to trusts as well.

Judge Mhlantla, and specifically with respect to the unconditional right referred to in the last sentence of the part quoted above, referred to a "tax case", namely *De Leef Family Trust v Commissioner for Inland Revenue* [1993] ZASCA SA 46*;* 1993 (3) SA 345 (A). Judge Joubert, in the De Leef case, said that *"in the case of a conditional right or interest no vested right is acquired prior to fulfilment of the condition"*. In Braun and Another v Botha and Another (263/82) [1984] ZASCA 19; [1984] 2 All SA 197 (D) ; 1984 (2) SA 850 (A) (22 March 1984), Judge Joubert specifically dealt with vesting with reference to a testamentary trust, and also referred to *dies cedit*, and *dies venit*, with respect to the right of the beneficiaries.

For purposes of this guide, it can be concluded that a vested right is one where the beneficiary is unconditionally entitled to something, mainly an amount, but also to get an asset. (or trust property). In a trust where a beneficiary will only become entitled to benefit from the trust, when the trustees acting within their discretionary mandate obtained from the trust deed, decided to vest the benefit in a beneficiary, the beneficiary would not have a vested right. The right of the beneficiary, in that instance, is conditional on the trustees excising their right to determine the vesting date (or entitlement). The conditional right then changes into a vested one, when the trustees exercise this discretion, and the beneficiary then acquires the vested right.

Trustees, and tax practitioners, often neglect to refer to the trust deed in order to confirm who the beneficiaries are and when the beneficiary would be entitled to benefit from the trust. It is of crucial importance, not only for trustees of the trust, but also the person submitting tax returns of the trust, in the first instance, to familiarise them with the vesting clauses in the trust deed.

4.4.2 Examples of a vested or discretionary right

4.4.2.1 Example of a vested right

[35] In this matter, *dies cedit* occurred in 1953 on the death of Mr Druiff and ... *dies venit* occurred in December 2017 when Ms Harper passed away.

Trust deeds often are relatively ambiguous with respect to the rights of the beneficiary. It is common that the word “vest” does not appear in these clauses, but rather that words such as “used”, or “paid” appear in the trust deed.

Here is an example of a clause, taken from a deed of trust that was used to set up a trust (by court order) to receive compensation awarded in a road accident fund claim.

> 6.1 The beneficiary of the Trust will be **A** v** V**.**
> 6.2 **A** v** V**** will be the beneficiary of the Trust with regard both to the capital and to the income derived therefrom (and who will be referred to hereinafter as "the beneficiary").
> 6.3 As outlined below, the capital and income of the Trust shall be used for the benefit of the beneficairy (*sic*), in such manner as the Trustee should deem appropriate, having regard to the interests of the beneficiary.
> 6.4 Should the beneficiary pass away, the Trust's assets will be transferred to his heirs as set out in his Will and Testament. Should the beneficiary not leave any Will and Testament, the Trust shall be transferred to the intestate heir or heirs of the beneficiary in accordance with the law of intestate succession as it then would apply.

From the wording of the above clause, one can do no more than to conclude that it actually created a vested right, for the beneficiary, to the capital and income of the trust. In some trust deeds the word “vest”, or “vesting”, or “vesting date” is defined.

Here is an example of a definition of “vesting date” in a trust deed:

> “THE VESTING DATE" is the date the trustee appoints at any time as the vesting date and indicates <u>when beneficiaries will obtain vested rights with reference to net trust assets</u> and the division of said trust assets among them in terms of paragraph 12 and/or paragraph 15 with reference to said beneficiary or group of beneficiaries in respect of whom the vesting date as such has been appointed.

The word “distribute” is commonly used in the definition of a beneficiary of the trust, and sometimes it actually envisages the vesting event.

"Beneficiaries" means the persons to whom the Trust income and capital <u>will be distributed</u> viz. those persons selected by the Trustees in their discretion from among the members of the class consisting of those persons listed in the preamble of this Trust Deed, and shall include...

4.4.2.2 Examples of a discretionary right

When it comes to the income of the trust, 5.2 reads thus:

> *"The trustees shall have the power, in their entire discretion. from time to time, and at any time to pay to, or to apply the whole or any part* of *the income* of *the trust fund for the general advantage* of *anyone or more* of *the beneficiaries* as *the Trustees may decide, and in such proportions and from such source* as *the Trustee may determine, and any income* so *paid or supplied shall accrue to the beneficiary. "*

It is undisputed that the trust that was created falls in the category of discretionary trusts, since the trustees have been given the right, within their discretion, to select beneficiaries from a list of potential beneficiaries. It follows that none of the potential beneficiaries can claim rights in perpetuity, as their rights are merely contingent.

In conclusion:
One must determine, from the trust deed, if the right to income, to a capital gain, or to trust property (or trust capital), is unconditional. If so, the right is a vested right, but entitlement may be an unconditional right, or there were *dies cedit*, but *dies venit* (or distribution) is deferred.

If the beneficiary does not have an unconditional (vested) right to but will only obtain such a right if the trustees so decide, then determine what are the conditions, or what is required for the beneficiary to be entitled to income, or capital gains, or both, derived by the trust; or trust property (or capital).

What is trust capital?

4.4.3 Trust capital
4.4.3.1 General discussion

Trust deeds typically will define the phrases "trust property", or "trust capital" or "trust fund". In practice however, some trust deeds fall short on this and, in interpreting the trust deed, the tax practitioner (or trustee) must often rely on the deed as a whole to distinguish between what is in essence the trust fund, and what is trust property (represented by the trust fund). In many instances the phrases are often used interchangeably in trust deeds, and this is so even where the phrases (or some of them) are actually defined in the trust deed.

As was already mentioned, a "*trust*" for income tax purposes, is a "*trust fund consisting of cash or other assets*", whereas the Trust Property Control Act, refers to "*the ownership in property ... placed under the control of ... the trustee*". The latter Act does not use the phrase "trust fund".

The word "cash", when used as a noun, is *"money in coins or notes[36]"* and also *"money in any form as an available resource"*. The word "money", in turn, means *"a medium of exchange in the form of coins and banknotes"*.

Whilst the word "cash" is used, and appears often in the Act, the word "cash" is not used or defined in the Income Tax Act. From the definition of an "asset", in the Eighth Schedule to the Act, it is clear that the meaning of an asset, for purposes of the Eighth Schedule, excludes "*currency*".

Because the Trust Property Control Act, in section 10(1), under the heading "trust account", requires that *"whenever a person receives money in his capacity as trustee, he shall deposit such money in a separate trust account at a banking institution or building society"*, it can be accepted that the word cash, should be interpreted as money in a bank account as an available resource.

The word "asset", or the term "other assets", is not defined in section 1(1) of the Income Tax Act either. Where the word "asset" is used in the main Act, in most cases it refers to the meaning given to the word in the Eighth Schedule to the Act. The only definition, in section 1(1) of the Act, is that of depreciable asset and it reads as follows:

[36] South African Concise Oxford Dictionary (2002) – "cash" and "money"

"In the Act, unless the context otherwise indicates "depreciable asset" means an asset as defined in paragraph 1 of the Eighth Schedule (other than any trading stock and any debt), in respect of which a deduction or allowance determined wholly or partly with reference to the cost or value of that asset is allowable in terms of this Act for purposes other than the determination of any capital gain or capital loss."

And that is relevant for the making of a deduction of the cost of acquiring an asset, or part thereof, for purposes of determining the taxable income – for purposes of the guide, a deduction available to either the trust or a beneficiary of the trust. The definition of "asset", in the Eighth Schedule, reads as follows:

"unless the context indicates otherwise, any meaning ascribed to any word or expression in section 1 of this Act must bear the meaning so ascribed, and 'asset' includes –

(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) *a right or interest of whatever nature to or in such property*; ..."

In the Trust Property Control Act, *"trust property" or "property" "means movable or immovable property, and includes contingent interests in property, which in accordance with the provisions of a trust instrument are to be administered or disposed of by a trustee"*. The fact that this definition does not refer to "cash" or "incorporeal property", and only refers to "contingent interests", is irrelevant for purposes of this guide. For income tax purposes, one is only concerned with assets, as they are defined in the Eighth Schedule to the Act.

For purpose of income tax, the distinction between trust property and the trust capital, or trust fund, is not all that important. This is because the income tax consequences can only follow when there was a receipt or accrual buy the trustees (income), or a disposal of an asset (the property) of the trust. Colloquially speaking, the vesting and distribution of cash, to beneficiaries will not have any income tax consequences.

It is very important to take care not to confuse trust capital with a "*capital gain*", the latter being a tax concept only. The same applies to the (accounting) profit made on the disposal of trust property. And that leads us to the conclusion on the term "trust fund" or "trust capital". It really is an accounting term, or how it should be reflected on the financial statements of the trust. And there, the Income Tax Act, comes close when it uses the phrase "trust fund". It is the term used to describe what property the trust consists of. In accounting terms, it is the credit entry of the value of all property held by the trustees. It will not always be the same amount as the total value of the property in the trust. It can, in principle, be compared to owner's equity (or share capital and retained income) of a company. The main example of where it would not be the same, is where the trustees were authorised to acquire property and funded that by way of loans.

From an accounting perspective, trust capital, or trust fund, would be the preferred description in the "capital side" of the (statement of assets and liabilities), whereas the trust property itself would be reflected as property, plant and equipment, intangible assets (goodwill) and financial instruments.

In this guide, the term "trust fund" will be used when the credit side is intended, or what is normally referred to as equity in financial statements.

The following is an extract, from a trust deed, that used the term "trust fund". It is defined in the trust deed as follows:

> In this trust deed, unless the context otherwise requires ... the following expression used in this trust deed shall have the meaning hereinafter respectively assigned to them unless the context shall clearly otherwise require, namely:
>
> > TRUST FUND shall mean the capital, income and/or accumulated income from time to time to be administered by the trustees, consisting *inter alia* in the first- place of the donation made by the DONOR, and any income derived therefrom and any additions hereafter made to the trust fund.

Another, and very good example of what is essentially the trust fund, is quoted by Judge Bam[37] as follows:

> *"Further on at sub-clause 3.4 is the definition of the Arathusa Family Trust as comprising of the initial donation or R100.00 as well as "all sums of money property or assets subsequently acquired whether by donation, purchase, loan, exchange, inheritance, reinvestment or otherwise for the purpose of the trust"."*

These above definitions cover the essence of how property can come into a trust or be owned by the trustees for the benefit of the beneficiaries of the trust. Whilst it is not known if the trust deed actually used the phrase "trust fund" (or trust capital, or trust property), it is clear that the above definitions envisage what is in essence the "trust fund". And is also the "trust fund" that is referred to in the definition of a trust in section 1(1) of the Act. It is the total value of the trust property, or what the trust consists of (the term used in the Act), or comprises of (see the above extract from the trust deed), and in essence it is the same as the equity of a company.

In the following example the concept of the trust fund trust, trust property and the tax consequences of the distributing the trust fund to the beneficiaries will be illustrated.

4.4.3.2 Example

<u>The facts for purposes of the example are as follows:</u>
Fixed property was bequeathed to a trust *inter vivos*. The market value[38] of the property, at the date of death of the deceased was R1 million.

The beneficiaries of the trust are the relatives of the deceased (the spouse and children of the deceased).

The beneficiary of the trust did not have a vested right to the property in the trust (trust property, or trust capital). The purpose of the trust was to partly meet the deceased's maintenance obligation (with respect to the surviving spouse). During the remaining life of the surviving spouse, the surviving spouse, as beneficiary and in terms of the trust deed, had a vested right to all the income derived from this property (being net rental income), which accrued to the trustees from this property.

The other beneficiaries had a vested right to the capital of the trust, but the property could only be distributed to them, after the date of death of the surviving spouse. The trustees could either transfer ownership (joint ownership) on the property to the beneficiaries or dispose of the property and distribute the amount in cash, by electronic transfer from the trust's bank account to the beneficiaries.

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[37] In De Kock v Griessel NO and Others (50776/16) [2017] ZAGPPHC 1163 (23 October 2017)
[38] It is also the value included in the liquidation and distribution, and in the estate duty addendum.

The tax consequences of the above:

The tax consequences of the acquisition of trust property

Journal entry to record the acquisition (by way of inheritance)

Account	*Debit (ZAR)*	*Credit (ZAR)*
Trust property	1 000 000	
Trust fund		1 000 000
Property inherited at the market value at date of death of the deceased		

Comments related to the above, or acquisition of the property by the trustees:

In this instance,

- the trust (as heir) was exempt from paying transfer duty (see below).
- section 25(3) of the Income Tax Act applies and in terms thereof, it treats the trust as having acquired the asset (property in the estate) at the market value of the property at the date of death of the deceased person (section 9H(1) of the Act). Where the date of death was before 1 March 2016, different provisions of the Act applied, but the treatment will be the same.

It is irrelevant to the trust that this property, or the amount of the market value at date of death, may well have been subject to estate duty. That tax (estate duty) would have been paid by the estate (the executor). The reason why it would have been subject to estate duty (or why it would have been included in the dutiable amount), is because the executor could not make a deduction of the amount of the bequest. This is because of proviso (ii)[39] of section 4(*q*) of the Estate Duty Act.

There were no income tax consequences for the trust, resulting from the acquisition of the property. What is relevant, is that this is the amount of the cost of acquisition of the property by the trust, or the beneficiaries of the trust.

It is (or must be) declared, in the return of income of the trust, the ITR12T, as an amount considered not taxable. The following question must be answered by clicking the "y".

With respect to transfer of ownership in this immovable property, from the estate to the trust, no transfer duty is payable by the trust[40].

Because the purpose of this example is to deal with the trust fund, the income derived from the property, and paid to the surviving spouse is not dealt with in the example. Suffice it to say, the trust would have been tax neutral, unless the surviving spouse was not a resident of the RSA. But all of this is specifically dealt with later in this guide.

The journal entry for the transfer of the money to the beneficiaries:

Account	*Debit (ZAR)*	*Credit (ZAR)*
Trust fund	1 000 000	
Beneficiaries		1 000 000

[39] *... no deduction shall be allowed under the provisions of this paragraph in respect of any property which accrues to a trust established by the deceased for the benefit of the surviving spouse, <u>if the trustee of such trust has a discretion to allocate such property</u> ... to any person other than the surving* [sic] *spouse.*

[40] *No duty shall be payable in respect of the acquisition of property by an heir or legatee in respect of property of the deceased acquired by ... testamentary succession ...* (Section 9(1)(e)(i) of the Transfer Duty Act).

Recording the vesting decision		
Beneficiaries	1000 000	
Bank		1 000 000
Recording the distribution of the amount to the beneficiaries		

The tax consequences of vesting and distribution of the trust capital.

In this instance, the distribution is made up of two different components:

- Trust capital (or the amount of the trust fund), and
- The gain, resulting from the disposal of the immovable property.

The capital gain, as determined in terms of paragraph 80(2) of the Eighth Schedule to the Income Tax Act, will be discussed later in this guide.

Further comments
The purpose of the example was to show that the distribution of the original “capital”, or the amount of the inheritance, will not have any tax consequences. From a tax point of view, the amount is not “income” and also not a capital gain and will therefore not have an income tax consequence.

It is a good example of the application of the conduit principle. Incidentally, should the trust have been created by a donation, there would also not have been any donations tax consequences, and that would have been so, even if the trustees did not realise the immovable property, but vested it in the beneficiaries and then transferred ownership to the beneficiaries.

The beneficiaries will also have had the benefit of an exemption from transfer duty, section 9(4)(b) of that Act, and because they are (in this instance) related to the deceased within the third degree of consanguinity.

The following example deals with income, retained in the trust, and subsequently (in a year of assessment following the year in which the income accrued to, or was received by the trustee) vested in the beneficiaries.

4.4.3.3 Example

Facts:
A trust was created by court order, to receive an award for damages which arose as a result of personal injuries sustained by the beneficiary of the trust in a motor vehicle collision. In this instance, Judge Adams granted judgment in favour of the plaintiff (the patient or later beneficiary of the trust) against the Road Accident Fund for payment of the sum of R2,551,017.08. The amount was made up as follows:

> [48][41]. In the premises, the monetary award which I intend to make in favour of the plaintiff comes to R5,102,034.15, which is computed as follows:
> 48.1. General damages: R600,000.00;
> 48.2. Past loss of earnings: R2,565,645.95.
> 48.3. Future loss of earnings: R1,936,388.20.

[41] Strydom v Road Accident Fund (2011/4407) [2016] ZAGPPHC 828 (5 September 2016)

[49]. To this total should be applied the 50/50% apportionment in respect of the liability issue, which means that the said total will be reduced by 50% resulting in the final amount of the judgment to be granted in favour of the plaintiff of R2,551,017.08.

The following definitions are found in the trust deed (approved by the court):

3.1 "**Beneficiary**" shall mean S* V* N* or any other person as set out in paragraph 6 below. The Beneficiary shall be entitled to receive the income and capital of the Trust upon the terms and conditions set out in the Deed and shall be entitled to the capital of the Trust upon its termination.

3.2 "**Trust Fund**" shall mean the sums to be settled on the Trustee in terms of the said order of Court, in particular the award referred to in paragraph 1 hereof together with any additions or accruals thereto; all assets which shall from time to time be acquired by the Trustee for the purpose of this Deed including, without being limited thereto, capital assets and all income thereon whether capitalised or not.

With respect to the *"all income thereon whether capitalised or not"*, clause 5 of the trust deed reads as follows:

> The Trustee shall collect the income accruing from the investment of the Trust Capital and, after making provisions for payment of all necessary expenses, interest due, taxation, premium of the bond of security and Trustee's commission, the nett income shall be accrued to and invested as part of the Trust Capital, for the benefit of the Beneficiary.[42]

Comments on the above:
There is no doubt that the beneficiary of this trust has a vested interest to the income and capital of the trust. This is common where the trustees receive an amount from the Road Accident Fund, or under a medical negligence claim (and is colloquially referred to as a vested trust).

In this instance, the person was 46 years old at the time of the “accident, and he sustained a moderate to severe brain injury, a back injury, a laceration of the left parietal side of the head and soft tissue injuries to the shoulder, the left leg and the left side of the back.”

The purpose of the example is to deal with the net income, capitalised to the trust fund. Later in this guide, the tax consequences of the income of the trust, and the deductions, will be explained.

Additional facts to be used for purposes of the example:

For purposes of the example, we accept that the trustee received the full amount (the contingency fee is ignored) and invested the amount of R2 551 017, in an interest-bearing deposit account. And for the first year of the existence of the trust, the following transactions took place:

Description	Note	Amount (ZAR)	Amount (ZAR)
Interest earned on money deposited (at 8,8% relevant to the 2025 year of assessment)		244 489,50	
Payment of all necessary expenses (in respect of beneficiary and other)	1	184 489,50	
Net amount (not “vested as part of trust capital”)		60 000,00	

[42] Strydom v Road Accident Fund (2011/4407) [2016] ZAGPPHC 828 (5 September 2016)

Taxation	2	Nil	
Balance transferred to the trust fund		60 000.00	60 000
Trust fund (opening balance)			2 551 017
Balance of trust fund at the end of the year			2 611 017

Notes:

1. In terms of clause 5 of the trust deed, "*the Trustee may in his entire discretion pay the whole of such nett income or any portion of the Trust Capital as may be necessary to the Beneficiary and/or apply the same for maintenance, education and advancement in life of the Beneficiary*".
    a. The use of the phrase "in his entire discretion", is not really appropriate where the beneficiary of the trust has a vested right to the income (or capital) of the trust.
    b. It may well be that the intention with this phrase was to allow the trustee to choose, from which source payments to maintain the beneficiary, must be made.
2. Normal tax – the trust, in this instance, will not have any taxable income.
    a. Because the beneficiary has a vested right to the income, in terms of section 25B, the tax will be payable by the beneficiary. This will be dealt with in a later example.
    b. The trustee will of course use the income of the trust to pay this amount by way provisional tax or when it is assessed by SARS during the next year of assessment. If paid, as provisional tax (but also on assessment), it would be reflected as a maintenance payment (or distribution really) to the beneficiary.
    c. The fact that the trustee retained the amount (the R60 000) in the trust, does not have an impact on the income tax consequences – the beneficiary will bear the tax on this full amount that accrued to the trust.
        i. Note: In practice this is problematic, as the individual will not need all the income earned in the first years but would want to retain the excess amounts and would have wanted the trustees to invest the amount to income (or growth) which would cover expenses in the later years. Based on the facts in this case, the rate of tax was the same, if the trust was recognised by SARS as a special trust or not. If the trust was a special trust, and the beneficiary did not have a vested right to the income, but only to the amounts paid in respect of maintenance, the amount retained in the trust would have been taxed at the rates applicable to a natural person and the after-tax amount that could be invested, would have been a greater amount.
3. The trustees would have had to open a current account at a bank, in the first instance to receive the R2,5 million, but also to be able to meet the payments related to the maintenance of the beneficiary. In practice, the deposit will be of the kind that pays interest on a monthly basis, and those amounts would then be paid into the current account. For purposes of the example, it is accepted that the R60 000 was transferred from the current account to the deposit account.

For purposes of the example, the trustee gave notice and withdrew an amount of R60 000 from the deposit account in the following year of assessment. It is irrelevant why this amount was needed to be paid, other than that it was to be applied for the "advancement in life of the beneficiary". And then the intention of the trustee was clear (and would ideally have been recorded in minutes of a meeting of trustees, if there were more than one trustee) – the payment, advancement in life, was funded by the net income of a previous year, which was capitalised to the trust fund. In other words, the original capital amount was not used for this.

The tax consequences of the distribution of the R60 000.

The step approach

Step 1: Did the trustees, during a year of assessment, receive an amount?

For purposes of the example, the fact that there may have been other receipts by the trustees, is irrelevant. The focus is on the R60 000. With respect to the R60 000, there was no receipt by the trustees during the year of assessment, and that is why, with respect to R60 000, the answer in step 1 would be "no".

Step 2: Did trustees distribute cash (or money) to a beneficiary of the trust?

The answer would be "yes".

This is an instance where the beneficiary benefitted from the trust, and where the trustees vested (or distributed), trust capital in a beneficiary (or beneficiaries), and that trust capital is not an asset for purposes of the Eighth Schedule. In such a case, neither section 25B (of the Act) or the Eighth Schedule (to the Act) will apply.

In other words, this would be where a beneficiary (or the beneficiaries) benefitted from the trust, not because there was a receipt of gross income, or proceeds in respect of the disposal of an asset, by the trustees in respect of which the beneficiaries had a vested right or obtained one. It would be a part of the "trust capital" (or of the trust fund[43]) that was distributed to the beneficiaries. It essentially would be a vesting and distribution of "cash" – see the discussion on cash.

The following extract from comments made by Judge Trollip, in Secretary for Inland Revenue v Rosen, is relevant:

> *"The balance of trust income of R792 brought forward from the previous year possibly represents partly or wholly accumulated dividends. To the extent that the R6,600 was drawn from that amount it might not constitute dividends in her hands in the year of assessment. I express no final view on that since it was not argued."*

At issue is whether the amount retained its nature, as it was colloquially referred to, or changed from dividends to something else. In the above example, the question is whether the R60 000 consists of interest, or trust capital (and in this respect, the question was the same if the net amount was transferred to the trust fund (or trust capital) or not at all). After the introduction of section 25B into the Act, this question became an academic one.

In this instance, the R60 000 is actually a distribution, or transfer of ownership of the amount (from the trustee to the beneficiary). Whilst it originated from interest that accrued to the trust and that vested in the beneficiary, the current vesting of this asset, is not the vesting of a receipt (or accrual) in the beneficiary in the current year of assessment. Consequently, section 25B does not apply. The only other provision that may apply is found in the Eighth Schedule – that will be discussed later in this guide. Suffice it to say for purposes of the example:

> In this instance, the decision of the trustee to pay this amount to (or for the benefit of) the beneficiary, is an instance "*where a trust vests an asset in a beneficiary of that trust*[44]". It was previously stated that this may well be "cash", or currency, and therefore not an asset, but only if held in notes (or coins). It was also stated that a deposit or bank account is an asset (for purposes of the Eighth Schedule). As the base cost of this asset, and the proceeds on disposal, will be the same (R60 000), and consequently the capital gain determined in respect of that disposal will be nil.

[43] See the part dealing with trust capital in this guide.
[44] The words used in paragraph 80(1) of the Eighth Schedule to the Act.

The conclusion on the example
There is no tax consequence, for the trust or the beneficiary of the trust, with respect to the R60 000 paid out, from the trust fund to the beneficiary. In this instance, the beneficiary had a vested right to the total interest and with respect to the R60 000, there was an entitlement thereto (or *dies cedit*) on receipt thereof by the trustees. When the trustees subsequently applied this for the benefit of the beneficiary, it was the day of distribution or *dies venit*.

And it is irrelevant what the nature of the amount of income is – that is only relevant in the year of accrual.

Whilst there are no income tax consequences, the trustees are still required to declare this in the third-party return that must be submitted to SARS - the IT3(t). And it must be declared as an amount that is not taxable in the ITR12 of the beneficiary. See above.

4.5 Instances where the donor is taxed
4.5.1 Introduction

The purpose of the third suggested step is to determine if a donor, in respect of the trust, must be taxed on the income or capital gain in the trust. The question reads as follows:
Step 3: was there a receipt of income, or a capital gain, which was derived by reason of, or in consequence of, or attributable to a donation, settlement or other disposition?

In order to determine if the donor must be taxed, the starting point is to establish
- if the amount of "income" weas derived by reason of, or in consequence of, a donation, settlement or other disposition; or
- whether a capital gain, arising from the disposal of an asset of the trust is attributable to a donation, settlement or other disposition.

The reason why one would do this step before the next steps, is because neither section 25B of the Act, or paragraph 80 of the Eighth Schedule to the Act, will apply is the full receipt, or capital gain (in respect of the disposal of an asset), is to be attributed to a donor. This of course follows from section 25B being "*subject to the provisions of section 7*", and paragraph 80(1) of the Eighth Schedule, being *"subject to paragraph 68, 69 and 71"*, whilst paragraph 80(2) and 80(2A), are *"subject to paragraphs 64E, 68, 69 and 71"*.

If it is so, then the person who made the donation or other disposition, will bear the tax on the income (as section 7 will apply), or the capital gain (as the attribution rules in Part X of the Eighth Schedule to the Act will apply).

The word "income" is used to refer to any "*amount (other than an amount of a capital nature which is not included in gross income or an amount contemplated in paragraph 3B of the Second Schedule) received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust*".

The ITR12T requires an answer to the following question:

> Did any amounts distributed by the trust or retained in the trust arise by reason of a donation, settlement or other disposition to this trust?

A trust, or really the trustees of a trust, can only distribute an "amount" to a beneficiary who has a vested right, or who acquired a vested right, to income or capital of the trust. In order to answer this question correctly, one must understand when this would apply.

The Act specifically prescribes when this applies. Common to that is the phrase "donation, settlement, or other disposition".

4.5.2 "Donation settlement, or other disposition"
4.5.2.1 Attribution

It was indicated earlier that the donor will (or may) be "taxed" on the "income":

- where the deeming provisions of section 7 apply (in respect of income), or
- where paragraphs 68 to 73 to the Eighth Schedule apply, but then on the capital gain which is attributed to the donor.

The attribution rules, contained in the Eighth Schedule, apply in circumstances similar to the circumstances under which income is deemed to be that of a donor under section 7.

It is important to remember that the donor, for purposes of attribution, is not necessarily the founder of the trust. This is so, even if the trust was founded by way of a donation. If there was a donation, settlement by some third party to the trust, these rules will also apply.

The word "attribution" is commonly used both with reference to instances where any of the subsection of section 7 or paragraphs 68 to 73 of the Eighth Schedule to, the Act, may apply. When the word is used colloquially, income, or a capital gain, of a trust will be deemed to be that of the donor, for purposes of tax (or that the person to whom it is attributed, will be taxed thereon).

The heading of Part X, of the Eighth Schedule, is "Attribution of Capital Gains"; whilst the heading of paragraph 80, of the Eighth Schedule, refers to the *"capital gain attributed to beneficiary"*. It is only in section 7(8), where the word "*attributable*" is used – "*is attributable to that donation, settlement or other disposition*". In the Eighth Schedule, the words "*can be attributed wholly or partly to*" or "*attributable to*" are used. Section 7 uses the phrase "*by reason of or in consequence of*".

Whilst section 7 uses the phrase "*deemed to*", the paragraphs in the Eighth Schedule, uses the phrase "*is treated as*". These provisions create, or result in, the fiction that someone, other than the trust or the beneficiaries of the trust, is to be taxed on the income or capital gain. That someone being the donor, and the income or capital gain is imputed to, or treated as being that of the donor.

Common to all is that any one of these provisions will apply where there is (or was) *"any donation, settlement or other disposition"*. Attribution is then a determination of whether the income was derived as a result (or in consequence) of that, or a capital gain can be attributed to that, donation in whole or in part. Simply put, what must be determined, is whether the donation caused the income or capital gain to be derived. This requires a two-step approach.

The steps, or actually sub-steps of step 3, to determine if the donor will be taxed, are the following:
Step 2.1 Determine if there was a donation, settlement or other disposition.
Step 2.2 Determine if the income, or capital gain, was derived as a result of the donation, settlement or other disposition, or is attributable thereto.

It is important to remember that the financial statements of a trust, will mostly not reflect if property in the trust was acquired by the trust by way of donation. With respect to an interest free loan, it should be apparent from the note to the financial statements. It is suggested that the trustees keep a record of assets that were acquired by way of donation. It is the responsibility of the donor to account to SARS for the income, or capital gain, that may be attributed to him or her.

Section 7, does not, as section 25B now does, refer to the nature of the receipt or accrual, and specifically, does not distinguish between those that may be of a capital nature, and others. However, it does use the word income – see the earlier discussion of what income would be for purposes of section 7 of the Act.

The Eighth Schedule deals with capital gains, which would generally arise from an initial receipt of property, which receipt would be of a capital nature. The property, or asset, would be treated as being owned by the trust until it is disposed of or distributed to a beneficiary who had, or obtained a vested right in the property (or capital gain).

In the context of trusts, the Eighth Schedule specifically deals with the vesting of trust property in beneficiaries of the trust, but also with the vesting of a capital gain in a beneficiary, which capital gain arose from the disposal of trust property during a year of assessment.
Paragraph 80 is the equivalent of section 25B, and is subject to the attribution rules, and the principle in this respect, is the same as section 7 of the Act. Put differently, one must first determine if there is attribution of the capital gain to a donor, before paragraph 80 will apply.

The attribution rules mirror section 7, in most instances. And they will be dealt with together with section 7 in the part following this general discussion.

4.5.2.2 When will there be a donation, settlement or other disposition?

It is necessary to start with a donation first.

In the Media Summary of the Judgment in Estate R F Welch v Commissioner for the South African Revenue Service, it was stated that the *"Supreme Court of Appeal held by a majority of three to two that only settlements of assets upon trustees which were motivated by pure liberality or disinterested benevolence and for which no consideration or value had been received by the settlor were donations liable to donations tax."*

The issue was whether assets settled upon trustees in terms of a trust deed which obliged the trustees to apply the income from the assets and, if necessary, the assets themselves to discharge certain maintenance obligations owed by the settlor (RF Welch) to his ex-wife and minor child in terms of an agreement between them which was made an order of court, ranked as a donation and therefore resulted in a liability to pay donations tax.

Where a trust is created, and the founder donated assets to the trust, it cannot be disputed that there will be a donation for purposes of the deeming or attribution rules.

The following is an extract from a trust deed, which is an example of how the contract of the donation is embodied in the trust deed:

> **NOTARIAL DEED OF TRUST**
> The DONOR is desirous of establishing the hereinafter mentioned Trust for and on behalf of the following DONEES and BENEFICIARIES:
> ...
> The TRUSTEES have agreed to accept the appointment <u>and to accept the donation</u> mentioned in the said Trust Deed subject to all the terms and conditions hereinafter set out.
> The DONOR does hereby give and grant undividedly (*sic*) as a donation inter vivos to the TRUSTEES an amount of R1 000,00 (ONE THOUSAND RAND) ...

Just a reminder, to the extent that the cumulative value of property donated by the donor exceeds the annual threshold[45], donations tax will be payable. The donor will be liable to pay the donations tax[46].

Because it is customary, in South Africa at least, for the initial donation to be small, provision is then made in the trust deed for the trust to acquire further property, but also to accept further donations or bequests. Where the donation is made after the trust was created, and that donation can be made by the founder or any other person, the contract of donation will not be included in (or form part of) the trust deed. It will be in a separate deed of donation, with the trust, represented by the trustees, being a party to that contract.

The following is an extract from a trust deed that provided for the acquisition of property, otherwise than by original donation:

> "**Trust Fund**" shall mean:
> (2.2.5.1) the <u>sum of R500 donated</u> by the DONOR in terms of this Deed;
> (2.2.5.2) all sums of money, property and assets hereinafter <u>acquired</u> whether <u>by donation</u>, purchase, loan, exchange or otherwise, for purpose of the TRUST;
> (2.2.5.3) all investments and property and unexpended or accumulated income which the Trustees may from time to time stand possessed ...

In most trust deeds it is typically dealt with in the definitions clause, and then either in the definition of "trust capital", "trust fund" (as in the extract above), or "trust property". The above definition is a good example as it embodies all the ways in which the trustees of a trust can acquire property (for the benefit of the beneficiaries).

4.5.2.3 What is a donation?

Judge van Zyl, in the Commissioner for the South African Revenue Service v R M S Marx NO, explained the common law relating to a donation as follows:

> *"It must be borne in mind that a donation made during the lifetime of the donor (donatio inter vivos) becomes contractually and legally binding from the moment the donees accept the donation. It creates rights and obligations just like any other consensual contract, as appears from the following definition and elucidation in LAWSA:*
>
> > *A donation is an agreement which has been induced by pure (or disinterested) benevolence or sheer liberality, whereby a person under no legal obligation undertakes to give something*

[45] Section 56(2)(b) of the Income Tax Act: "*Donations tax shall not be payable in respect of ... so much of the sum of the values of all property disposed of under donations by a donor who is a natural person as does not during any year of assessment exceed R100 000*"

[46] Should the donor fail to pay the tax within the period prescribed in section 60(1) of the Act, the donor and the donee shall be jointly and severally liable for the tax.

… to another person, called the "donee", with the intention of enriching the donee, in return for which the donor receives no consideration nor expects any future advantage."

Expanding on the "induced by" part, Judge van Zyl commented as follows:

> *"The donor's intention to make a donation (animus donandi) must arise from generosity (liberalitas) or liberality (munificentia) and be expressed as a promise (offer) to donate, which promise (offer) must be accepted by the donee before a binding contract of donation comes into existence. Once this happens the donation is perfected and it may be revoked only under certain circumstances.*
>
> *The resultant contract is not sufficient, however, for purposes of transferring the donated asset into the ownership (dominium) of the donee. Performance of the obligation arising from the donation, in the form of delivery (traditio) of the asset donated, first has to take place, as appears from the following dictum of Jansen JA in Mankowitz v Loewenthal:*
>
> > *At the outset it must be remembered that a contract of donation and the performance thereof, viz the delivery of the article donated, are <u>two separate juristic acts</u>: the one directed at creating an obligation and the other at transferring possession (and dominium)."*

The deeming provisions, in section 7 and the attribution rules, do not only apply where there is a donation. It also includes the word "settlement", and the phrase, "other disposition".

For purpose of section 7, the intention of a party, typically the donor, is irrelevant. Put differently, for purposes of attribution, one does not have to establish if there was an intention to avoid tax. Judge Trollip referred, in Ovenstone v CIR, the phrase used in section 7, as the "critical phrase", and said that *"the associated words in the critical phrase, ie 'donation' and 'settlement', can legitimately be looked to for assistance"*. When one interprets section 7, the following comment by Judge Trollip must never be ignored:

> *"That intention was to hit at certain gratuitous disposals of property whereby the taxpayer diverts from himself the income derived therefrom without replacing or being able to replace it fully or at all."*

Judge Trollip, with respect to whether there is a *"limitation that must be imposed upon"* the meaning of disposition, in "other disposition", said the following:

> *"In view of that uncertainty, the associated words in the critical phrase, ie 'donation' and 'settlement', can legitimately be looked to for assistance. Noscitur a sociis."*

And then provided an excellent discussion of the meaning of the phrase, which discussion is duplicated below:

> ***<u>"In a donation</u>*** *the donor disposes of the property gratuitously out of liberality or generosity, the donee being thereby enriched and the donor correspondingly improverished (sic), so much so that, if the donee gives any consideration at all therefor, it is not a donation ... It can therefore be regarded as a unilateral contract in the sense that the donor is the only party upon whom any obligation lies.*
>
> ***<u>In a 'settlement'</u>*** *the property is usually disposed of upon specific terms and conditions, set out in a deed of settlement, to or through the medium of a trustee or trustees for the benefit of some person, or for the benefit of persons in succession as in a fideicommissum 'settlement'). As far as the beneficiaries are concerned a settlement is also generally made gratuitously out of liberality*

or generosity in the sense that no consideration usually passes from them to the settlor for the benefits conferred on them. 'Settlement' is thus usually of the same genus as 'donation'. It is probably separately mentioned in the critical phrase because in form, substance, or effect it may sometimes not be regarded as a true donation. For example, where the recipients of the property are trustees who are not themselves enriched by the settlement. That the trustees are, in terms of the settlement, to be remunerated for their services as such, does not detract from the settlement being gratuitous. But because they obligate themselves to perform those services, the settlement is not a unilateral contract. True, consideration may sometimes pass for a settlement, but the kind of 'settlement' envisaged by the critical phrase, especially by reason of its being closely associated with 'donation', is a gratuitous one <u>or one that is gratuitous to an appreciable extent</u>. For if a settlement is made for due consideration, it would, in reality be a purely commercial or business transaction, which, for reasons already given, would fall outside the scope of s 7(3)-(6).

Hence, the words '<u>donation, settlement or other disposition</u>' all have this feature in common: they each connote the disposal of property to another otherwise than for due consideration, i.e. otherwise than commercially or in the course of business. 'Donation' and 'settlement' have this further feature in common: the disposal of property is made gratuitously or (occasionally in the case of a 'settlement') gratuitously to an appreciable extent.

<u>Since 'disposition'</u>, the general word that rounds off the critical phrase, was not intended to have its wide, unrestricted meaning, I think that this is an appropriate situation in which to circumscribe its scope by extending that common element of gratuitousness to it too by the ejusdem generis or noscitur a sociis rule. The critical phrase should, in other words, be read as 'any donation, settlement or other similar disposition.' So construed, 'disposition' means any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer. It need not flow from a unilateral contract, for that is not necessarily a common element of a 'donation' and 'settlement'. That a 'disposition' need not be wholly gratuitous and is not restricted to any particular form of disposal of property differentiates it to some extent from a 'donation' and 'settlement'. To the extent, however, that it does overlap either of the latter that is quite understandable and acceptable as having been done ex abundanti cautela in these anti-tax avoidance subsection of s 7. For 'donation' and 'settlement' are technical terms of the law; whether a particular disposal of property constitutes a true 'donation' or 'settlement' may give rise to difficulty and contention; and the legislature probably used the more general, comprehensive word 'disposition' for the sake of achieving clarity and certainty and in order to eliminate any such problems ..."

Judge Trollip then concluded as follows:

"The aforegoing construction of the critical phrase accords, I think, with the intention of the legislature as manifested in s 7(3)-(6). This aspect has already been mentioned earlier in this judgment. That intention was to hit at certain gratuitous disposals of property whereby the taxpayer diverts from himself the income derived therefrom without replacing or being able to replace it fully or at all."

With respect to the meaning of the word "settlement", the Oxford Advanced Learner's Dictionary, gives it as follows:

"the conditions, or a document stating the conditions, on which money or property is given to".

This document is the trust deed, and this was expressed by Judge Trollip as follows:

> *"... the property is usually disposed of upon specific terms and conditions, set out in a deed of settlement, to or through the medium of a trustee or trustees for the benefit of some person, or for the benefit of persons ..."*

With respect to the phrase "other disposition", Judge Trollip stated as follows:

> *"The critical phrase should, in other words, be read as 'any donation, settlement or other similar disposition.' So construed, 'disposition' means any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer."*

It is common for a founder of the trust to transfer ownership of property to the trust and credit the amount to a loan account that is free of interest, or the interest charged thereon by the founder is not at a commercial rate.

Judge Froneman said[47] that *"as long as the capital remains unpaid the failure to charge interest represents a continuing donation …"*

The interest that should have been charged (the extent of the donation) may then, depending on the circumstances, be regarded as that portion of the income deemed to be that of the parent within the meaning of section 7(3).

4.5.2.4 What does the phrase "*by reason of*" mean in the context of section 7?

4.5.2.4.1 Explanation

The phrase "by reason of" is not defined in the Act. Judge Howie, in Stevens v CSARS [2006] SCA 145 (RSA), said that *"... the expressions 'in respect of' and 'by virtue of' ... connote a causal relationship between the amount received and the taxpayer's services or employment."* This was said with respect to paragraph (c) of the definition of gross income, but the interpretation will apply also to section 7. In other words, for purposes of section 7, a causal relationship between the *"donation, settlement or other disposition"* must exist, or is required, in order for the income to by reason of the donation, settlement or other disposition.

The meaning of this causal relationship has not been defined in tax legislation or considered in tax cases. In Lee v Minister of Correctional Services, judge Nkabinde set out in general terms the functioning of causation as an element of a delict. She stated:

> *"The point of departure is to have clarity on what causation is. This element of liability gives rise to two distinct enquiries. The first is a factual enquiry into whether the negligent act or omission caused the harm giving rise to the claim. If it did not, then that is the end of the matter. If it did, the second enquiry, a juridical problem, arises. The question is then whether the negligent act or omission is linked to the harm sufficiently closely or directly for legal liability to ensue or whether the harm is too remote. This is termed legal causation."*

In this matter, it is only factual causation that is in issue. This proper approach to this issue was set out as follows by Corbett CJ in *International Shipping Co (Pty) Ltd v Bentley*:

> *"The enquiry as to factual causation is generally conducted by applying the so-called "but-for" test, which is designed to determine whether a postulated cause can be identified as a causa sine*

[47] In CSARS v RM Woulidge (24/2000) [2001] ZASCA 94; [2002] 2 All SA 199 (A) (20 September 2001)

qua non of the loss in question. In order to apply this test one must make a hypothetical enquiry as to what probably would have happened but for the wrongful conduct of the defendant. This enquiry may involve the mental elimination of the wrongful conduct and the substitution of a hypothetical course of lawful conduct and the posing of the question as to whether upon such an hypothesis plaintiff's loss would have ensued or not. If it would in any event have ensued, then the wrongful conduct was not a cause of the plaintiff's loss; aliter, if it would not so have ensued. If the wrongful act is shown in this way not to be a causa sine qua non of the loss suffered, then no legal liability can arise."

Judge Norton[48] explained this as follows:

> *"Factual causation is established if, hypothetically speaking, the loss or occurrence would not have happened 'but for' the insured peril (Lee v Minister for Correctional Services 2013 (2) SA 144 (CC) para 40, citing International Shipping Co (Pty) Ltd v Bentley 1990 (1) SA 680 (A) at 700F-H).*
>
> *Legal causation is established if there is a sufficiently close relationship between the insured peril and the loss or occurrence that the former can be said to be the legal cause of the latter. The test for legal causation has been described as 'a flexible one in which factors such as reasonable foreseeability, directness, the absence or presence of a novus actus interveniens, legal policy, reasonability, fairness and justice all play their part' ...*
>
> *When there are two or more possible causes of the loss or occurrence which is covered by the contract, a court must determine which is the 'proximate cause' (Incorporated General Insurances Ltd v Shooter t/a Shooter's Fisheries 1987 (1) SA 842 (A) 862 C-D) as the insurer will only be liable if the loss or occurrence for which a claim is brought is the proximate result of the peril insured against.*
>
> *A cause has been held to be proximate if it can be described by terms such as dominant, effective, direct, real, actual, determining, operative, predominant or efficient (Reinecke et al, South African Insurance Law, 2013, para 13.85). If the causal relationship is indirect and fortuitous, the cause is not proximate and there is no legal causation (Napier, 146H). The proximate cause is not merely the one which was latest in time, but the one which is 'proximate in efficiency'"*

4.5.2.4.2 Conclusion

When there is a donation (by the founder or another donor) of property to the trustees, and the income is derived by the trust, from this property, it is submitted that there is a factual causation. The trust would not have derived the income, if there was no donation. Put differently, "but for" the donation, the trust would not have derived the income. There must be a nexus between the income and the donation.

The test is to determine if a certain act (donation) had a certain result (income).

Legal causation is established if there is a sufficiently close relationship between the income derived and the absence or presence of a *novus actus interveniens*. If the causal relationship is indirect and fortuitous (or remote), the cause is not proximate and there is no legal causation.

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48 Grassy Knoll Trading 78 CC t/a Fat Cactus and Another v Guardrisk Insurance Company Limited (10035/2020) [2020] ZAWCHC 168; [2021] 1 All SA 503 (WCC) (20 November 2020)

4.5.2.4.3 Example

Facts:
A founder of a trust transferred, at an arm's length value[49], immovable property (from which the founder of the trust derived rental income) to the trust (a family trust – the beneficiaries are relatives of the founder). The trustees entered in a number of lease agreements and derive rental from the lessees.

The trust did not pay for the immovable property, but entered into a loan agreement with the founder, in terms of which the loan must be repaid after the date of death of the founder, or after the founder gave 12 months' notice, whichever is the earlier. The agreement reached between the founder and the trustees, is that loan is interest free.

On the face of the facts, whilst a market related value was used for the transaction, this is not a commercial transaction, or the parties were not dealing at arm's length. As Judge Trollip said, the intention of section 7 *"was to hit at certain gratuitous disposals of property whereby the taxpayer diverts from himself the income derived therefrom without replacing or being able to replace it fully or at all."* If the loan was subject to interest, the founder would have replaced the rental income that he (or she) could have earned from the immovable property (if not in full, at least to an extent) with the interest received from the trust. The trust will be entitled to a higher amount of income, because it does not have to pay interest to the founder, or to a financial institution, if the founder was not prepared to fund this transaction. Consequently, there is a gratuitous element to this transaction.

The income derived by the trust will therefore be derived, at least partially, by reason of any donation, settlement or other disposition made by the person providing the interest free loan. If partially, an apportionment may be required.

Note, it is the person who provided the interest free loan, or who made this continuing donation, and whilst it may be the founder of the trust, it will not always be the founder.

4.5.2.5 When does section 7 apply?

Judge Corbett, in Estate Dempers v Secretary for Inland Revenue, said the following:

> *"Generally speaking, a taxpayer is perfectly entitled to reduce the amount of his income, and thereby the income tax payable, by giving away income producing assets owned by him.*
> *It would seem that the mischief which the subsection is designed to combat is a certain type of tax avoidance."*

The issue before the court was a section that reads substantially the same as the current section 7(5) of the Act. It is submitted that what the judge said, is relevant, and applies to all of section 7, where the phrase *"donation, settlement or other disposal"* is used. Section 7, at least from section 7(2) to section 7(8), is therefore a specific anti avoidance provision.

4.5.3 Section 7(1)

Section 7(1) of the Act reads as follows:

---

[49] Where the founder and the trust are connected persons in relation to each other, the transaction would be treated as having been made at market value even if it was donated.

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

Section 7(1) is the only subsection (of section 7), where the phrase “donation, settlement or other disposition”, does not appear. In the context of a trust, section 7(1) could apply to the beneficiaries of the trust.

Section 7(1) does not contain the critical phrase. As was said by Meyerowitz, *“the explanation or purpose of this provision is far from plain”*. Silke said that the *“precise meaning to be attributed to s 7(1) is obscure”*.

Meyerowitz submitted that the provision, does not enlarge the meaning of “accrue” despite the words *“income shall be deemed to accrue”*, for it does not say there shall be deemed to be an accrual in the circumstances set out but that there shall be deemed to be an accrual notwithstanding these circumstances.

At the time, the meaning of the word “accrue” was yet debated, at least until it was conclusively decided on in the People’s Stores case. The phrase “due and payable”, is used in section 7(1), to further qualify income, or the word “accrue”.

An example of where section 7(1) will apply, is where the beneficiary is a minor child, and the income (or a capital gain) is vested in the beneficiary, but in terms of the trust deed, this is not payable to the child until the child turns 21 years of age.

A beneficiary would not be able to argue, where section 25B applies, that the amount that was vested in him or her, but were not paid (or distributed), did not accrue to him. In a sense it merely confirms what section 25B stipulates and is superfluous.

Section 7(1) therefore has limited application as far as section 25B, or paragraph 80(2) of the Eighth Schedule is concerned. It would only apply if none of the other subsections of section 7 applies.

The purpose of section 8, which is substantially the same as the current day section 7(1), according to Meyerowitz *“appears to be to prevent an accrual being regarded as postponed by reason of the income being dealt with in the ways set out and it also makes it clear that the fate of the income after it has accrued does not concerned the incidence of tax.”*

Conclusion on section 7(1)
Where a beneficiary of a trust has a vested right to the income of the trust, or acquired such a right, the fact that the income has not been distributed to the beneficiaries, is irrelevant. The time of the accrual for the beneficiary is the vesting event, and it is not deferred until the time it is paid to the beneficiary.

The next provision is found in section 7(2)(a) and deals with a spouse of a donor.

4.5.4 Section 7(2)(a)

4.5.4.1 Income

As far as a trust, and the beneficiaries or donor, are concerned, it is only section 7(2)(a) of the Act that can apply[50]. It reads as follows:

> *"Any income received by or accrued to any person married in or out of community of property (hereinafter referred to as the recipient) shall be deemed for the purposes of this Act to be income accrued to such person's spouse (hereinafter referred to as the donor) <u>if such income was derived by the recipient</u> in consequence of a donation, settlement or other disposition made by the donor ... or of a transaction, operation or scheme entered into or carried out by the donor ..., and the sole or main purpose of such donation, settlement or other disposition or of such transaction, operation or scheme was the reduction, postponement or <u>avoidance of the donor's liability for any tax</u>, levy or duty which, but for such donation, settlement, other disposition, transaction, operation or scheme, would have become payable by the donor under this Act or any other Act administered by the Commissioner*."

Comments on section 7(2)(a)

The provision actually contains two requirements before it can apply. They are:

- Income must have been derived by the recipient (the one spouse) in consequence of a donation, settlement or other disposition (or of a transaction, operation or scheme entered into or carried out by the donor) made by the donor (the other spouse).
- And the purpose of any of the above, must be the reduction, postponement or avoidance of the donor's liability for any tax.

4.5.4.2 Capital gains

4.5.4.2.1 The legislation

The equivalent of section 7(2)(a) is found in paragraph 68 of the Eighth Schedule to the Act; Attribution of capital gain to spouse.

Paragraph 68(1) reads as follows:

> *"Where a person's capital gain or a capital gain that has vested in or is treated as having vested in that person during the year of assessment in which it arose can be attributed wholly or partly to -*
>
> *(a) any donation, settlement or other disposition; or*
>
> *(b) any transaction, operation or scheme,*
>
> *made, entered into or carried out by that person's spouse mainly for purposes of reducing, postponing or avoiding that spouse's liability for any tax, duty or levy which would otherwise have become payable under any Act administered by the Commissioner, so much of the gain as can be so attributed must be disregarded when determining that person's aggregate capital gain or aggregate capital loss and taken into account when determining the aggregate capital gain or aggregate capital loss of that person's spouse"*.

[50] Section 7(2)(b) applies where two spouses carry on a trade in partnership, and section 7(2A) and 7(2B) deal with spouses who are married in community of property. Section 7(2C) do, deals with annuities paid, benefits paid by retirement funds and royalties (patents copyrights owned by one of the spouses).

4.5.4.2.2 Discussion of paragraph 68

As was done in section 7(2), this paragraph also has the avoidance of tax in mind. However, the wording differs.

Section 7(2) refers to the main or sole purpose, which must be the reduction, postponement or avoidance of the donor's liability to tax. Paragraph 68(1) does not have the word "sole", in it.

Both section 7(2), and paragraph 68(1), refer to *"any transaction, operation or scheme"*, and the intended taxes, for both, includes any tax, duty or levy which would otherwise have become payable under any Act administered by SARS.

The main difference, however, is that section 7(2) is prompted by an amount of income received by the spouse of the donor. Paragraph 68, requires a capital gain, arising for the disposal of an asset, which capital gain is then vested in the spouse, or treated as being vested in the spouse.

Both section 7(2), and paragraph 68(1), then require that the main purpose of the spouse, the other spouse, must be reducing, postponing or avoiding that spouse's liability for any tax, duty or levy.

Relevant to a trust, paragraph 68(1) applies to a capital gain that has vested in or is treated as having vested in the spouse, not being the spouse that made the donation, or entered into a scheme to avoid tax.
It is important to remember that a donation between spouses[51] is exempt[52] from donations tax. And a donation *"by a person to that person's spouse will as a general rule not result in a capital gain in that person's hands, as the base cost of that asset will be transferred to that spouse[53]"*. At the time it was in terms of paragraph 67 of the Eighth Schedule to the Act. Since the promulgation of the Taxation Laws Amendment Act[54], 2018, it is dealt with in section 9HB of the Act.

With respect to paragraph 68, the following explanation was given:

> *"Where the donation was, however, made mainly for purposes of avoiding a tax administered by the Commissioner, the subsequent disposal of that asset by the spouse to whom it was donated might result in the inclusion of any resultant capital gain in the hands of the spouse who made that donation.*
>
> *Such donation, settlement or other disposition made by a person to a trust of which that person's spouse is a beneficiary, might also result in the application of this rule where a trust asset or the capital gain from the disposal of such asset is subsequently vested in that spouse."*

4.5.5 Example

The facts (the trust):
A natural person set up a family trust, and the beneficiaries of this trust, are his spouse and their children. The trust was created by way of a donation, by the founder of the trust, of an interest-bearing

[51] As defined in section 1(1) of the Income Tax Act.
[52] See section 56(1)(a) and section 56(1)(b) of the Income Tax Act.
[53] Explanatory Memorandum on the taxation laws amendment bill, 2001
[54] The Taxation Laws Amendment Act, 2018, Act No. 23 of 2018, was promulgated on 17 January 2019.

bond to the trust. The founder (donor) paid the donations tax on the market value of the bond, on the date the donation took effect - which value was R 1 million.

These bonds pay interest twice a year and the market price of these bonds fluctuates with prevailing interest rates. The total amount of interest that accrued to the trust for the year of assessment was R90 000.

The following extract is from the trust deed:

The term “BENEFICIARIES”, CHILD/CHILDREN shall mean:

- 2.7.1 THE FOUNDER, and/or,
- 2.7.2 The lawfully wedded spouse of the FOUNDER, and/or
- 2.7.3 The children of the FOUNDER or any of them.

With respect to income received by the trustees, the trust deed reads as follows:

APPLICATION OF NET INCOME:

- Until the death of the beneficiary in clause 2.7.2[55], the Trustees shall distribute all the net income in each financial year to that beneficiary.”
    - o “Net income” is defined in the Trust Deed as the “income of the investment of the Trust Fund, after payment of all expenses lawfully incurred by the trustees in the performance of their duties hereunder and includes payment of the taxes.”

- With respect to the trust capital, or trust property, and in terms of the trust deed, the spouse also had a vested right to any capital gain derived from the property (originally donated to the trust).

Further facts

The interest rate that applied to the bond was 9%.

The founder, together with the trustees, when the SA Reserve Bank started reducing the prime interest rate, and the market value of certain bonds increased to above the value at which the trust acquired them, disposed of this bond before the maturity date thereof. The trustees distributed the resulting capital gain, which for purposes of the example, is R125 000, to the spouse.

For purposes of the example, the donation was made on the last day of a year of assessment, and the trustees disposed of the bond exactly a year later.

The taxable income of the founder of the trust, mainly from remuneration and director’s fees, is in excess of the tax threshold and the maximum rate of tax, 45%, applies to any other taxable income or a taxable capital gain that accrues to the founder.

The spouse of the founder was not a taxpayer at the time of the donation and registered subsequently (on receipt of the interest distributed by the trustees) as such.

In terms of the “net income-clause”, the children were discretionary beneficiaries of the trust, but the trustees could only vest, and distribute, income in them after the spouse of the founder died. The same applied to the founder - also a discretionary beneficiary to income of the trust.

[55] The beneficiary in clause 2.72, is the lawfully wedded spouse of the FOUNDER.

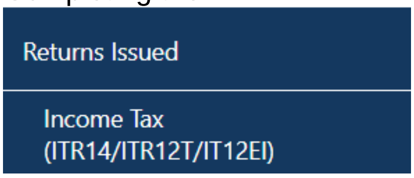
On the facts it is submitted that the founder of the trust, and donor to the trust, would find it difficult to prove that the reason for this donation was anything other than the reduction of tax[56]. The spouse, with respect to the interest-income vested, will be taxed at a lower rate of tax (the progressive tax tables). The same applies to the taxable capital gain, that resulted from the disposal of the bonds – the marginal rate of tax is much lower than the rate applicable to the founder.

<u>Accounting for this in the return of income (ITR12) for the trust:</u>
The steps to determine who must be taxed:

- There was a receipt, by the trustees, of the interest and proceeds during the year of assessment (step 1 = yes).
- The answer to step 2 is "non"; the trustees did not distribute cash (or trust capital) to the spouse.
- The answer to step 3, is "yes", there was a receipt of income, or a capital gain, by the beneficiary (the spouse), both of which was attributable to a donation.

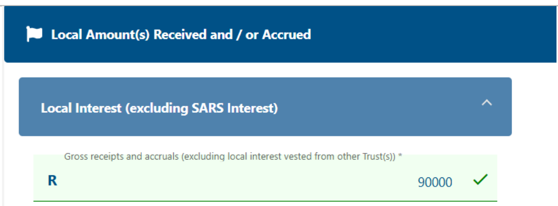
The conclusion is that the income and capital gain will be attributed to donor, in this case also the founder of the trust, who must then be taxed.

Completing the ITR12T:

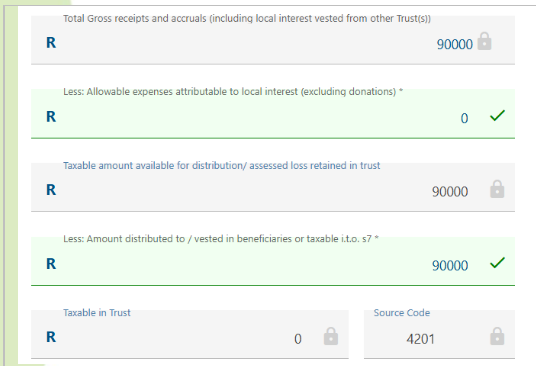


<u>Income</u>

Question	Answer
Was any local amount(s) received by and / or accrued to the trust during the year of assessment? (excluding amount(s) vested from other Trust(s)) Indicate the type of local amount(s) received / accrued to the trust: • Interest (excluding SARS interest)	Yes Yes

	Local Amount(s) Received and /or Accrued Interest (excluding SARS interest)	90 000

[56] It is outside the scope of this guide to discuss tax avoidance in any detail.

 Total Gross receipts and accruals (including local interest vested from other Trust(s)) R 90000 Less: Allowable expenses attributable to local interest (excluding donations) * R 0 Taxable amount available for distribution/ assessed loss retained in trust R 90000 Less: Amount distributed to / vested in beneficiaries or taxable i.t.o. s7 * R 90000 Taxable in Trust R 0 Source Code 4201	Less: amount distributed to / vested in or taxable i.t.o. s7 Taxable in trust	90 000 Nil

Note:
The ITR12T does not require that amounts that a beneficiary of a trust may have a vested right to, or amounts distributed, or the amounts that are attributed to the donor (and on which the donor must be taxed), must be disclosed separately.

This is not a problem, in the first instance, as that detail will in future, from 30 September 2024, be provided to SARS by means of the third-party report. As the purpose of the ITR12T is to determine the taxable income of the trust, this is also all that is necessary, namely, to determine the amount that will be taxed in the trust, the total amount that must be attributed to the donor and that will be taxed in the hands of the beneficiaries, must be deducted.

Capital gain
As with section 7(2), paragraph 68 will apply to the above facts, if two requirements were met.

The first is that, with respect to the capital gain arising from the disposal of an asset, and which vested in a beneficiary of the trust, the capital gain must be a gain that can be attributed wholly (or partly) to any donation made by the spouse of the person in whom the capital gain vested during the year.

The second requirement is that the purpose of this donation, must have been mainly to reduce, postpone or avoid the donor-spouse's liability for any income tax (in this instance), which would otherwise have become payable.

As will be seen later, the gain would have been disregarded in the trust, in terms of paragraph 80, and would have been treated as being a gain for the spouse. But paragraph 80 is subject to paragraph 68.

On the facts of this example, there is a tax benefit, and in terms of section 80G, of the Act, there is a presumption that this donation was made for the sole or main purpose of obtaining a tax benefit. There is no question that the donation itself, was a step in or part of what is essentially an avoidance arrangement. The tax benefit, with respect to capital gains, following from the donation of the asset, after which the founder (donor) was no longer entitled to the capital from the subsequent increase in the value of the bonds. The second step then was to creation of a vested right, for the spouse to receive any capital gain that resulted from a disposal of the bond by the trust.

There is no tax benefit by using the trust, mainly because the spouse has a vested right to the gain from inception of the trust. It was therefore irrelevant that the inclusion rate for the trust is 80%. The benefit lies in the fact that the spouse will, because of the progressive rates of tax, pay less tax on the capital gain, than the spouse would have, if the donation was not made and ownership in the bond kept in the donor spouse's name.

It is submitted, as was said with respect to the interest, that it would be very difficult for the donor, or the party obtaining the tax benefit, to prove that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement.

There is relief for the donor in this instance, because the interest was deemed to be received by the donor spouse in terms of section 7(2) of the Act, the capital gain will be reduced - see the discussion of paragraph 73, later in this guide.

In completing the return with respect to the capital gain:
Answer the following question, under the heading "Capital Gain / Loss):

Did the trust dispose of any local assets attracting capital gain or loss (including crypto asset(s))?

Once the question is answered by ticking the "Y", a container opens, and the number of assets disposed of must be captured there. In this instance, there was only 1 asset, therefore a "1".
The next question that must be answered is:

Specify the number of persons or beneficiaries who during this year of assessment participated in any one or more of the following:

Number

The answer is 2, the spouse and then the donor.

The next question that must be answered is:

Is taxable on income/ capital gains distributed to / vested in beneficiaries or taxable i.t.o. s7 or par 68 - 72 of the Eight Schedule

	ZAR	Comments
Local Capital Gain Loss 1		
Note: The annual exclusion and inclusion rate and carried forward losses will be calculated by SARS		
Proceeds	1 125 000	
Base Cost	1 000 000	The market value at the date of the donation is the base cost of the asset for the trust. Section 9HB does not apply.
Exclusion / Rollover	0	
Capital gain / loss	125 000	
Amount taxable in terms of s7	125 000	
Capital gain available for distribution	0	

The next subsection deals with minor children and is section 7(3).

4.5.6 Section 7(3)
4.5.6.1 The legislation

Section 7(3)

> *"Income shall be deemed to have been received by the parent of any minor child or stepchild, 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."*

NOTE: It is important to remember that, when section 7(3) applies, the individuals (the minor children) who benefited from the trust, will not be taxed. It is the parent of the minor child, who made a donation, settlement, or other disposition, who will be taxed.

When the ambit of section 7(3) and (4) was widened to include a stepchild of a parent, the following explanation[57] was given for the purpose both sections:

> *"Section 7(3) and (4) of the Income Tax Act deal with parent to minor child dispositions. These provisions deem any income derived by a minor child back to the parent if the income results from a donation, settlement or other disposition by the parent, whether directly or indirectly."*

Section 7(4)

> *"Any income received by or accrued to or in favour of any minor child or stepchild of any person, by reason of any donation, settlement or other disposition made by any other person, shall be deemed to be the income of the parent of that child, if such parent or his or her spouse has made a donation, settlement or other disposition or given some other consideration in favour directly or indirectly of the said other person or his or her family*."

Section 7(3) and section 7(4) essentially are in principle the same. Income accrues to a minor child by reason of a donation made. The difference between section 7(4) and section 7(3), lies in the fact that in section 7(4) there are reciprocal donations made, whereas in section 7(3) the donation is by the parent of the minor child.

Applied to a trust, a parent of a minor child, donates money to the trust and the beneficiary of this trust is a minor child of a parent who in turn donated money, the income of which accrues to the minor child of the first mentioned parent (in a trust or otherwise). The income that accrues to the minor child (beneficiary in the trust), which is derived by reason of the donation made by the first-mentioned parent, is then deemed to be the income of the parent of the minor child.

It is clear that section 7(4) was introduced to prevent parents from entering into such reciprocal arrangements to avoid section 7(3) applying.

The tax consequences, where section 7(4) applies, are exactly the same as section 7(3) and the only difference is that the income is not attributable to the donation made by the parent of the minor child (which would not have been to the trust).

Applying the law to the above transactions:

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[57] See the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2008

Step 1:
Factually, there was a receipt, or an accrual, by the trustees for the benefit of the beneficiaries of the trust (of the interest and the rental).

Step 2:
The fact that beneficiaries benefited from the trust, is irrelevant in this instance. This is because the beneficiaries (the minor children) benefited from the income that accrued to the trust, and not from trust capital.

Step 3:
There was no disposal of an asset by the trustees, and the amounts are not capital in nature.

Step 4:
So, the next step involves determining whether there was a donation, settlement or other disposition to the trust. And if so, to then determine if the amount of "income" were derived by reason of a donation, settlement or other disposition. Section 7(3) (or section 7(4)) does not use the term "in consequence of"; both only use the phrase "in respect of".

Was the "income" derived by reason of a donation settlement or other disposition?

This must be tested for each receipt (or accrual) by the trust(ees).

4.5.6.2 Income

There is no question, with respect to the transfer of ownership in the bond, that the founder of the trust made a donation to the trust (of R1 million). And it is also not in dispute that the income derived by the trust, the interest earned on that bond, was received by the trustees from this bond, or from property that was donated to the trust. The interest was therefore derived by the trustees by reason of a donation.

With respect to the rent derived from the property, ownership in the property was transferred to the trust at market value. SARS should also not be of the opinion that this property has been disposed of for a consideration which is not an adequate consideration. With respect to TWV Senior, he received a *quid pro quo*, the undertaking by the trustees to repay the amount credited to the loan account. As was said by Judge Trollip (in Ovenstone), *"it is manifestly clear that 'disposition' was not intended to bear its wide, unrestricted meaning of any making over, parting with, or transferring of property to another. For that would then include a disposition of property made under a bona fide commercial, business, or at arm's length contract for full or fair consideration in money or money's worth"*.

However, the trust enjoys the benefit of not having to pay interest on the loan from the person whom they acquired the property from. It is important to remember, as was stated earlier in this guide, that it is not with reference to the founder of the trust that this is tested – it is with respect to the person who provided the loan to the trust and in respect to which loan, there is interest foregone (or partially so).

It is discussed in more detail earlier in this guide, but the interest free loan is, whilst not an outright donation, a settlement or other disposition. Judge Froneman stated the following:

> *"For its application section 7(3) requires a disposition made wholly or to an appreciable extent gratuitously out of liberality or generosity ...*

Where the disposition contains both appreciable elements of gratuitousness and of proper consideration an apportionment may be made between the two elements for the purpose of determining the income deemed to have accrued to, or received by, the parent under section 7(3). The taxpayer bears the burden of proof to show that such an apportionment is possible and how a court should give effect to the apportionment ... One of the ways in which such an apportionment may arise is where a loan is made (or credit granted) in terms of which capital is to be repaid at some later stage, on proper commercial or business grounds, but no interest is charged on the outstanding capital. As long as the capital remains unpaid the failure to charge interest represents a continuing donation ...

The interest that should have been charged (the extent of the donation) may then, depending on the circumstances, be regarded as that portion of the income deemed to be that of the parent within the meaning of section 7(3)."

Conclusion

Important to note, that because of this (interest derived by reason of a donation), and because section 25B is subject to section 7, it follows that section 25B does not apply to this interest.

4.5.6.3 Capital gains

The equivalent of section 7(3) is found in paragraph 69 of the Eighth Schedule to the Act; *Attribution of capital gain to parent of minor child*. There is no separate equivalent for section 7(4) – it is incorporated in paragraph 69.

The wording of paragraph 69:

"Where a minor child's capital gain or a capital gain that has vested in or is treated as having vested in or that has been used for the benefit of that child during the year of assessment in which it arose can be attributed wholly or partly to any donation, settlement or other disposition –

(a) made by a parent of that child; or

(b) made by another person in return for any donation, settlement or other disposition or some other consideration made or given by a parent of that child in favour directly or indirectly of that person or his or her family,

so much of that gain as can be so attributed must be disregarded when determining that child's aggregate capital gain or aggregate capital loss and must be taken into account in determining the aggregate capital gain or aggregate capital loss of that parent."

Discussion of the legislation

As was done in section 7(3), this paragraph also has the avoidance of tax in mind. However, the wording differs, mainly because the principle of section 7(4) was incorporated in paragraph 69 of the Eighth Schedule to the Act.

Both section 7(3) and section 7(4), and paragraph 68(1), refer to *"any transaction, operation or scheme"*, and the intended taxes, for both, includes any tax, duty or levy which would otherwise have become payable under any Act administered by SARS. However, it is only section 7(3) and section 7(4) which includes a stepchild.

The main difference, however, is that section 7(3) requires that an amount of income was received by or has accrued to or in favour of a child; or has been expended for the maintenance, education or benefit of a child; or it has been accumulated for the benefit of a child. The child of the parent who made the donation. Section 7(4), in turn, applies when an amount of income was received by or has accrued to or in favour of any minor child or stepchild of any person.

Paragraph 68, requires a capital gain, arising for the disposal of an asset, which capital gain then has vested in or is treated as having vested in or that has been used for the benefit of that child.

Both section 7(3), and section 7(4)(1), uses the phrase “by reason of”. Paragraph 69 refers to a capital gain which can be attributed wholly or partly to (the donation).

The purpose of paragraph 69 was explained[58] as follows:

> *“This rule mirrors the rule embodied in section 7(3) and 7(4) in terms of which income received by, accruing to or in favour of or expended for the benefit of a minor is in certain circumstances deemed to be that of a parent of that minor. Any amount of a minor child's capital gain or of a capital gain that has vested in or is treated as having vested in that child during the year in which it arose and that is attributable to a donation, settlement or other disposition made by a parent of that child, is treated as the capital gain of that parent. This rule also applies where the gain is attributable to a donation, settlement or other disposition made by another person in return for some donation, settlement or other disposition or some other consideration made or given by a parent of that child in favour, directly or indirectly, of that person or his or her family.*
>
> *Note: nothing hangs on the fact that the explanation makes no reference to a capital gain “that has been used for the benefit of that child.”*

4.5.6.4 Section 7(3) example

Facts

An individual created a family trust by making a donation of R1 million to the trust. The trustees accepted the donation, and as was required in terms of the trust deed placed this trust property in an income fund (bonds), at a South African financial institution. The interest on the investment is paid out monthly to the trust by the financial institution.

The beneficiaries of the trust are the grandchildren of the founder (the children of the founder’s child – TWV senior). The beneficiary clause, in the trust deed of the family trust, reads as follows:

> *“The “beneficiaries” mean TWV (junior), RMV and the lawful descendants of TVW (senior).*
> *The income of the trusts shall be applied by the trustees in such amounts and in such manner, for the benefit of the children and for their maintenance, well-being, education, upbringing and reasonable pleasures, as the trustees may determine in their absolute discretion.*
>
> *According to another clause in the trust deed, the phrase “maintenance, education and advancement of life” shall be interpreted in the widest sense wherever it appears in this Trust Deed so as to include for example, attendance at schools, colleges, finishing schools and universities anywhere in the world.”*

[58] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001

TWV (senior) is the son of the founder of the trust, and also the parent of TWV (junior) and RMV, both of them will only reach the age of 18 years after two years (from the current year of assessment).

TWV (senior) sold a rental producing property to the trust. The full purchase price of the property was left outstanding on a loan account and TWV (senior) also paid the transfer duty which was also credited to his loan account in the trust. The loan account does not carry any interest and is repayable after TWV (senior) gave 12 months' notice requiring repayment, to the trustees.

The transaction for the current year of assessment that ended on the last day of February, are as follows:

	Interest on bond	Rental
Receipts (accruals) during the year of assessment	90 000	120 000
Expenses incurred to produce the rental income, including insurance, property rate and taxes.		28 000
	90 000	92 000
Amounts incurred in respect of the two children (beneficiaries) school fees: TWV (junior) RMV	 45 000 45 000	 46 000 46 000

<u>Note</u>

In the year the donation was made, the founder would have had to declare the value of the donation and would have paid donations tax on the cumulative value of donations made by that person during the year of assessment, less the annual exemption.

With respect to the interest free loan, TWV senior would have been deemed to have made a donation under section 7C and would annually (as long as it remained unpaid by the trust) have had to pay donations tax on the cumulative value of that deemed donation, less the annual exemption. The payment of the donations tax is required to be made by the end of March following the last day of the year of assessment under consideration.

Requesting the ITR12T

Returns Issued

Income Tax
(ITR14/ITR12T/IT12EI)

Completing the ITR12T

Question	Answer
Was any local amount(s) distributed to the Trust / vested in the Trust as a beneficiary of another Trust or deemed to have accrued in terms of s7 during this year of assessment?	No
Was any local amount(s) received by and / or accrued to the trust during the year of assessment? (excluding amount(s) vested from other Trust(s))	Yes

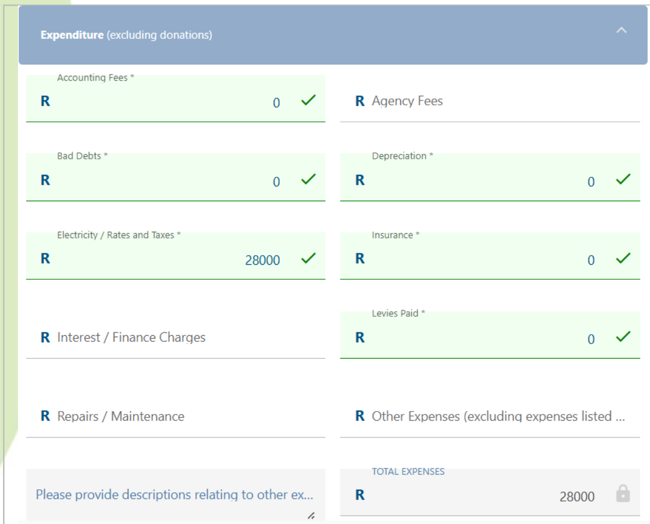
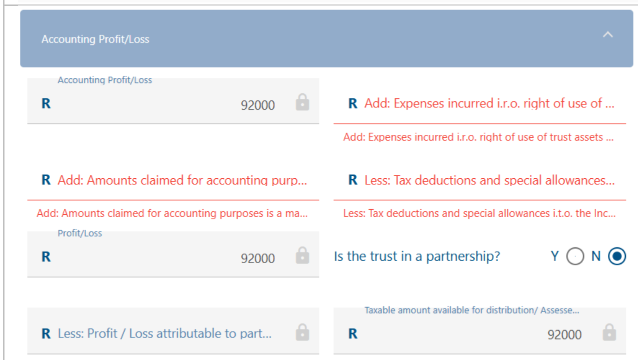
Indicate the type of local amount(s) received / accrued to the trust: • Interest (excluding SARS interest) • Local Rental Income from letting of Fixed Property	 Yes Yes

Completing the ITR12T:

<u>Income</u>

Question	Answer
Was any local amount(s) received by and / or accrued to the trust during the year of assessment? (excluding amount(s) vested from other Trust(s)) Indicate the type of local amount(s) received / accrued to the trust: • Interest (excluding SARS interest)	Yes Yes

Local Amount(s) Received and / or Accrued Local Interest (excluding SARS Interest) Gross receipts and accruals (excluding local interest vested from other Trust(s)) * R 90000	Local Amount(s) Received and /or Accrued Interest (excluding SARS interest)	90 000
Total Gross receipts and accruals (including local interest vested from other Trust(s)) R 90000 Less: Allowable expenses attributable to local interest (excluding donations) * R 0 Taxable amount available for distribution/ assessed loss retained in trust R 90000 Less: Amount distributed to / vested in beneficiaries or taxable i.t.o. s7 * R 90000 Taxable in Trust R 0 Source Code 4201	Less: amount distributed to / vested in or taxable i.t.o. s7 Taxable in trust	90 000 Nil
Local Amount(s) Received and / or Accrued Local Rental Income from the Letting of Fixed Property Income Rental Income (excluding ... R 120000 Add: Aggregate local renta... R 0 Total Rental Income (inclu... R 120000	Local Rental Income from the Letting of Property	120 000

 Expenditure (excluding donations) Accounting Fees * R 0 R Agency Fees Bad Debts * R 0 Depreciation * R 0 Electricity / Rates and Taxes * R 28000 Insurance * R 0 R Interest / Finance Charges Levies Paid * R 0 R Repairs / Maintenance R Other Expenses (excluding expenses listed ... Please provide descriptions relating to other ex... TOTAL EXPENSES R 28000	Expenses incurred to produce the rental income: insurance, Rates and taxes. For purposes of the example, it is not necessary to go in too much detail of the expenses. See example of an assessment for more detailed expenses.	 14 000 12 000
 Accounting Profit/Loss Accounting Profit/Loss R 92000 R Add: Expenses incurred i.r.o. right of use of ... Add: Expenses incurred i.r.o. right of use of trust assets ... R Add: Amounts claimed for accounting purp... Add: Amounts claimed for accounting purposes is a ma... R Less: Tax deductions and special allowances... Less: Tax deductions and special allowances i.t.o. the Inc... Profit/Loss R 92000 Is the trust in a partnership? Y N R Less: Profit / Loss attributable to part... Taxable amount available for distribution/ Assesse... R 92000	Accounting profit Taxable amount available for distribution	92 000 92 000

The following facts are relevant to the disposal of an asset by the trust:
TWV (senior) sold a rental producing property to the trust. The full purchase price of the property, of R5 million, was left outstanding on a loan account. TWV (senior) also paid the transfer duty which was also credited to his loan account in the trust (this amounted to R366 000) and other transfer costs of R60 000. The loan account does not carry any interest and is repayable after TWV (senior) gave 12 months' notice requiring repayment, to the trustees.

The trustees of the trust received a good offer and disposed of this building for R6 million.

In terms of the trust deed, the trustees, acting within their discretionary powers, vested the capital gain in the beneficiaries. This was done in order to pay for their school fees and education, until a replacement building was acquired, and rental income derived therefrom.

The steps are different now, essentially there was a disposal by the trust of an asset held by it, and the capital gain arising from that disposal was attributed to the donation made by TWV (senior).

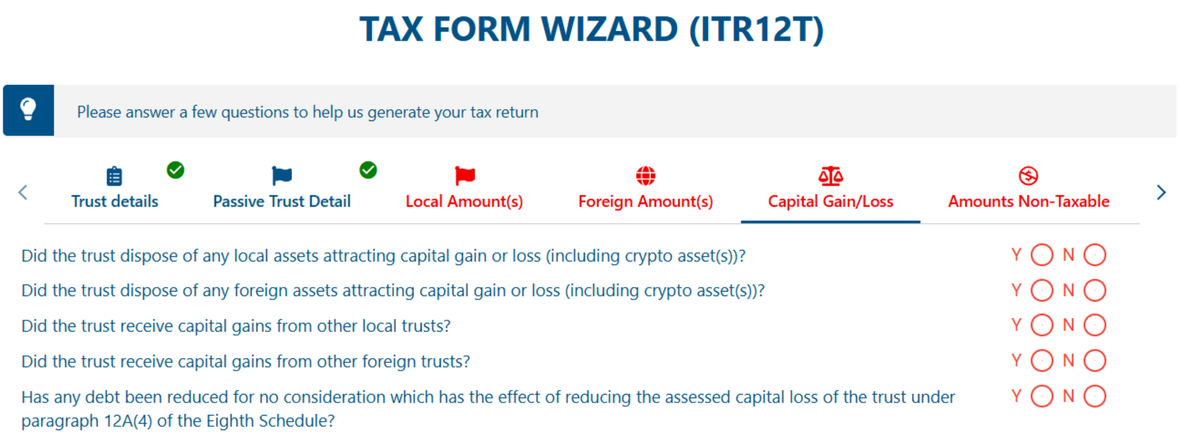
<u>The calculation of the capital gain</u>
The base cost of the asset, to the trust, is the market value at the time it was acquired from TWV (senior). Because the trust, and TWV (senior), are connected persons in relation to each other,

paragraph 38 of the Eighth Schedule applies, and the value at which the acquisition transaction took place, is the market value of the asset at the time the donation took effect.

Note: TWV (senior) would have used the same market value when the recoupment, if any, and the capital gain resulting from the disposal to the trust was calculated. And this same value is the base cost of the trust.

Description	Notes	Amount (ZAR)
Proceeds The amount that accrued to the trust on the sale of the building.	Paragraph 35(1) of the Eighth Schedule The trust did not qualify for a section 6quin allowance – building was not new and unused when it was acquired from TWV (senior)	R6 000 000
Base cost Cost of acquisition	Paragraph 20(1)(a), read with paragraph 38(1)(b)	5 000 000
Expenditure incurred, by the trust, directly related to the acquisition of the asset • transfer costs • transfer duty	Paragraph 20(1)(c)(ii) Paragraph 20(1)(c)(iii)	60 000 366 000
Total base cost		5 426 000
Capital gain		574 000

Declaring the capital gain in the ITR12T



In completing the return with respect to the capital gain:
Answer the following question, under the heading "Capital Gain / Loss):

Did the trust dispose of any local assets attracting capital gain or loss (including crypto asset(s))?

Once the question is answered by ticking the "Y", a container opens, and the number of assets disposed of must be captured there. In this instance, there was only 1 asset, therefore a "1".

The next question that must be answered is:

Specify the number of persons or beneficiaries who during this year of assessment participated in any one or more of the following:

The answer is 3, the two minor children, and then the donor.

Number 3

Is taxable on income/ capital gains distributed to / vested in beneficiaries or taxable i.t.o. s7 or par 68 - 72 of the Eight Schedule

There of course is just one capital gain, and it is completed as follows:

Local Capital Gain Loss 1

Note: The annual exclusion and inclusion rate and carry forward losses will be calculated by SARS.

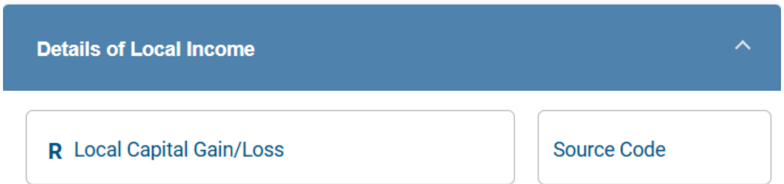
Proceeds *	R	6000000
Base Cost *	R	5426000
Exclusion / Rollover *	R	0
Capital Gain / Loss	R	574000
Capital Gain / Loss	R	574000
Add: Clogged loss included in amounts listed above to be carried forward (par. 39 of ...	R	0
Less: Prior year clogged loss brought forward and deductible from the capital gain list...	R	0
Less: Aggregate amount of capital loss vested in this trust due to a disposal of an ass...	R	0
Capital Gain available for distribution / Capital Loss retained in trust	R	574000
Less: Amount distributed to / vested in beneficiaries or taxable i.t.o. of par. 68 –72 of t...	R	574000
Taxable in Trust (vested in foreign beneficiaries) *	R	0
Taxable in Trust (not vested in beneficiaries)	R	0

		Notes
Local Capital Gain Loss 1		
Note: The annual exclusion and inclusion rate and carried forward losses will be calculated by SARS		
Proceeds	6 000 000	
Base Cost	5 426 000	
Exclusion / Rollover		
Capital gain / loss	574 000	This amount is automatically calculated (eFiling)
Capital gain available for distribution	574 000	This amount is automatically captured by the system after reducing the capital gain above, with a “clogged loss” (or the aggregate of clogged losses).
Less amount distributed to / vested in beneficiaries or taxable i.t.o of (*sic*) par. 68 – 72 of the Eighth Schedule	574 000	
The amount of the capital gain that must be disregarded when determining the child’s aggregate capital gain:	276 000	This amount must be taken into account when the aggregate capital gain of the parent is determined. It is limited, in terms of paragraph 73 – the benefit received from the donation R92 000 times 3 = R276 000.
		Trust held the property for three full years, and the net rental income was the same in all three years.
Amount vested: R574 000 But attributed to parents R276 000	298 000	This of course will be equally split between the two minor children. They will each qualify for the annual exclusion of R40 000 and their inclusion rate will be 40%.

In the return of income of the donor:
The R276 000 is accounted for as follows in the donor parent’s return of income (the ITR12):

> Was any income distributed to you / vested in you as a beneficiary of a trust, or deemed to have accrued in terms of s7?
> Indicate the number of trust(s) applicable?

And the donor parent will answer “yes” and capture a “1” in the container on the return.



The capital gain, attributed to the donor, of R276 000, is captured here. It will be added to the other taxable capital gains or losses from actual disposals by the parent (if any), and the resultant taxable capital gain will then be included in the parent's taxable income and taxed.

The donor must not, with respect to this gain attributed to him or her, answer the question relating to a disposal of an asset.

4.5.7 Section 7(5)

4.5.7.1 Legislation

It is necessary to start with the reason for the introduction of section 7(5) into the Act. Clause 9, of the 1966 Amendment Act, dealt with "Donations, Settlements and Other Dispositions", and the following extract is copied from the Explanatory Memorandum on the Income Tax Bill, 1966:

> "*The provisions of section 7 (5) are <u>designed to prevent tax avoidance</u> by means of a donation, settlement or other disposition of assets made so as to divest the person making the donation, settlement or other disposition of his right to the income from such assets and at the same time to withhold such income from the beneficiaries until the happening of some event.*
>
> *The amendment is framed to close a loophole by making it clear that section 7 (5) applies whether the stipulation or condition for the withholding of the income from the beneficiaries was made or imposed directly by the person making the donation, settlement or other disposition or by some third person*."

Section 7(5), in the first instance, is a specific anti-tax-avoidance provision. It reads as follows:

> *"If any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of any income as would, but for such stipulation or condition, in consequence of the donation, settlement or other disposition be received by or accrue to or in favour of the beneficiaries, shall, until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person*."

Comment with respect to "*any person*", and "*by such person or anybody else".*

As is explained in the 1966 Explanatory Memorandum, it can be "some third person", some person other than the person who made the donation, settlement, or other disposition. It is submitted that the intention of section 7 was to prevent taxable income from being moved to another person, such as a minor child or a spouse, for purposes of getting a tax benefit. Section 7(3) will apply where the donation was made by a parent of the minor child, and section 7(2) when made by a spouse. In both instances, the income was in actual fact received by the minor child, or the spouse, and not retained in the trust.

Section 7(5)[59] applies when the income is retained in the trust and was not vested in the beneficiaries.

Example of the stipulation or clause in a trust deed:

[59] Section 9(5), in an older Income Tax Act, was similar to the current section 7(5), other than the addition that was made to section 7(5) in 1966.

Paragraph (a)(i) of clause 2 provides[60]:

> 'THIS Trust shall determine with regard to all the following taking place:–
> (aa) the death of the DONOR; and
> (bb) the death of the DONOR's wife, MILLICENT SIDLEY (born GOLDBERG);
> (cc) the attainment by the DONEE of the age of thirty (30) years;

According to Judge Kotzé

> *"The instant case is clearly one in which, but for the stipulation or condition to which the deeds of donation are subject, the income withheld during the years of assessment ended 28 February 1971 and 29 February 1972 would have been received by or accrued to or in favour of the donees."*

With respect to the example, the right question to ask, as far as section 7(5) is concerned, is whether the income, the amounts distributed by the REIT to the trust, would have accrued to the beneficiaries if it was not subject to the decision of trustees.

That decision, or the trust deed, created a suspensive condition, which if not so, there would have been an accrual to the beneficiaries.

According to Judge Corbett[61]:

> *"As has been pointed out in many of the previous cases dealing with the South African legislation, upon analysis s 9(5)[62] first of all contemplates a hypothesis and, secondly, provides for a deemed devolution of income. In the case of donations, the hypothesis is that the deed of donation contains a stipulation to the effect that the beneficiaries thereof or some of them shall not receive the income thereunder, or some portion thereof, until the happening of some event, whether fixed or contingent. If it does, then (and here I ignore the case of income deemed to accrue or to be received) so much of any income as would in consequence of the donation, but for the stipulation, be received by or accrue to or in favour of the beneficiaries is deemed to be the income of the donor until the happening of the event or the death of the donor, whichever first takes place. It would seem that the mischief which the subsection is designed to combat is a certain type of tax avoidance. Generally speaking, a taxpayer is perfectly entitled to reduce the amount of his income, and thereby the income tax payable, by giving away income producing assets owned by him."*

It is interesting to note that, currently, there would be no loss to the fiscus as the rate of tax is 45%, which is the same as the maximum marginal rate of tax payable by a natural person. By taxing the income in the hands of the donor, the fiscus actually gets less tax (because of the progressive rate of tax applying to a natural person (and the rebates), the average rate of tax only approaches 45%).

4.5.7.2 Example – section 7(5)

A founder created a trust by way of a donation of property to the trust. The beneficiaries of the trust have discretionary rights to the income, or capital of the trust. A third party, not the founder of the trust, advanced an interest free loan to the trustees to acquire a rental-earning property.

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60 Secretary for Inland Revenue v Sidley (39 SATC 153)
61 In Estate Dempers v Secretary for Inland Revenue (39 SATC 95)
62 Section 9(5), in an older Income Tax Act, was similar to the current section 7(5), other than the addition that was made to section 7(5) in 1966.

The interest-free loan, as was explained earlier, will constitute a donation, settlement or other disposition, and section 7 would apply to it. It is the third-party person who is, for purpose of section 7, the donor, and made a donation.

The fact that the beneficiaries, by reason of the trust deed, and which conditions were imposed by someone other than the donor, will not be entitled to the benefit of the income, will result in that the income being deemed to be that of the person who made the donation, settlement or other disposition (and not the other person, or the founder of the trust). If the trustees were to exercise their discretion, or act within their mandate obtained from the trust deed, and vest an amount in the beneficiaries, then the event happened, and the income would be deemed to be that of the beneficiaries. Put differently, section 7(5) would then not apply, and the income would not be deemed to have accrued to the donor. Section 25B(2) (read with section 25B(1)) will then apply, and the beneficiary will be taxed.

Section 7(5) would therefore apply when the income is retained in the trust. To the extent that section 7(5) applies, to the income which was (during a year of assessment) retained in the trust, the trust will not be taxed, but the donor will be taxed. This is because there was a stipulation or condition, contained in the trust deed, to the effect that the beneficiaries of the trust (or some of them) will not receive the income or some portion of the income thereunder until the happening of some event – the event in this instance, the exercise by the trustees of their discretion. And in this respect, it matters not whether the stipulation or condition was made or imposed by the donor or anybody else, such as the founder of the trust.

<u>The facts:</u>
<u>Extract from trust deed</u>:
Clause 25 of the deed read:

> *"25. ALL nett income accruing from the assets in the TRUST from time to time shall be utilised and devoted by the TRUSTEES for the maintenance, support, education and reasonable pleasures of the DONEE or other beneficiary, but the TRUSTEES shall have the power, in their absolute discretion, to withhold the whole or any portion of the income and such income or portion thereof so withheld shall be added to the capital and re-invested."*

<u>The transactions:</u>
A family trust was set up by the grandfather of the children who are beneficiaries of the trust. The parent of the children (who are not minors) advanced on loan account, an amount of R1 million to the trust, which the trustees used to invest in a REIT. In terms of the arrangement, the loan is interest free, and there are no fixed terms of repayment of the loan.

For purposes of the example, the trustees, when the investment was made, took a decision that the income earned on this investment, will NOT be vested in the beneficiaries of the trust, until the loan is repaid. And that the amount of the (net) distributions made by the REIT to the trust, must be used by the trustees to make repayments of the capital outstanding on the loan from time to time.

Notes:

- The above is often done where the underlying investment is in shares held by the trustees in a company, resident in the RSA. Because the dividends, other than distributions by a REIT, are free from the normal tax, the full amount received, of course net of the dividends tax, can then be used to repay the loan.

- It is irrelevant, for purposes of the example, why the trustees decided not to vest the income in the beneficiaries, but to rather use that to reduce the amount owing to the parent of the beneficiaries.
- The fact that the distributions, or income, is used to repay the loan, does not constitute a vesting of the income in the founder of the trust. That would be so, even if the founder was a beneficiary of the trust with a contingent interest in the income of the trust.

Application of the law to the facts:

Step 1:

Factually, there was a receipt, or an accrual, by the trustees for the benefit of the beneficiaries of the trust (of the amounts distributed to the trust by the REIT during the year of assessment).

Step 2:

The beneficiaries, in the year of assessment, did not benefit from the trust (at least not from these amounts). If a beneficiary in a subsequent year of assessment, becomes entitled to the income added to the trust capital it will be a vesting of money (see this discussion about this earlier in this guide).

There was no disposal of an asset by the trustees, and the amounts are not capital in nature.

Step 3:

So, the next step involves determining whether there was a donation, settlement or other disposition to the trust. And if so, to then determine if the amount of "income" was derived by reason of a donation, settlement or other disposition.

For the same reasons as provided earlier, because the acquisition of the asset, that gives rise to the income, was funded by an interest free loan, there indeed would be a donation, settlement or other disposition as envisaged by section 7(5).

The beneficiaries did not have a vested right to the income (on receipt by the trustees), and the trustees did not, during the year, decide to vest any of this income in the beneficiaries. This is in terms of the trust deed, that the trustees decided to *"withhold the whole or any portion of the income and such income or portion thereof so withheld shall be added to the capital and re-invested".* The *"whole or portion of the income"* being the amount distributed by the REIT.

One would expect that the trust would be taxed on this income. However, the trust will not be taxed on this income (so retained in the trust). It would rather be the donor, who would be taxed. This is because the income was attributed to a donation, settlement or other disposition, and was withheld in terms of the stipulation or condition.

The enquiry stops here, and the trust, or any of the beneficiaries of the trust will not be taxed on the amounts distributed by the REIT.

With respect to the income retained in the trust, and the beneficiaries of the trust, it cannot be said that section 7(1) applies, because the income did not accrue to them (because of the suspensive condition).

What about capital gains?

It is paragraph 67, of the Eighth Schedule to the Act, that mirrors section 7(5), is copied below:

70. Attribution of capital gain subject to conditional vesting

"Where –

(a) a person has made a donation, settlement or other disposition that is subject to a stipulation or condition imposed by that person or anyone else in terms of which a capital gain or a portion of any capital gain attributable to that donation, settlement or other disposition shall not vest in the beneficiaries of that donation, settlement or other disposition or some of those beneficiaries until the happening of some fixed or contingent event;

(b) a capital gain that is attributable to that donation, settlement or other disposition has arisen during a year of assessment throughout which the person who made that donation, settlement or other disposition has been a resident; and

(c) that capital gain or a portion thereof has not vested during that year in any beneficiary who is a resident,

that capital gain or that portion thereof must be taken into account in determining the aggregate capital gain or aggregate capital loss of the person who made that donation, settlement or other disposition and disregarded when determining the aggregate capital gain or aggregate capital loss of any other person."

The important principle that follows from the attribution to the donor of capital gain rules, is that the amount of the capital gain that must be attributed to the donor will always be reduced by the income that was deemed, in terms of any of the subsection to section 7, to be that of the donor.

The similarities:
Both section 7(5) and paragraph 70 will apply

- where the income or capital gain is attributable to a donation, settlement or other disposition
- when the entitlement of a beneficiary is subject to a stipulation or condition
- which was imposed by a person (the donor) or anyone else
- and in terms of which the income has not accrued to, or a capital gain has not vested in the beneficiary.

The is a significant difference between section 7(5) and paragraph 70. Section 7(5) makes no reference to the resident status of the person who may, if not for the condition, have benefitted from the income.

Paragraph 70 however, requires specifically that *"that capital gain or a portion thereof has not vested during that year in any beneficiary who is a resident"*.

Paragraph 72, of the Eighth Schedule, deals with instances where the capital gain is vested in a beneficiary who is not tax resident in the RSA and this aspect will be dealt with later on in this guide.

The conclusion here is that, if the capital gain that arose from a disposal of an asset of a trust, was retained in the trust, and this capital gain is attributable to a donation, then the capital gain (that could have been vested in RSA resident beneficiaries) would be attributed to the donor.

Paragraph 72 does not, as does section 7(5), contain the phrase "*or the death of the that person*" (that person being the donor).

Where the asset produced income, and that income was deemed (in terms of section 7(5)) to have accrued to the donor, the full capital gain will not be attributed. It is explained as follows in the SARS guide[63]:

> *"When an asset acquired by the trust is funded by a low or interest-free loan, the amount of the capital gain to be attributed to the donor (the lender) under para 70 is limited to the benefit derived by the trust. This benefit is the difference between the interest that the trust actually paid and the interest that the trust would have paid had it borrowed the funds from a third party on an arm's length basis. But when the acquisition of the asset is funded by a donation, there is no limit on the amount of the capital gain that can be attributed to the donor."*

Paragraph 73, of the Eighth Schedule, that limits the capital gain that can be attributed to the donor.

The following example deals with an instance where section 7(5) did not apply, but the capital gain is attributed to a donor.

4.5.7.3 Example – paragraph 72

The facts:
The founder of a trust donated undeveloped immovable property to a trust. No income accrued to the trust in respect of this immovable property.

The terms of the trust deed, and the condition:

> The trustees shall have the right, if they in their sole and absolute discretion deem it necessary, to apply and utilize any portion of the capital of the trusts towards the purposes set out in 11.1, for the benefit of the child for whom the trust has been established and should they in their discretion deem fit, for the benefit of any of the other children, should circumstances in their opinion so warrant[64].

The trustees of the trust disposed of this immovable property and decided to utilise the amount so received, to acquire a rent producing property in its place. The trustees therefore did not decide, as their discretionary mandate allows them to do, to apply the trust capital for the benefit of the beneficiary and did not vest the capital gain, resulting from the disposal, in the beneficiary.

With respect to the steps to be followed:
Step 1: there was a receipt of proceeds in respect of the disposal of an asset by the trustees.
Step 2: the trustees made no distribution to the beneficiary of the trust.
Step 3: the capital gain arising in the trust was attributable to a donation.

In this instance, the right of the beneficiary was conditional and in terms of paragraph 70 of the Eighth Schedule, the capital gain must be taken into account in determining the aggregate capital gain of the donor.

Completing the ITR12T of the trust (amounts just added for illustrative purposes):

Description	Notes	Amount (ZAR)

[63] Comprehensive Guide to Capital Gains Tax (Issue 9)
[64] The Abraham Krok Trust v SARS (58/10) [2010] ZASCA 153 (29 November 2010)

Proceeds (amount captured in the ITR12T)	Paragraph 35(1) of the Eighth Schedule - the amount that accrued to the trust on the sale of the immovable property	R6 426 000
Base cost Cost of acquisition	Paragraph 20(1)(a), read with paragraph 38(1)(b) – the market value of the asset at the time it was donated to the trust.	5 000 000
Expenditure incurred, by the trust, directly related to the acquisition of the asset • transfer costs • transfer duty	Paragraph 20(1)(c)(ii) Paragraph 20(1)(c)(iii)	60 000 366 000
	The trust did not incur any expenditure directly related to the disposal of the asset	
Total base cost (amount captured in the ITR12T)		5 426 000
Capital gain		1 000 000
Less amount ... taxable i.t.o of (*sic*) par. 68 – 72 of the Eighth Schedule		1 000 000

This amount must be added to the aggregate capital gain of the donor.

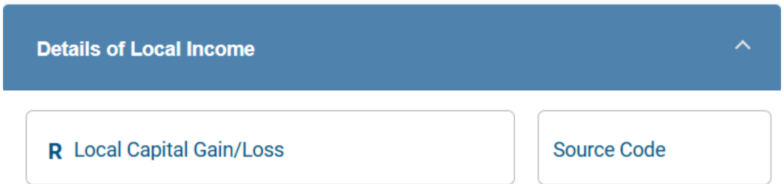
In the return of income of the donor:

The R276 000 is accounted for as follows in the donor parent's return of income (the ITR12):

Was any income distributed to you / vested in you as a beneficiary of a trust, or deemed to have accrued in terms of s7?

Indicate the number of trust(s) applicable?

And the donor parent will answer "yes" and capture a "1" in the container on the return.



The capital gain, attributed to the donor, the R276 000, is captured here. It will be added to the other taxable capital gains or losses from actual disposals by the parent (if any), and the resultant taxable capital will then be included in the parent's taxable income and taxed.

The donor must not, with respect to this gain attributed to him or her, answer the question relating to a disposal of an asset.

4.5.8 Section 7(6) and 7(7)

The two subsections are dealt with together.

4.5.8.1 Section 7(6)

Section 7(6)reads as follows:

> *"If any deed of donation, settlement or other disposition contains any stipulation that the right to receive any income thereby conferred may, under powers retained by the person by whom that right is conferred, <u>be revoked or conferred</u> upon another, so much of any income as in consequence of the donation, settlement or other disposition is received by or accrues to or in favour of the person on whom that right is conferred, shall be deemed to be the income of the person by whom it is conferred, so long as he retains those powers*."

Relevant to trusts, and the beneficiaries of the trust, section 7(6) is another instance where the income was actually vested in the beneficiary of a trust, but the beneficiary will not be taxed on that income.

The capital gain equivalent of section 7(6) is found in paragraph 71.

Attribution of capital gain subject to revocable vesting

> *"Where –*
>
> *(a) a deed of donation, settlement or other disposition confers a right upon a beneficiary thereof who is a resident to receive a capital gain attributable to that donation, settlement or other disposition or any portion of that gain;*
>
> *(b) <u>that right may be revoked or conferred</u> upon another by the person who conferred it; and*
>
> *(c) a capital gain attributable to that donation, settlement or other disposition or a portion of that gain has in terms of that right vested in that beneficiary during a year of assessment throughout which the person who conferred that right has been a resident and has retained the power to revoke that right,*
>
> *that capital gain or that portion thereof must be disregarded when determining the aggregate capital gain or aggregate capital loss of that beneficiary and be taken into account when determining the aggregate capital gain or aggregate capital loss of the person retaining the power of revocation*."

The similarities between the two provisions are:

- the trust deed contains a stipulation that the right of the beneficiary to income, or a capital gain, may be revoked or conferred on another person;
- the income or capital gain is attributable to a donation; and
- the income or capital gain was conferred on a person.

The use of the word "may" in both, is important. In this respect, the comment by SARS, in their capital is very appropriate:

> *"It is irrelevant that the vesting was revoked in the subsequent year of assessment. Attribution occurs because the trustee has the power to revoke the vested right. Whether that power is exercised is irrelevant."*

As with the conditional vesting, paragraph 71 also requires the person on whom the right is conferred, to be *"a beneficiary thereof who is a resident"* of the RSA. See the comments about that above.

Accounting for this in the ITR12T and ITR12 of the donor:
The income, or capital gain, is declared in the ITR12T, and then deducted as amounts which is "taxable" in terms of "par. 68 – 72 of the Eighth Schedule". The trust is therefore tax neutral, and the donor must account for these amounts as income, or a capital gain which must added to the aggregate capital gain of the donor.

Paragraph 73 would of course also apply here and limit the capital gain that can be attributed, with the amounts of income that was deemed to have accrued to the donor in terms of section 7(6).

4.5.8.2 Section 7(7)

> *"If by reason of any donation, settlement or other disposition made, whether before or after the commencement of this Act, by any person (hereinafter referred to as the donor) –*
>
> *(a) the donor's right to receive or have paid to him or for his benefit any amount by way of rent, dividend, foreign dividend, interest, royalty or similar income in respect of any movable or immovable property (including without limiting the foregoing any lease, company share, marketable security, deposit, loan, copyright, design or trade mark) or in respect of the use of, or the granting of permission to use, such property, <u>is ceded or otherwise</u> made over to any other person or to a third party for that other person's benefit in such manner that the donor remains the owner of or retains an interest in the said property or if the said property or interest is transferred, delivered or made over to the said other person or to a third party for the said other person's benefit, in such manner that the donor is or will at a fixed or determinable time be entitled to regain ownership of or the interest in the said property; or*
>
> *(b) the donor's right to receive or have paid to him or for his benefit any income that is or may become due to him by any other person acting in a fiduciary capacity is ceded or otherwise made over to any other person or to a third party for that other person's benefit in such manner that the donor is or will at a determinable time be entitled to regain the said right,*
>
> *any such rent, dividend, foreign dividend, interest, royalty or income (including any amount which, but for this subsection, would have been exempt from tax in the hands of the said other person) as is received by or accrues to or for the benefit of the said other person on or after 1 July 1983 and which would otherwise, but for the said donation, settlement or other disposition, have been received by or have accrued to or for the benefit of the donor, shall be deemed to have been received by or to have accrued to the donor.*"

When section 7(7) was introduced into the Act, it was explained[65] as follows:

> *"When income is deemed to have accrued or to have been received: Insertion of new subsection (7) in section 7 of the principal Act*
>
> > *"This section contains inter alia provisions designed to counter tax avoidance schemes in terms of which a taxpayer may seek to transfer certain of his income to others without necessarily surrendering control over that income or, where the income in question is derived from investments, over those investments.*
> >
> > *A further type of scheme has recently come to light under which the taxpayer cedes certain rights to income to another person for a limited period. This is tantamount to the disposal of income after it has accrued to the taxpayer, but as the law is at present interpreted the*

[65] Explanatory Memorandum on the Income Tax Bill, 1983

income so made over to someone else cannot be taxed in the hands of the person making the disposition.

The new subsection to be added in terms of this clause will ensure that where a taxpayer makes over to some other person his right to receive income from movable or immovable property but retains ownership of, or his interest in, that property he will continue to be taxed on that income.

The subsection provides further that should the taxpayer go so far as to transfer the property in question to some other person, but retain the right to regain the property at some future date, the income will continue to be taxed in his hands. Similar rules in regard to the temporary cession of income arising from a fiduciary interest enjoyed by a taxpayer are also provided.

The new subsection is so worded that its provisions will come into operation on 1 July 1983. Subclause (2) provides that where a taxpayer is assessed to tax on an amount so deemed to be his income he may recover the tax payable on that amount from the person who actually received the amount."

It is necessary to also refer to section 103(5) of the Income Tax Act. It reads as follows:

"Where under any transaction, operation or scheme –

(a) any taxpayer has ceded the right to receive any amount in exchange for the right to receive any amount of dividends; and

(b) in consequence of that cession the liability for normal tax of the taxpayer or any other party to the transaction, operation or scheme, as determined before applying the provisions of this subsection, <u>has been reduced or extinguished</u>,

the Commissioner shall determine the liability for normal tax of the taxpayer and any other party to the transaction, operation or scheme as if that cession had not been effected."

Whilst section 7(7) requires a *"donation, settlement or other disposition"*, section 103(5) will apply if there was a session and there is a reduction (or extinguishing) of the liability to tax on the amounts.

When section 7(7) applies, the income that accrued to a trust, will be deemed to have accrued to the donor, or the person who effected the session. The donor accounts for it in his or her return of income.

The treatment in the trust, for both subsections, is the same as was explained in the previous subsections of section 7 – a "deduction" is made of the amounts of income that are deemed to have accrued to the donor and the trust, or the beneficiaries of the trust, will not be taxed on that income.

In the next paragraphs, the instances where a beneficiary of a trust will be taxed, will be discussed.

4.6 Amounts that vested in a beneficiary of a trust

4.6.1 General, or the starting point

The next relevant step, is step 5, which requires an answer to the following question:

Is the beneficiary of the trust a person who have, or who obtained, a vested right to "income" or a "capital gain" during the year of assessment, a resident of the RSA?

Note:
- If the beneficiary is a resident of the RSA (for tax purposes), the conduit pipe principle applies (colloquially speaking). The income, after making the allowable deduction, will then be taxed in the hands of the beneficiary. The trust will be a mere conduit, and to the extent that the income "flowed through" to the beneficiaries, there will not be any income tax consequences in the trust. The same applies to a capital gain.
- The above applies in respect of years of assessment commencing on or after 1 March 2024. Before that, the conduit pipe principle also applied to amounts of income vested in a non-resident beneficiary. The resident status of the beneficiary then was irrelevant with respect to income.
- The same does not apply to a capital gain. Since the inception of a tax on capital gains, capital gains vested in non-resident beneficiaries were taxed in the trust and there was no flow-through.

When will income, or a capital gain be taxed in the hands of the beneficiaries?
Following the step approach, when no amount of the income was deemed to have accrued to a donor. And the beneficiary then, is a resident of South Africa, has (or obtained) a vested right to the income that accrued to the trustees of the trust, or a capital arose from a disposal of an asset by the trustees which was vested in the resident beneficiary.

4.6.2 Amounts of income
4.6.2.1 Section 25B

If there was a receipt (or accrual) by the trustees, that was not of a capital nature, and section 7 does not apply (in other words, there was no donation, settlement or other disposition), then the only "person" that can be taxed, is a beneficiary of the trust or the trust itself.

This is in terms of section 25B(1), and section 25B(2) of the Act. For ease of reference, the two subsections are copied below:

25B. Taxation of trusts and beneficiaries of trusts

(1) *Any amount (other than an amount of a capital nature which is not included in gross income or an amount contemplated in paragraph 3B of the Second Schedule) received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary, who is a resident and has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.*

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

<u>Important note</u>:
This is the current wording in the Act, which came into operation on, and applies in respect of years of assessment commencing **on or after 1 March 2024**. The change related to the vesting of income in foreign beneficiaries will be dealt with later on in this guide. The position before 1 March 2024, was that there was a flow through to the foreign beneficiary which meant that the foreign beneficiary was treated exactly the same as the RSA resident beneficiary.

Before 1 March 2024, it was irrelevant if the beneficiary was not a resident of South Africa. With respect to amounts of income vested in such a beneficiary, the tax treatment would have been the same as for a beneficiary who is a resident of the RSA. And for years of assessment, what follows with respect to the disclosure in the ITR12T, and ITR12 of the individual, would have been the same.

It was already explained that section 25B does not apply if there was a donation and the income was attributed to the donor and the donor was taxed thereon. The Taxation Laws Amendment Act, 2020, added two further instances where section 25B will not apply. They are, where the receipt of accrual is

- an amount of a capital nature which is not included in gross income, or
- a lump sum benefit which becomes recoverable from a retirement fund[66] or an insurer[67]

if that lump sum benefit is payable by or provided in consequence of membership or past membership of a retirement fund in consequence of the termination of a trust an amount contemplated in paragraph 3B of the Second Schedule to the Act.

4.6.2.2 Amounts of a capital nature

The wording of section 25B(1) was provided in paragraph 3.5.2.1 above.

It follows from the addition of the phrase, "*other than an amount of a capital nature which is not included in gross income"*, to section 25B(1), that the accrual (or the receipt) of an amount which is gross income will be dealt with in section 25B, whereas paragraph 80 of the Eighth Schedule to the Act, will apply to a capital gain, resulting from the disposal of an asset of the trust, or the vesting of trust property in a beneficiary of a trust.

<u>An example</u>:

> A trust owned a building and had made a deduction in respect of the cost of acquisition of the building, in terms of section 13*quin* of the Act. If the trust were to dispose of the building, and were to realise a capital gain thereon, the trust would also have recouped the amount of allowance allowed as a deduction.
>
> If the trustees were to vest the amount recouped, as well as the capital gain, in the beneficiaries of the trust, section 25B will apply to the recoupment (being the amount that is capital in nature, but is included in gross income in terms of paragraph (n) of the definition, read with section 8(4)(a)), and paragraph 80(2) will apply to the capital gain.

There was a further reason for making this addition, which was explained[68] as follows:

> *"... some commentators have contended that section 25B(1) also applies to amounts of a capital nature (for example, proceeds on disposal of a capital asset). There is no substance in this contention because the Eighth Schedule contains specific provisions dealing with such amounts, but for the purposes of clarity it is proposed to exclude amounts of a capital nature that are not deemed to be included in gross income from the ambit of section 25B(1)."*

This issue was initially decided on in favour of a taxpayer in a Tax Court case, essentially on the basis that section 25B applied. SARS appealed the decision and the SCA held that section 25B does not

[66] a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund
[67] as defined in section 29A(1)
[68] in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2020 (20 January 2021)

apply, and that there was no flow through from the second trust to its beneficiaries. The trustees of the Thistle Trust referred the matter to the Constitutional Court, who heard the matter (in February 2024) and ruled on it in October 2024. The decision in the Constitutional Court essentially confirmed SARS's view relating to the vesting of capital gains in multiple trusts – refer to the part in this guide where this issue is discussed.

Where a trust disposed of an asset and a capital gain arose in a trust, and the gain was vested in a beneficiary of the trust, which beneficiary is also a trust, who then (or the trustees of which) in turn on-vested the capital gain in the beneficiaries of the (second) trust, then there will be no flow through and the capital gain will be taxed in the second trust. This will be discussed later on.

4.6.2.3 A lump sum benefit

It was explained that the amendment to section 25B(1)

- ... is a consequential amendment to the proposed amendment in the definition of "living annuity" in section 1 of the Act to make provision for the termination of a trust as the word "death" in the definition of "living annuity" is problematic as trusts cannot die but can only be terminated. Therefore, if the word "die" is only limited to the death of a natural person, there is an anomaly because a when trust that was initially nominated as the owner of a living annuity upon the death of the original annuitant is subsequently terminated, such trust is unable to make payments to its nominees.
- In addition, it is a consequential amendment to the proposed amendment regarding the insertion of paragraph 3B of the Second Schedule that makes provision for the amount to be taxable in the trust immediately prior to the date of termination of the trust.

It is outside the scope of this guide to deal with the above.

4.6.3 Amounts of income vested and distributed through multiple resident discretionary trusts

Capital gains
It's important to remember that there is a difference between section 25B and paragraph 80 of the Eighth Schedule. Paragraph 80, on the interpretation of SARS thereof, which interpretation was confirmed in the Constitutional Court, does not allow for a capital gain to flow-through to a beneficiary of another trust, in which the trustees of the trust in which the capital gain arose vested the capital gain and the trustees of the other trust then in turn vested that gain in its beneficiaries. It will be taxed in the trust (the other trust) in which the gain was vested.

The Thistle trust disputed SARS's view that the conduit principle does not apply when a capital gain, that arose in one trust, was vested in a second trust, and this trust in turn vested that capital gain in the beneficiaries of the second trust. The Thistle trust won the argument in the Tax Court, which decision SARS appealed against and won in the Supreme Court of appeal. The taxpayer, the Thistle trust, applied for permission to appeal the matter and this was heard by the Constitutional Court, and judgement was handed down on 2 October 2024[69].

Judge Chaskalson, writing for the majority, with respect to SARS's view, said the following:

[69] The Thistle Trust v Commissioner for the South African Revenue Service [2024] ZACC 19

"SARS submits that section 25B does not apply to capital gains, only to other income that is relevant for income tax purposes. It emphasises that section 25B was introduced into the ITA at a time when capital gains tax did not exist in South Africa and accordingly could not, originally, have been intended to apply to capital gains. Instead, section 26A and the Eighth Schedule to the ITA should be interpreted to make clear that all matters relating to the calculation of the taxable capital gain of a trust are to be determined in accordance with the Eighth Schedule."

The wording of section 25B, for the years of assessment in dispute, did not contain the "of a capital nature" that was added subsequently (and discussed above).
Judge Chaskalson made the following important remark about the conduit principle:

> *"In Rosen, the Appellate Division held that Armstrong did not merely interpret the relevant provisions of the Income Tax Act. Rather, it established the conduit principle as a common law principle applicable to the taxation of trusts and beneficiaries where appropriate, albeit one that was always subject to a contrary intention in the proper construction of the revenue statute."*

The important point there is that the conduit principle applied, unless there was *"a contrary intention in the proper construction of the revenue statute"*.

And added:

> *"A review of the Commonwealth and South African cases shows that the conduit principle was developed to address two separate issues in the context of tax statutes that did not address these issues directly. The first issue concerned the identification of the taxpayer who was liable to taxation on particular income – was it to be the trustee or the beneficiary? In that context, the conduit principle was used as a mechanism to ensure that income of a particular nature was taxed in the hands of its true beneficial owner."*

And,

> *"... absent a clear indication to the contrary in the ITA, "robust common sense" would militate against the application of the conduit principle to the capital gains distributed by a trust. This is because the legislature has chosen to tax the capital gains of a trust at twice the rate of those of an individual. Application of the conduit principle to treat capital gains that are distributed on a discretionary basis from a trust to a natural person as capital gains taxable in the hands of the natural person, not the trust, would appear to subvert the legislative intention of taxing capital gains realised by trusts at the higher rate.*
>
> *Application of the conduit principle to treat capital gains that are distributed on a discretionary basis from a trust to a natural person as capital gains taxable in the hands of the natural person, not the trust, would appear to subvert the legislative intention of taxing capital gains realised by trusts at the higher rate.*
>
> *When a taxation statute addressed either of these issues directly, the case no longer became an exercise in applying the conduit principle. Instead, it became an exercise in giving effect to the direct legislative intention expressed in the statute.*
>
> *In South Africa, the Income Tax Act of 1991 (1991 Act) represents a watershed in relation to the conduit principle. The 1991 Act, for the first time, introduced into the ITA provisions dealing specifically with the taxation of trusts. Since 1991, questions relating to the taxation of trusts and beneficiaries under the ITA have accordingly become questions of the interpretation of the*

relevant provisions of the ITA that deal directly with trusts and beneficiaries. Common law principles relating to the conduit principle may inform these questions of interpretation, particularly where the ITA does not expressly regulate the respective tax treatment of trusts and beneficiaries. However, the exercise remains primarily one of statutory interpretation."

It was in the abovementioned Act that the conduit principle was codified into the Act, and section 25B of the Act was introduced - see earlier discussion in this guide.

The judge then, in arriving at the judgement, said the following:

> *"... there are clear indications in the ITA that the application of the conduit principle to the taxation of capital gains in the hands of trusts and beneficiaries is governed not by section 25B, but by paragraph 80.*
>
> *If the Eighth Schedule said nothing about liability for the taxation of capital gains arising out of the disposal of assets by trusts, it would have been arguable that section 25B (as a specific provision addressing the conduit principle and the taxation of trusts) should govern the application of the conduit principle to the taxation of capital gains realised by the sale of assets by a trust.*
>
> *However, <u>paragraph 80 addresses itself pertinently to the conduit principle</u> and the liability for taxation on capital gains realised by the sale of assets by a trust. Therefore, it is the specific provision that applies. Paragraph 80 must have been included in the Eighth Schedule for some purpose. It cannot be interpreted as though everything that it provides is to be rendered irrelevant because the pre-existing deeming provision in section 25B overrides paragraph 80. Therefore, paragraph 80 governs how the conduit principle is to be applied to establish which taxpayer is liable for taxation on the capital gains realised by the sale of assets by a trust.*
>
> *... prior to the 2008 Amendment, paragraph 80(2) provided for the conduit principle to apply through multi-tiered trusts all the way to the ultimate beneficiaries. As we have seen above, following the 2008 Amendment, paragraph 80(2) prevented the conduit principle from operating beyond the first beneficiary trust in a multi-tiered trust structure.*
>
> *To sum up: the wording of paragraph 80(2) shows that the provision applies the conduit principle only to the first beneficiary trust in a multi-tiered trust structure. It is not reasonably possible to interpret paragraph 80(2) to allow the conduit principle to run through a multi-tiered trust structure to attribute liability for capital gains tax in respect of the disposal of an asset to a beneficiary beyond the first beneficiary of the trust that realised the capital gain by disposing of that asset. The legislative history of paragraph 80(2) and the 2008 memorandum both confirm that paragraph 80(2) was amended into its present form for the purpose of preventing the conduit principle operating through multiple discretionary trusts in a tiered trust structure. Paragraph 80(2) must be interpreted accordingly."*

In other words, where a trust, in which a capital gain was determined, vested that capital in a beneficiary of the trust, which beneficiary is also a trust, the capital gain will be taxed in that trust and cannot flow through to its (the second trust's) beneficiaries. The conduit pipe principle does not apply.

Income

The same does not apply when the amount is deemed to be that of the trust as beneficiary under section 25B. In essence then, section 25B doesn't have the same wording as the relevant paragraphs in the

Eighth Schedule and must be interpreted that the amount vested 'flows through to the ultimate beneficiary'.

In terms of section 25B(2), for instance, "*where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant deed of trust, agreement or will of a deceased person, that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary*." A beneficiary, in this respect will also include a trust (resident in the RSA) – the trust being a person who has a contingent interest in all or a portion of the receipts or accruals of a trust. To the extent to which that amount has been vested, it is deemed to have been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year.

In conclusion, the conduit applies where income, or a capital gain is vested in a beneficiary of the trust, if the beneficiary is a resident of the RSA. But if the resident beneficiary is a trust, then the capital gain stops there (so to speak) and cannot flow through to its ultimate beneficiaries.

Why does section 25B deal with a beneficiary who has a vested right in section 25B(1), and then with a discretionary beneficiary in section 25B(2).

4.6.4 Section 25B
4.6.4.1 Why section 25B(1) and also section 25B(2)?

It is important to note that section 25B applied (and still applies) separately to so-called discretionary trusts (in section 25B(2)) and to trusts where the beneficiaries have vested rights to capital or income of the trust (in section 25B(1). No indication was given (in the Explanatory Memorandum) why it was necessary to deal with beneficiaries with vested rights, in section 25B(1), or why section 25B(1) was required in the first place. It could well have been handled in one provision. The question is why section 25B dealt with beneficiaries with a vested right and other beneficiaries.

In a case that dealt with the Secondary Tax on Companies and loans from two companies to a trust, SARS argued[70] that *"the Legislature, when it came to taxing income, distinguished between the situation where trust beneficiaries have a vested right to income of a trust and the situation where they have no such right"*. With reference to SARS's argument, Judge Combrink writing for the minority, considered the distinction between sections 25B(1) and 25B(2), and said that

- section 25B(1)
    - does not characterise a person who does not have a vested right to income as a 'beneficiary'.
    - All it does is to confirm that income which is derived for the immediate or future benefit of the beneficiary with a vested right to such income accrues to such person.
    - Similarly, it distinguishes a situation where the income is deemed to accrue to a trust.
- Subsection (2) deals with the position where a person becomes a beneficiary as a consequence of the trustee exercising his discretion and confirms ... the established 'conduit pipe principle', namely that where income is awarded to a beneficiary by virtue of the exercise of the trustee's discretion in the same year in which the income arises, such income is regarded as accruing direct to such beneficiary.

[70] In CSARS v Airworld CC and Another 2008 (3) SA 335 (SCA)

Conclusion:
In conclusion, and for purpose of this guide, it is accepted that section 25B(1) deals with beneficiaries of trusts who have a vested right to the income of the trust. And section 25B(2) then applies where the beneficiaries did not have a vested right but obtained such a right following the exercise of a decision by the trustees of the trust to vest an amount of income in a beneficiary. It is very important to note, that the decision by the trustees must be taken in the year of assessment that the amount accrued to the trustees.

It is submitted that section 25B(1) will also apply to a beneficiary, who did not acquire a vested right following the exercise by a trustee of a discretion to vest an amount in him or her but acquired it in terms of the vesting clause in the trust deed during the current year of assessment.

Section 25B(1) and (2) are best explained by why of an example.

4.6.4.2 Example section 25B(1)

The first example deals with section 25B(1). A trust *mortis causa* is used in the example, to make it absolutely clear that section 7 does not apply.

Facts:
The relevant clauses in the trust deed:

3.2 The remainder of my estate to the trustee in trust of the P** B*** FAMILY TRUST which is hereby created. My trustee will be vested with the following powers, duties and trust assignments, namely: 3.2.1 To accept, control and administer any assets. 3.2.5 To transfer and pay out the net income to the testatrix until her death.

This is a trust *mortis causa*, and the wording is taken from the last will and testament of the deceased, which then constituted the trust deed. This was a joint will, with the two spouses being the testator and testatrix. The testatrix then, after death of the first-dying spouse, became a beneficiary of the trust *mortis causa*.

It is common to provide for the maintenance of the surviving spouse (after death of the other spouse), by creating a trust. For a number of reasons, it is better to make a bequest to an *inter vivos* trust, that was set up before date of death, to receive the property to fund the maintenance needs of the surviving spouse. And the surviving spouse will also have vested rights in such a trust. The point is that the tax consequences for the trust and the beneficiary (spouse), will be the same. Trusts are often created by order of Court where awards are made in claims for damages arising out of motor vehicle accidents where plaintiffs are minors or mentally incapacitated persons to protect the awards. And it is also common for the beneficiary to have a vested right to the income of the trust.

From the above, it is clear that the beneficiary, had a vested right to any income that accrued to the trust. Put differently, this was an unconditional right, and the trustees did not have a discretionary power in this respect. And furthermore, the trustees had to pay the net income to the beneficiary. The beneficiary therefore did not have a vested right to the amount received, but to the amount remaining after the expenses were deducted.

Further facts:
The facts, or detail of income and expenses, relating to the trust, and the amounts paid over to the spouse, during the current year of assessment, are as follows:

- The property bequeathed to the trust, and in respect of which income is derived, is immovable property. In terms of the lease agreement, the trustees (as registered owner of the property) will monthly receive an amount of rent. For the current year of assessment, the aggregate amount which accrued to the trust by way of rent, was R360 000.

The trustees incurred the administration costs (including trustees fees), paid insurance and municipal rates and taxes.

The fees payable to the trustees, are in respect of the services rendered by the trustees, not in an employment relationship. The trustees, in terms of the trust deed, were entitled to this, and it is calculated as a percentage of the rent collected. The idea was that it was payment for their services rendered to the trust with respect to the maintaining of the lease agreement, the collection of the monthly rent and the payment of the expenses related to the rental income. For the trustees, these fees are gross income. The trust would be entitled to make a deduction of the expenses – it was carrying on a trade[71]; the income (rental) was derived from that trade, and the purpose of incurring the expense was to produce the rental income (section 11(a)).

The trustees prepared the following summary of the transactions relating to the leasing activities:

Description	Amount
Income: rental	360 000
Expenses	
Electricity, rates and taxes	60 000
Insurance of the property	28 000
Other expenses: Bank charges Internet (banking and meetings of trustees) Trustees' remuneration	 200 1 000 36 000
Repairs	15 000
Net amount available for distribution	219 800

The trustees made payments, in total, of R219 800 to the beneficiary – the testatrix, before the end of February of the relevant year of assessment.

4.6.4.3 Completing the income tax return (the ITR12T) for the trust

The return requires the following information to be provided:

Questions related to the return itself

Income Tax Return for Trusts
(Income Tax Act, No. 58 of 1962, as amended)

- Is the Trust passive?
- Was any local amount(s) distributed to the Trust / vested in the Trust as a beneficiary of another Trust or deemed to have accrued in terms of s7 during this year of assessment?

[71] See the meaning of the word "trade", in section 1(1) of the Act.

Questions relating to the income derived by trustees

Was any local amount(s) distributed to the Trust / vested in the Trust as a beneficiary of another Trust or deemed to have accrued in terms of s7 during this year of assessment?

Was any local amount(s) received by and / or accrued to the trust during the year of assessment? (excluding amount(s) vested from other Trust(s))

Indicate the type of local amount(s) received / accrued to the trust:

- Remuneration
- Annuities
- Lump Sum Benefits Received or Accrued
- Interest (excluding SARS interest)
- SARS Interest
- Dividends deemed to be income in terms of s8E and s8EA
- Distribution from a Real Estate Investment Trust (REIT)
- Local Rental Income from letting of Fixed Property
- Business, trade (including crypto asset(s)) or professional income (excluding Rental Income from the letting of Fixed Property and Farming)
- Farming Income
- Other local income (excluding income listed above)

Detail related to the beneficiaries or donors

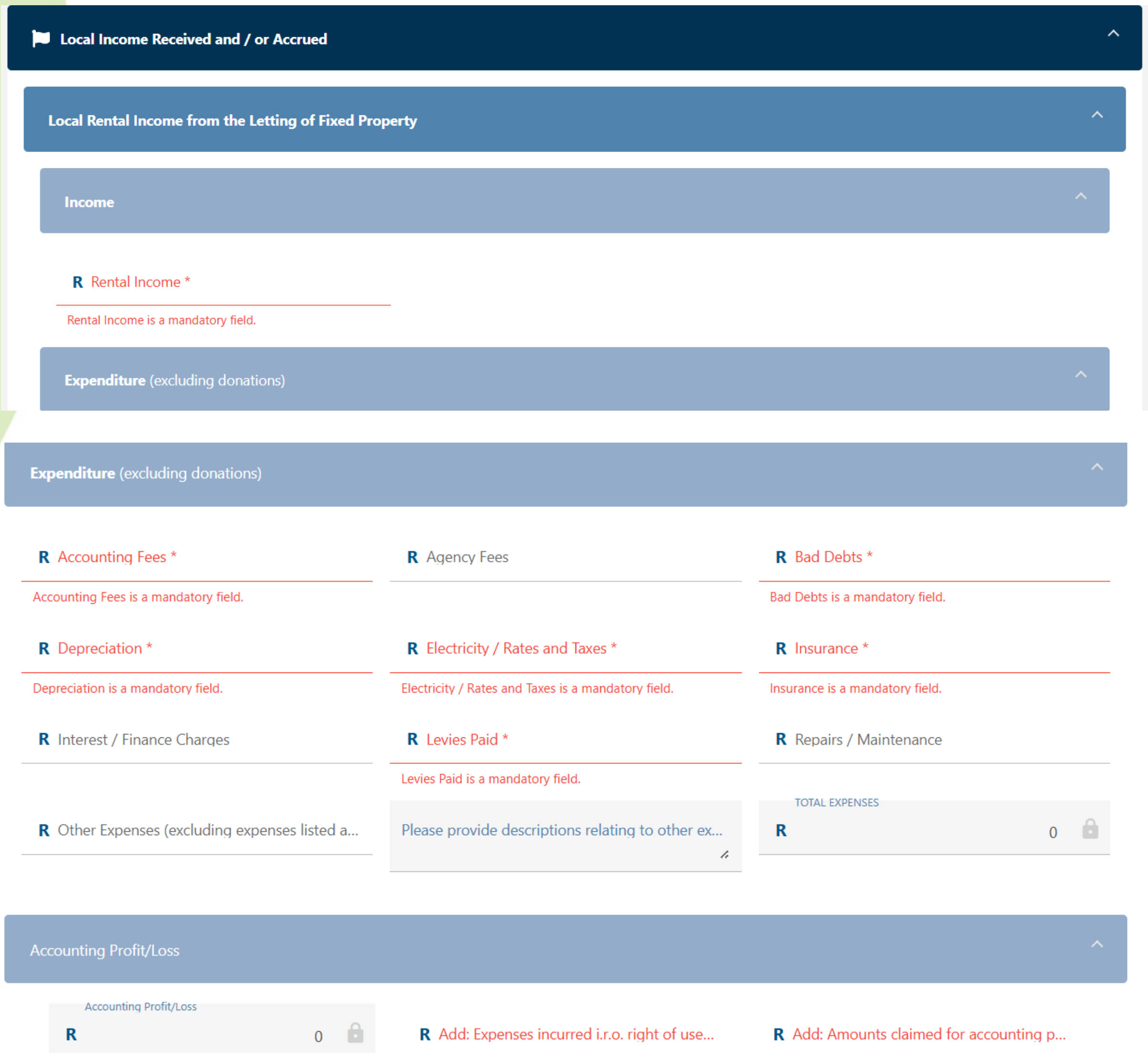
Specify the number of persons or beneficiaries who during this year of assessment participated in any one or more of the following:

Number *

Number is a mandatory field.

- Is taxable on income/ capital gains distributed to / vested in beneficiaries or taxable in terms of s7 or par 68 - 72 of the Eight Schedule
- Received a distribution / vesting of non-taxable income from this trust
- Received a distribution / vesting of capital or assets from this trust
- Had a loan agreement with the trust
- Made / Received donation(s) / contribution(s) to / from the trust
- Received distributions from other trusts of foundations
- Received a return of contribution(s) made to this trust
- Had the right of use of asset(s) retained in this trust

And then the following is opened in the return in order to capture the information. In this example the only source of income is rental. The form would be completed in exactly the same way for other income derived by the trustees for the benefit of the beneficiaries of the trust.



Following the step approach:

Steps	Comments
Step 1: Did the trustees, during a year of assessment, receive an amount?	Yes, the trustees received an amount of rental.
Step 2: Did trustees distribute cash (or money) to a beneficiary of the trust?	The answer is “no” – the amount vested and distributed will not be from the trust capital, but income which accrued during the year.
Step 3: Was the receipt of income derived by reason of a donation, settlement or other disposition?	No. The amount received was not attributable to a donation, etc. and section 7 does not apply.
Step 4: Did a beneficiary of the trust, who is a resident, during the year of assessment, have a vested right to the income, or acquired such a right	The answer is that the beneficiary, (or testatrix, or surviving spouse of the

following the exercise by the trustees of a discretion to vest the amount in the beneficiary.	founder) had a vested right to the income.

Conclusion:
Section 25B(1) applies and neither the donor, nor the trust can be taxed on the income. The trust is a pure conduit.

Completing the return:

Description	Notes	Amounts in ZAR
Income Rental income	In practice the trust may have earned interest, but for the sake of the example, the only income of this trust is the rental.	360 000
Accounting fees	This a mandatory field on the return, but let us assume that the trustees did not contract this out, and completed the accounting statements themselves (without any cost to the trust)	
Electricity, rates and taxes		60 000
Insurance		28 000
Repairs	Section 11(d)	15 000
Other expenses Bank charges Internet (banking and meetings of trustees)	Section 11(a)	200 1 000
Trustee's remuneration	At 10% of the gross rental but shared equally between the three trustees of the trust.	36 000
		219 800
Amounts paid to the beneficiary – in terms of clause 3.2.5 of the trust deed	It is assumed that the full net amount was paid out during the year, but that is irrelevant as the full net amount vested in the beneficiary during the year of assessment.	219 800
Taxable in the trust		Zero

Comments on the above (for purposes of completeness)
The rental receipts:
As was said already, section 25B(1) applies. This is an amount (other than an amount of a capital nature which is not included in gross income) received by or accrued to or in favour of the trustees of the trust, and the provisions of section 7 do not apply to that amount.

Consequently, to the extent to which an amount has been derived for the immediate or future benefit of any ascertained beneficiary, who is a resident and has a vested right to that amount during that year, that amount is deemed to be an amount which has accrued to that beneficiary. In this instance, it was the net amount that accrued to the beneficiary.

Expenses incurred by the beneficiaries

What is the position if the beneficiary was entitled to the full amount that was received by the beneficiary? And not to the net amount, as in this example?

Section 25B(3) deals with the deduction[72] that may be made, and it reads as follows:

> *"Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any amount referred to in subsection (1), must, to the extent to which that amount is under that subsection deemed to be an amount which has accrued to a beneficiary, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary*."

Applied to the example, as the total amount, or gross rental, received by the trustees during the year of assessment, did not vest in the beneficiary (the surviving spouse), the extent to which the beneficiary had a vested right, is to the amount after deducting the expenses.

With respect to the expenses incurred by the trustees, where the beneficiary's entitlement is not a net amount, as in this instance, the total rent would have been deemed to have accrued to the beneficiary (where the beneficiary had a vested right to the full rental accrual for the year). The beneficiary would then account for, or declare, the gross amount in his or her return of income, and would then, in terms of section 25B(3), also have been entitled to deduct the expenses incurred by the trustees.

At common law, the trustee actually is an agent for the beneficiaries, and should really account for it as a creditor, and debit expenses incurred to this account, as well as payments made to the beneficiary. In practice, trustees in the majority of the cases, actually account for this to the trustees, by way of an income statement, and then show the amounts paid to the beneficiary as an application of the net profit.

Applied to the example, because the beneficiary (the surviving spouse) had a vested right to the net amount only, the gross amount of R360 000 is not deemed to have accrued to her. In the words of section 25B(1), *"the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary, who is a resident"*, the extent to which the R360 000 has been derived for the benefit of the beneficiary, is R219 800. The balance is then not deemed to accrue to her, and she cannot make any deduction (in respect of the expenses incurred).

Where a beneficiary's entitlement was to the full amount, then the full amount would have accrued to her, and she would have been able to make the deductions. The ITR12, for the beneficiary, requires the net amount to be declared in respect of both (vested right to the full amount, or vested right to a portion of the full amount). And this applies irrespective of whether the beneficiary was entitled to the full amount that accrued to trust, or otherwise. It is submitted that this was the intention and follows from an amendment to section 25B(3) made during 2000. The purpose of that amendment was explained as follows[73]:

> *"Section 25B(3) was amended by the Revenue Laws Amendment Act, 2000, to provide that deductions and allowances of a trust will not be deemed to be incurred by a beneficiary where that beneficiary acquired a vested right as a result of the exercise of a discretion by the trustee of a trust. It is proposed that this amendment be deleted with retroactive effect to ensure that the trust principles in section 25B are consistent with those contained in the capital gains tax provisions in the Eighth Schedule."*

---

[72] Remember that expenses may not qualify for a deduction and would require an apportionment – see the separate discussion on this later on.

[73] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2001

The principle in the Eighth Schedule is that it is the capital gain that is attributed to the beneficiary. On that basis, it would be the taxable income that would be deemed to be that of the beneficiary and would be why the deductions are made in the return of the trust and not in the return of the beneficiary.

Declaration of beneficial owner

It is submitted, that with respect to the IT3(t), in this instance, it would only require the net amount to be declared to SARS. That is the amount that was vested in the beneficiary. Where the beneficiary had a vested right to the gross amount, the expenses incurred by the trustees must also be declared in the third-party return.

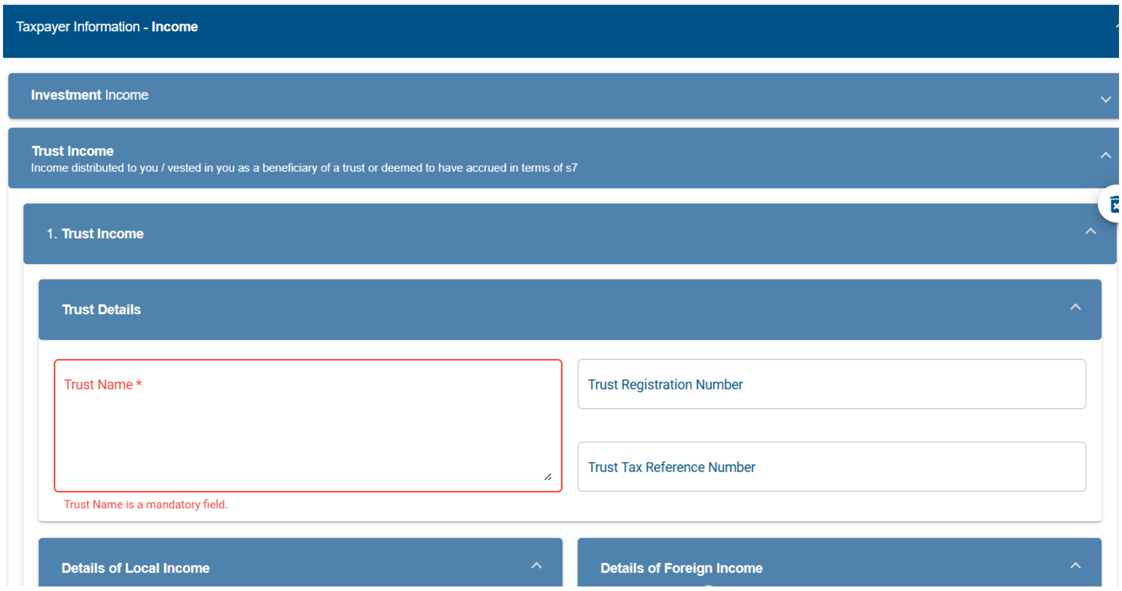
On the basis of the above explanation, the intention may well be that the gross rental, and the related expenses incurred by the trustees (qualifying for a deduction), should be declared on the IT3(t).

<u>Completing the income tax return (ITR12)</u> **of the beneficiary of the trust**

The following question must be answered:

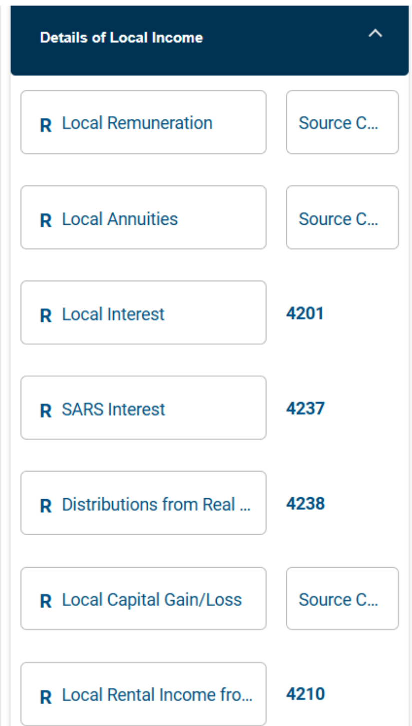
> Was any income distributed to you / vested in you as a beneficiary of a trust, or deemed to have accrued in terms of s7?
>
> Indicate the number of trust(s) applicable?
>
> > In this instance, a “1” will be captured in the available block.

The return then requires detail of the trust, its name, and the trust registration number (with the Master) as well as the tax registration number of the trust.



The beneficiary can now complete the detail of the income that was vested in her:

The SARS ITR12	
Question Was any income distributed to you / vested in you as a beneficiary of a trust, or deemed to have accrued in terms of s7?	The net rental amount was vested in the beneficiary. As was said earlier, it is

	irrelevant that the amount may have not been paid to her in full. This is also the amount that would have been reported to SARS by the trustees on the IT3(t).
	Details of income vested in the beneficiary of the trust: Local rental income Note: In practice the beneficiary will not have all of this information, and it became customary for trustees to provide this information to the beneficiary. It is expected that this detail will be populated to the beneficiary's ITR12 in future. SARS will obtain the detail from the third-party report, the first report was due by 30 September 2024, by the trustees. In future these reports will have to be submitted to SARS by 31 May. Local Rental Income from the letting of fixed properties of R219 800.

The principle with respect to a capital gain, that was determined in a trust following the disposal of an asset by the trust, is the same. The capital gain is not taxed in the trust but will flow through to the beneficiaries of the trust (paragraph 80(2) applies). In that respect it is the same treatment as when the trustees vested an asset in a resident beneficiary of the trust and when paragraph 80(1) applies.

With respect to the latter, step 6 is relevant. The question reads as follows:

Was an asset vested in a beneficiary of the trust who is a resident of the RSA?

The guide will now deal with both capital gains.

4.7 Capital gains arising from disposal of, or the vesting of trust assets

4.7.1 Capital gains and the conduit principle

As was explained in the Thistle trust case, with respect to capital gains, the Eighth Schedule contains the conduit principle in paragraph 80. The Act, or the Eighth Schedule, refers to this as the attribution of capital gains. And what is attributed, is the capital gain arising from the disposal of an asset held (or owned) by the trustees, or from the vesting of trust property (an asset as defined), in a beneficiary of the trust.

The disposal of an asset, by the trustees, will normally be by way of a sale of the asset in question to a third party. In terms of paragraph 11(1)(a), "*a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset, and includes*

- *the sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset*;
- *the vesting of an interest in an asset of a trust in a beneficiary;"*

The proceeds that accrue to a trust upon the vesting of an asset in a beneficiary and the base cost of the vested right for the beneficiary will usually be determined under paragraph 38 of the Eighth Schedule to the Act at market value.

Paragraph 80(2) of the Eighth Schedule deals with the disposal of an asset, whereas paragraph 80(1) deals with the vesting of an asset in a beneficiary of the trust.

Paragraph 13(1)(a) of the Eighth Schedule deals with the time of disposal (of an asset to a third party), and it reads as follows:

> *"The time of disposal of an asset by means of a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by the operation of law is, in the case of—*
> *(i) an agreement subject to a suspensive condition, the date on which the condition is satisfied;*
> *(ii) any agreement which is not subject to a suspensive condition, the date on which the agreement is concluded;"*

Judge Wallis, in the recent CSARS v Bosch, said:

> *"A suspensive condition is one that suspends the exigible content of a contract, either in whole or in part, pending the occurrence of an uncertain future event." In terms of paragraph 13(1)(a)(iiA) of the Eighth Schedule, the time of disposal of an asset by means of the distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset, the date on which the interest vests."*

Please note that deferral of the obligation to make payment of the purchase price, is generally not a suspensive condition.

With respect to the distribution of an asset to a beneficiary, 13(1)(a)(iiA) of the Eighth Schedule, is relevant and reads as follows:

> *"The time of disposal of an asset by means of a change of ownership effected or to be effected from one person to another because of an event, act, forbearance or by the operation of law is, in the case of the distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset, the date on which the interest vests*."

The above was explained as follows[74]:

> *"Under current law a disposal is triggered in the hands of a beneficiary of a trust when that beneficiary acquires an asset from the trust in respect of which that beneficiary had a pre-existing vested right. This follows from paragraph 13(1)(d) which stipulates that the time of disposal in respect of the vesting of an asset is the date of vesting. When the beneficiary receives the actual asset there is a further disposal in the form of an exchange of a vested right for a real right in the*

[74] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008

asset, and the time of that disposal is the date when the change of ownership occurs (paragraph 13(1)(a)(ix)). This treatment is inconsistent with the treatment of other assets when delivery is deferred. In such cases, paragraph 13(1)(a)(ii) ensures that the exchange of personal and real rights is backdated to the date of the agreement, thereby ensuring that the disposal is tax neutral. The tax neutrality flows from the fact that the base cost of the vested (personal) right is equal to the market value of the real right received (proceeds), resulting in no capital gain or loss when the rights are exchanged."

In other words, the timing of the tax event, is the time the beneficiary obtains a vested right to the asset. This is when, in terms of the trust deed, the vested beneficiary became unconditionally entitled to the asset. For a beneficiary who does not have a vested right to the asset, it is the time the trustees, acting within their discretionary powers, decided to vest the asset in the beneficiary. Both of those events are the tax event envisaged in paragraph 80. It is the first sub-moment of vesting. When the asset is actually distributed to the beneficiary, or when the transfer of ownership occurs, there is no further disposal of the asset to the beneficiary, for purposes of the Eighth Schedule.

4.7.2 The legislation

Paragraph 80(1) of the Eighth Schedule

"Subject to paragraphs 68, 69 and 71, where a trust vests an asset in a beneficiary of that trust (other than any person contemplated in paragraph 62(a) to (e) or a person who acquires that asset as an equity instrument as contemplated in section 8C(1)) who is a resident, and determines a capital gain in respect of that disposal or, if that trust is not a resident, would have determined a capital gain in respect of that disposal had it been a resident——

(a) that capital gain must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) that capital gain or the amount that would have been determined as a capital gain must be taken into account as a capital gain for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of."

Paragraph 80(2) of the Eighth Schedule

"Subject to paragraphs 64E, 68, 69 and 71, where a trust determines a capital gain in respect of the disposal of an asset in a year of assessment during which a beneficiary of that trust (other than any person contemplated in paragraph 62(a) to (e)) who is a resident has a vested right or acquires a vested right (including a right created by the exercise of a discretion) to an amount derived from that capital gain but not to the asset disposed of, an amount that is equal to so much of the amount to which that beneficiary of that trust is entitled in terms of that right—

(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account as a capital gain for the purpose of calculating the aggregate capital gain or aggregate capital loss of that beneficiary."

<u>Comments on paragraph 80</u>:
There are a number of differences, and important ones, between section 25B of the Act of paragraph 80 of the Eighth Schedule to the Act.

Paragraph 80, has since its inception, effective 1 October 2001, contained the following:

"... *a beneficiary ... who is a resident has a vested right or acquires a vested right* ..."

At the time, the reason for this treatment, which differs from section 25B (at the time and until 29 February 2024), was not given[75]. It was merely stated *"that a capital gain determined <u>in respect of the disposal of a trust asset to a resident</u> who is a trust beneficiary be ignored in the hands of the trust and treated as that beneficiary's gain."* Put differently, the flow-through only applies where the beneficiary is a resident of the RSA.

Paragraph 80 deals with beneficiaries with vested rights, and beneficiaries who acquired a vested right only during the year of assessment, in the same paragraph.

With respect to *"the assets of a discretionary trust be treated as those of the trust until they are vested in a beneficiary"*. Such vesting will be treated as a disposal by the trust at market value.

Acquisition of an asset, in respect which the beneficiary has a vested right, and an asset that may be vested in a beneficiary of a trust by the trustees (in their sole discretion). Time of acquisition is the same, but in the latter, it is acquired by the trust first, and then on vesting, there is a disposal by the trust to the beneficiary.

It is paragraph 80(2), that most commonly applies in practice, and it will be dealt with first. However, as vesting is the tax event, it must be explained before that is done. Vesting, as was already said before, is the tipping point to determine if the beneficiary of a trust will be taxed on the benefit derived from a trust. For a detailed explanation, and discussion of vesting, or a vested right, see paragraph 4.4.1.

4.7.3 Example

In this example the beneficiaries obtained, during a year of assessment, a vested right to the trust capital, consisting of trust property held by the trustees.

<u>Extracts from the trust deed</u>:
The phrase "Vesting date" shall mean:

> 19.2.2 in the event of the Trustees not having appointed a vesting date in terms of 19.2.1 above prior thereto, then on the date that the youngest beneficiary born at date hereof … attains the age of 25 (TWENTY-FIVE) years; ...
>
> 21. DISTRIBUTION OF CAPITAL
> Subject to the powers conferred on them in terms of the provisions of clause 23 hereunder, the capital of the Trust shall be held by the Trustees until the vesting date, whereupon the capital then still held in trust shall vest in and be paid to the Beneficiaries alive at that date subject to the provisions of clause 22 below.

<u>Activities of the trustees</u>:
It is clear, from the minutes of the trustees, since formation of the trust to date, that:

- the trustees at no stage acted in accordance with the discretionary clause (19.2.1 in the trust deed) and accordingly have never "appointed" a vesting date; and
- the capital of the trust has never been paid to any beneficiary, and nor have the trustees ever taken a decision as to the proportions in which it should be distributed.

[75] In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001.

A beneficiary of the trust attained the age of 25 years on 8 January 20*4.

Facts relevant to the trust property
The trust property consists of a portfolio of shares listed on the JSE. The portfolio of shares was bequeathed to, and acquired by the trust, after the death of the founder, and was held by the trustees until the current year of assessment. The fair market value of the portfolio, for purposes of estate duty, was R750 000.

Extract from the minutes of the meeting of trustees
The trustees met on 8 January 20*4 and resolved that the broker, acting for the trust, be instructed to transfer ownership of one half of the 9 000 shares held by the trust (or 4 500 shares each), to the following persons:

- The beneficiary who turned 25 (resident in the RSA)
- Beneficiary 2 (resident in the RSA).

From the note, received from the broker, the actual transfer took place on 10 January and the market value thereof at that time, was R2 800 000. The market value of the shares, at the close of business on 7 January 20*4 was R2 750 000, and on 8 January 20*4, was R2 749 000.

Completing the tax return:
Responding to the questions on the return:
Under capital gain / loss:

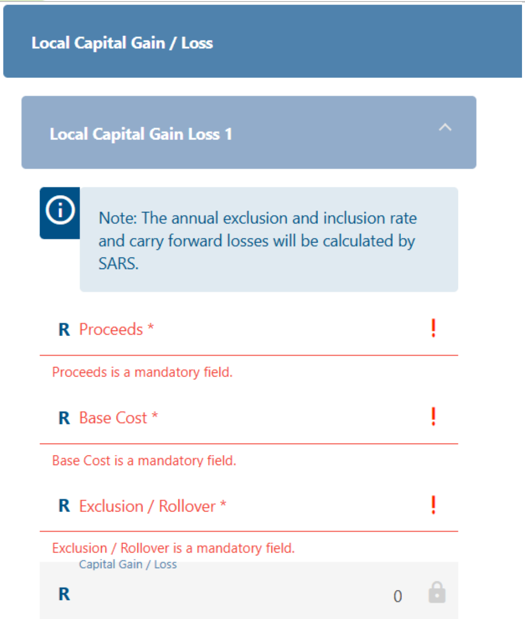
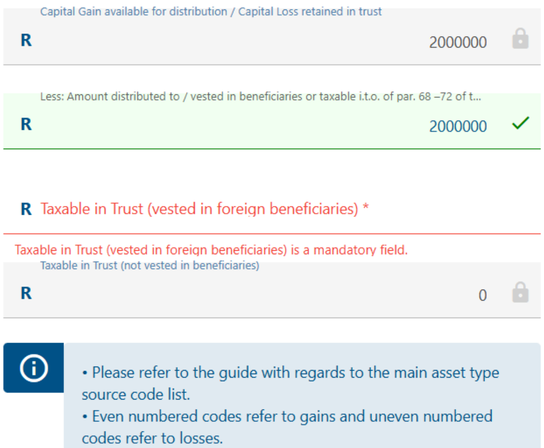
Did the trust dispose of any local assets attracting capital gain or loss (including crypto asset(s))?
Did the trust dispose of any foreign assets attracting capital gain or loss (including crypto asset(s))?
Did the trust receive capital gains from other local trusts?
Did the trust receive capital gains from other foreign trusts?
Has any debt been reduced for no consideration which has the effect of reducing the assessed capital loss of the trust under paragraph 12A(4) of the Eighth Schedule?

The question relevant to the example, is:

Did the trust dispose of any local assets attracting capital gain or loss (including crypto asset(s))?

Once the question is answered, the following appears:

How many disposals? One would probably use “1” here, although there were a number of shares transferred and transferred in two transes, one each to each beneficiary.

	Proceeds Base cost Exclusion / Rollover Capital gain / Loss	2 750 000 750 000 0 2 000 000
	Capital gain available for distribution Less: amount distributed to / vested in beneficiaries ... Taxable in trust	2 000 000 2 000 000 0

Comments with respect to the above

<u>Foreign assets</u>
This refers to assets, the source of the capital gain of which, if disposed of, would be outside the RSA. It is treated exactly the same, other than that the capital gain may be determined in a foreign currency – see paragraph 43 of the Eighth Schedule.

<u>Proceeds:</u>
There is a disposal – this is in terms of paragraph 11(1)(d) of the Eighth Schedule to the Act:

> "... *a disposal ... includes ... the vesting of an interest in an asset of a trust in a beneficiary* ..."

The time of disposal, in terms of paragraph 13(1)(a)(iiA) of the Eighth Schedule, *"The time of disposal of an asset by means of ... the distribution of an asset of a trust by a trustee to a beneficiary to the extent that the beneficiary has a vested interest in the asset, the date on which the interest vests*."

Because the disposal of the assets, the shares to each beneficiary, is *"a disposal (by the trust) ... to a person who is a connected person immediately prior to or immediately after that disposal in relation to that person for a consideration which does not reflect an arm's length price the person who disposed of that asset must be treated as having disposed of that asset for an amount received or accrued equal to the market value of that asset as at the date of that disposal".* This is in terms of paragraph 38(1)(a) of the Eighth Schedule.

Note, in terms of paragraph 31(1)(a) of the Eighth Schedule to the Act, the *"**market value** of an asset on a specified date is in the case of an asset which is a financial instrument listed on a recognised exchange and for which a price was quoted on that exchange, the ruling price in respect of that financial instrument on that recognised exchange at close of business on the last business day before that date"*. It therefore differs from an outright disposal by the trustees to a third-party (not a connected person in relation to the trust or the beneficiaries), and where the consideration received will be the proceeds on disposal – see paragraph 35(1).

Base cost

The base cost of these shares, to the trust, must be determined under section 23(3)(b) of the Act. For purposes of completeness, section 25(3) reads as follows:

"Where the deceased estate of a person disposes of an asset to an heir or legatee of that person—

(a) that deceased estate must be treated as having disposed of that asset for an amount received or accrued equal to the amount of expenditure incurred by the deceased estate in respect of that asset;

(b) the heir or legatee must be treated as having acquired that asset for an amount of expenditure incurred equal to the expenditure incurred by the deceased estate in respect of that asset"

Under that provision, the heir or legatee acquires the asset at the expenditure to the deceased estate (market value on date of death).

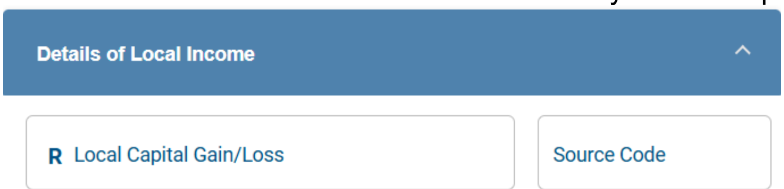
For the beneficiary

In the individual beneficiary's (each one of them), the ITR12 is completed as follows:

Was any income distributed to you / vested in you as a beneficiary of a trust, or deemed to have accrued in terms of s7?

Indicate the number of trust(s) applicable?

And each one of the beneficiaries will answer "yes" and capture a "1" in the container on the return.


Details of Local Income

R Local Capital Gain/Loss

Source Code

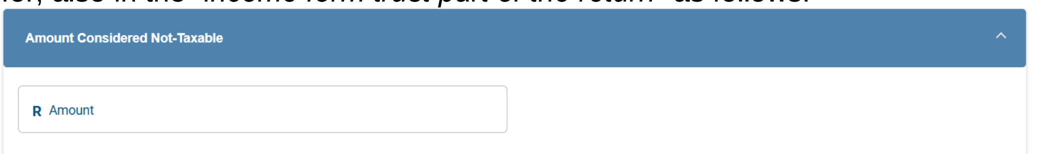
If the source of the capital gain was outside the RSA, then the following would be completed:

It is irrelevant that the asset is deemed to have been acquired by the beneficiary, on the day it was distributed to the beneficiary. The individual did not acquire the asset, prior to the vesting thereof, and the proceeds are also not deemed to have accrued to the beneficiary.

For each one of the beneficiaries, the amount, that was vested in each one of them, and subsequently distributed to each one of beneficiaries, is actually made up of:

- A capital gain of R1 million = being 50% of R2 million; and
- A capital amount, of R375 000.

As this is not an amount of income, or a capital, but actually trust capital distributed to them, it is accounted for, by each beneficiary, as an amount that is considered not to be taxable. It is accounted for, also in the *"income form trust part of the return"* as follows:



So far, we have only dealt with beneficiaries who are resident in the RSA. There actually are two instances where the nature of the beneficiary will result in the amount not flowing through to a beneficiary. They are where:

- the beneficiary, which had or obtained the vested right, is itself a trust, and then
- the beneficiary is not resident in the RSA.

What if the trust is a beneficiary of another trust?

4.7.4 The beneficiary is another trust

The relevant question on the ITR12T:

> Was any local amount(s) distributed to the Trust / vested in the Trust as a beneficiary of another Trust or deemed to have accrued in terms of s7 during this year of assessment? From how many other trusts were amount(s) received or accrued?

The relevant words are:

> Was any local amount(s) distributed to the Trust / vested in the Trust as a beneficiary of another Trust ...?
>
> There is a similar question that relates to foreign amounts distributed to the trust.

And later on, the following question:

> Is this trust a beneficiary of another trust or are other trust(s) beneficiaries of this trust?

<u>Income vested by one trust in another trust:</u>

With respect to an amount of income (not of a capital nature) that accrued to the first trust, if in terms of section 25B(1) of the Act, that the *"amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year"*, or where the beneficiary obtained a vested right to that income (in terms of a trustee discretion), that the amount of income is then *"deemed to be an amount which has accrued to that beneficiary"*. The first trust is then, in a sense, tax neutral with respect to the amount so derived and vested (in the same year).

The same principle applies with respect to the second trust. With respect to the amount vested by the first trust in the second trust, there is also an *"amount … derived* (by the second trust) *for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year".*

And section 25B would then also apply. And in terms of section 25B(2) "*where a beneficiary* (of the second trust) *has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant deed of trust ... that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary*."

For purposes of the amount of income, derived by a beneficiary (a discretionary or vested right one) will also include a trust (in a discretionary trust, being a person who has a contingent interest in all or a portion of the receipts or accruals of a trust). To the extent to which that amount has been vested, it is deemed to have been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year. It then is treated the same as if the recipient trust had a vested interest in the 'income'. And when the trustees of the second trust, in turn, vest the income in its beneficiaries, the conduit will apply.

The position with respect to a capital gain that arises in the first trust and is then vested in a second trust, differ substantially from the above.

The principles are the following:
The capital gain can accrue to the beneficiaries of the trust because they have a vested right thereto; or they can get the right, if the trustees, acting within their mandate, in their discretion vested the capital gain in them.

The SARS view, with regard to paragraph 80(2) is found in their guide, and reads as follows:

> *"Can a capital gain flow through multiple resident discretionary trusts when it is vested by each consecutive trustee in the same year of assessment?*
>
> > *The words 'the trust' in para 80(2)(a) refer to the same trust mentioned in the opening words of the subparagraph, namely, the trust that has determined a capital gain in respect of the disposal of an asset. A beneficiary that happens to be a trust does not determine a capital gain in respect of the disposal of an asset – it must simply account for the capital gain attributed to it under para 80(2)(b). Such an attributed capital gain cannot be further attributed.*
> >
> > *Thus, <u>a capital gain of a discretionary trust can be attributed only once</u> and cannot flow through multiple resident discretionary trusts in the same year of assessment. Any subsequent on-distribution of an amount equal to the attributed capital gain simply represents a disposal which does not give rise to a capital gain or loss, usually just a part-disposal of the on-distributing trust's bank account."*

Following the decision of the Constitutional Court, in the Thistle case, SARS's view above is correct.

Another important point is that the vesting of the capital gain must happen in the same year the asset is disposed of by the trustees.

Paragraph 80(2) of the Eighth Schedule then applies. It allows the first trust to disregard the capital gain and treat the capital gain to be that of the beneficiary who is entitled to the amount (of the gain).

This is recorded in the ITR12T by capturing the amount vested in the container below the following question:

> "Less: Amount distributed to / vested in beneficiaries or taxable i.t.o. par. 68 – 72 of the Eighth schedule"

R Capital Gain available for distribution / Capital Loss retained in ...	Amount of the capital gain is captured here.
Less: Amount distributed to / vested in beneficiaries or taxable i.t.o. of par. 68 –72 of ... R 0	Amount of the capital gain vested, is captured here to reduce the capital gain in the trust (so to speak).

This of course accepts that no attribution of the capital gain is required for the donor (due to an interest free loan or otherwise).

In conclusion, a capital gain of a discretionary trust can be attributed only once and cannot flow through multiple resident discretionary trusts in the same year of assessment. Any subsequent on-distribution of an amount equal to the attributed capital gain simply represents a disposal which does not give rise to a capital gain or loss, usually just a part-disposal of the on-distributing trust's bank account[76].

The conduit principle however applies where an asset is vested in a beneficiary of a trust, which beneficiary is also a trust. SARS's view with respect to multiple vesting trusts and the flow-through principle, is as follows:

> *"Unlike multiple discretionary trusts, the flow-through principle can apply to multiple vesting trusts. This result follows from para 11(1)(d), which results in the disposal of an asset of a trust to a beneficiary when that asset is vested in that beneficiary[77].*
>
> *A similar result will ensue when a discretionary trust has a vesting trust as one of its beneficiaries. If the discretionary trust sells an asset to a third party and vests the resulting capital gain in the vesting trust, it is the resident beneficiaries of the vesting trust who must account for the capital gain, since the vesting trust stands in the position of a pure administrator having no beneficial interest in the capital gain. However, the trust deed must be carefully scrutinized in order to determine whether the beneficiaries indeed have a vested interest in the capital gain."*

The reason why this view cannot be faulted is that each of these, subsequent trusts, will be disposing of an asset, and the capital gain arises from that disposal. As SARS explains, the two trusts *"are unaffected by the transaction for CGT purposes because they have already disposed of the asset to*

[76] Comprehensive Guide to Capital Gains Tax (Issue 9)
[77] Paragraph 14.11.6.3A of the Comprehensive Guide to Capital Gains Tax (Issue 9)

their respective beneficiaries on vesting under para 11(1)(d)." Distribution of the asset, by the first trust to the second trust, is not a further disposal.

If the second trust disposes of the asset and vests the capital gain in its beneficiary, the second trust will be able to disregard the capital gain, and the beneficiary of the trust will have to account for that capital gain.

And it then does not matter if that disposal, by the second trust, happens in a subsequent year of assessment.
All of that only applies if the trust, or beneficiary is a resident of the RSA.

4.7.5 The tax consequence for beneficiaries not resident in the RSA (for tax purposes)
4.7.5.1 Income and capital

Prior to 29 February 2024, section 25B(1) and 25B(2) of the Act, made no distinction in the treatment of beneficiaries on any basis, but specifically also not on the country in which the beneficiary is a resident for tax purposes. The Minister of Finance, in Annexure C (Additional Tax Policy and Administrative Adjustments) of the 2023 Budget Review, said that *"section 25B does not distinguish between beneficiaries who are and are not South African tax residents."* The Minister then proposed *"that changes be made to section 25B to align it with the provisions of paragraph 80."*

It was the *"increase in applications to SARS for confirmation of tax compliance status of a person for purposes of transferring funds offshore via authorised dealers"*, that led Government to reconsider this position. And one can only assume that SARS, would have noticed that these applications were made because of amounts vested by RSA trusts in foreign beneficiaries. The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2023 (2 February 2024), provided the following as further background information:

> *"The flow through of amounts by South African trusts to non-residents places SARS in a difficult position to collect income tax from those beneficiaries as they may not be taxed on foreign sourced amounts, tax recovery actions may be difficult and in the case of non-resident trusts that are beneficiaries, SARS may not have information on the persons in whom the foreign trusts vest the income."*

And explained that the purpose of the changes made to section 25B(1) and (2), or the reason therefore, was *"to align it [section 25B] with the provisions of paragraph 80 of the Eighth Schedule to the Act by limiting the flow through principle only to resident beneficiaries."* This limiting of the flow through, adversely impacted the foreign beneficiary, and effectively moved the right of the RSA to tax RSA sourced income which accrues to the foreign person, as a beneficiary of a trust in the RSA, to the trust. Trustees of trusts, who vested income in a foreign beneficiary, would not be able to distribute the full amount of the income that accrued to the trust, and would have had to reduce this by 45%, to leave money available in the trust to enable the trustees to pay the income tax levied on this income.

Another consequence of this, is that the foreign beneficiary may not be able to get relief for RSA tax suffered on this income, if his or her country of residence taxes this income as well.

In conclusion, and effective for years of assessment commencing on or after 1 March 2024, where a beneficiary who is not tax resident in the RSA, and who has a vested right to income that accrued to the trustees of a trust (resident in the RSA), or who acquires such a right because the trustees exercised a discretion to vest such income in the foreign beneficiary (during the same year of assessment the income accrued to the trust), will not be treated as having received that income. The income will be treated as having accrued (or received) by the trust, who will bear the income tax imposed on that income, or the taxable income thereof).

In that respect, the position would be the same as it was with respect to a capital gain that was attributed to a non-resident beneficiary. No conduit! With respect to capital gains arising in a trust and vested in a non-resident beneficiary, the position has always been that the capital gain must be taxed in the RSA trust.

This is another instance where the conduit, or flow-through, does not apply.

But before it is dealt with, it must first be mentioned that there is section 7 that deems the income that was vested in a non-resident to be income of a resident. That would be so if there was a donation, settlement or other disposition.

4.7.5.2 Non-resident, section 7(8)

It is necessary to start with the historical development of section 7(8).

Section 7(8) was introduced into the Act, by the Revenue Laws Amendment Act, 2000, Act 59 of 2000, and it came into operation on, and must apply in respect of years of assessment commencing on or after 1 January 2001. Its introduction was explained as follows:

> *"The provisions of section 9D currently provide for the taxation of investment income of controlled foreign entities and investment income arising from donations, settlements or other dispositions. It is proposed that the provisions of section 9D should deal solely with the income of controlled foreign entities and that the anti-avoidance provisions relating to donations, settlements or other dispositions should be included in section 7 which contains similar provisions."*

Section 7(8), as was the intention of section 25B, was to prevent RSA residents from changing the incidence of the tax on a RSA resident, by changing the taxpayer entitled to the amount, from a resident to a non-resident. The qualifier of the deeming provision, *"would have constituted income had that person been a resident"*, effectively resulted in foreign sourced amounts which accrued to a person not resident in the RSA, to now be gross income in the RSA, because the non-resident is deemed to be a resident.

Unfortunately, as was explained in an Explanatory Memorandum, present law may be argued to contain a technical defect that limits section 7(8) to South African sourced (as opposed to foreign sourced) income. This defect arises from the term *"income."* Under section 1, the term *"income"* means the amount remaining of *"gross income"* after deducting amounts exempt from tax. In turn, *"gross income"* means, in the case of a non-resident, the total amount received by or accrued to or in favour of a non-resident from South African actual or deemed sources. Hence, income outside this ambit (i.e., foreign sourced income) of a non-resident (e.g., trust) technically falls outside the anti-avoidance rules of section 7(8).

The subsection has subsequently been amended, and the current wording of section 7(8)(a) reads as follows:

"Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition."

When section 7(8) was expanded, the following explanation was provided:

"Under current law, section 7(8) provides that income of a non-resident will be deemed to be income of a resident if that income is attributable to the non-resident by reason (or in consequence) of a donation, settlement or other disposition by the resident. However, section 7(8) does not apply to income of a controlled foreign company (because that income may be shifted back to a resident by virtue of section 9D) nor to foreign public benefit organisations. This section can potentially apply when a resident makes a donation, settlement or other disposition <u>to a non-resident trust</u>."

Conceptionally, section 7(8) has the same result as any of the other provision of section 7. For purposes of this guide, it would be income that accrues to a foreign beneficiary due to the vesting of that income in the foreign beneficiary by a trust resident in the RSA. And section 7(8) then deems the income received by the non-resident, to be income that accrued to the RSA donor – the income that was derived (or can be attributed) by reason of or in consequence of any donation, settlement or other disposition.

4.7.5.3 Capital gains

The Act never allowed for capital gains to flow through to non-residents. SARS's view, as far as the non-resident is concerned, and not really seriously disputed, is that the capital gain must be 'taxed' in the trust. SARS discusses this in detail in paragraph 14.11.4 (of their Comprehensive Guide to Capital Gains Tax). Their first statement relevant to this issue reads as follows:

"The default position is that a trust must account for any capital gain or loss that arises when it disposes of an asset. As discussed in 14.11.1, para 80 provides an exception to the default position by attributing a capital gain from the trust in which it arises to a resident beneficiary. No mention is made in para 80(1) and (2) of a non-resident beneficiary, and so no attribution to such a person is possible."

The second relevant part reads as follows:

"The intention of the legislature in not providing for attribution to non-resident beneficiaries was to prevent loss to the fiscus, since non-residents are subject to CGT only on the limited range of assets listed in para 2(1)(b), namely, immovable property in South Africa, interests and rights in such immovable property, assets effectively connected with a permanent establishment in South Africa and other deemed interests in immovable property such as shares in a land-rich company meeting specified requirements. The capital gains are derived by the trust and are clearly within South Africa's taxing jurisdiction. South Africa has a right to keep such capital gains within its jurisdiction by permitting attribution only to resident beneficiaries."

Refer to the discussion on the conduit pipe principle, and judge Chaskalson's comments in the Thistle trust case relating to the fact that revenue authorities can legislate that the conduit does not apply.

It is paragraph 72, of the Eighth Schedule in terms of which there is attribution of capital gains and other amounts vesting in a person that is not a resident.

Paragraph 72(1)

"This paragraph applies where—

(a) a resident has made a donation, settlement or other disposition to any person (other than an entity which is not resident and which is similar to a public benefit organisation contemplated in section 30);

(b) a capital gain (including any amount that would have constituted a capital gain had that person been a resident) attributable to that donation, settlement or other disposition has arisen during a year of assessment; and

(c) an amount consisting of or derived, directly or indirectly, from—

(i) that capital gain; or

(ii) the amount that would have constituted a capital gain,

has during that year vested in or is treated as having vested in any person who is not a resident (other than a controlled foreign company, in relation to that resident)."

Both section 7(8), and paragraph 72, applies when income accrued to, or a capital gain was vested in a foreign beneficiary by a South African resident trust. The donor, for the purposes of the two provisions, is a resident of the RSA, and the beneficiary of the donation, settlement or other disposition, is not a resident of the RSA. The result of section 7(8) is that there will be no flow-through to the foreign beneficiary and either of those amounts will be taxed in hands of the RSA donor.

Facts:
On 1 March 201* Millhouse sold an asset to the Millhouse Family Trust at market value of R100 000. The trust was a discretionary trust. The purchase price was credited to his loan account, and no interest was charged on the loan. Had the trust borrowed the funds from the bank to purchase the asset, it would have paid interest at the annual rate of 15%.

The beneficiaries of the trust are Millhouse and his son Richard who resides in Brisbane, Australia. During February 202* the trustees vested the asset in Richard at a time when its market value was R150 000.

Result:
The interest saved by the trust amounted to R45 000 (R100 000 × 15% × 3). Under paragraph 11(1)(d) the vesting of an asset in Richard is a disposal. Since Richard is a connected person in relation to the trust, the transaction must be accounted for at market value under para 38. Therefore, the vesting of the asset gives rise to a capital gain of R50 000 (R150 000 −R100 000). Of this amount, R45 000 will be taxed in the hands of Millhouse under paragraph 72, and the remaining R5 000 will be taxed in the trust.

Paragraph 80 makes no provision for a flow-through of a capital gain to a non-resident beneficiary.

4.7.5.4 Further development

In 2018, draft bills were made available for comment, which draft legislation was (after some amendments were made in response to public comments received. The reason for these amendments, was *"to close the loophole in the current tax legislation regarding the use of trusts to avoid tax or recharacterise the nature of income ...[78]"*

Amendments were made to sections 7(8), 10B(2)(a) and 25B(2A) of the Act and paragraphs 64B, 72 and 80 of the Eighth Schedule to the Act. And the impact thereof was on the RSA donor. The following extract from the Explanatory Memorandum to this Bill, explains this well enough:

> *"A. Disregarding the participation exemption in respect of foreign dividends for purposes of income inclusion in terms of section 7(8) of the Act*
> *In determining the amount that should be included as taxable income in terms of section 7(8)(a) of the Act, in the hands of a resident who made a donation, settlement or other disposition to a foreign trust that holds shares in a foreign company, it is proposed that the participation exemption as contemplated in section 10B(2)(a) of the Act in respect of foreign dividends should be disregarded, in respect of foreign dividends paid by that foreign company if that resident holds or can exercise, either alone or together with any person or persons that are connected persons in relation to that resident, more than 50 per cent of the total participation rights or voting rights in that foreign company, The rule will not apply in respect of a foreign dividend that is derived from an amount that must be included in the income of or attributed as a capital gain to that resident or to any person that is a connected person in relation to that resident.*
>
> *B. Disregarding the participation exemption in respect of foreign dividends for purposes of income inclusion in terms of section 25B of the Act*
> *In determining the amount that should be included as taxable income in terms of section 25B(2A) of the Act, in the hands of a resident who acquires a vested right in a foreign trust that holds shares in a foreign company, it is proposed that the participation exemption as contemplated in section 10B(2)(a) of the Act in respect of foreign dividends should be disregarded in respect of foreign dividends paid by that foreign company if that trust holds or can exercise, either alone or together with any person or persons that are connected persons in relation to that trust, more than 50 per cent of the total participation rights or voting rights in that foreign company, The rule will not apply in respect of a foreign dividend that is derived from an amount that must be included in the income of or attributed as a capital gain to that resident or to any person that is a connected person in relation to that resident.*
>
> *C. Disregarding the participation exemption in respect of capital gains derived from the sale of foreign shares for purposes of attribution of capital gain in terms of paragraph 72 of the Eighth Schedule to the Act*
> *In determining the amount that should be attributed in terms of paragraph 72 of the Eighth Schedule to the Act, as a capital gain to a resident who has made a donation, settlement or other disposition to a person who is not a resident it is proposed that the participation exemption as contemplated in paragraph 64B of the Eighth Schedule to the Act must be disregarded in respect of an amount derived from the disposal by the person who is not a resident, of shares in a foreign company if-*
>
> - *that person holds or can exercise, either alone or together with any person or persons that are connected persons in relation to that person, more than 50 per cent of the total participation rights or voting rights in that foreign company;*

[78] Taxation Laws Amendment Bill, 2018 (17 January 2019)

- *the resident who made the donation, settlement or other disposition or any person that is a connected in relation to that resident is a connected in relation to the person who is not a resident; and*
- *the amount derived from that disposal is not included in the income of or attributed as a capital gain to the resident who made the donation, settlement or other disposition or to a resident who is a connected person in relation to the resident who made the donation, settlement or other disposition.*

D. Disregarding participation exemption in respect of capital gains derived from the sale of foreign shares for purposes of attribution of capital gain in terms of paragraph 80 of the Eighth Schedule to the Act

In determining the amount that should be attributed in terms of paragraph 80 of the Eighth Schedule to the Act as a capital gain to a resident who is a beneficiary of a trust, it is proposed that the participation exemption as contemplated in paragraph 64B of the Eighth Schedule to the Act must be disregarded in respect of an amount derived from the disposal of shares held by the foreign trust (in which a beneficiary is a resident) in a foreign company if

- *that trust holds or can exercise, either alone or together with any person or persons that are connected persons in relation to that trust, more than 50 per cent of the total participation rights or voting rights in that foreign company; and*
- *the amount derived from that disposal is not included in the income of or attributed as a capital gain to the resident to whom an amount is attributed in terms of paragraph 80, or to a resident who is a connected person in relation to that resident."*

4.7.5.5 Conclusion

For purposes of this guide, with respect to the income, or capital gains, attributed to the RSA resident, the person who made the donation, settlement or other disposition, the position is the same as for, for instance section 7(3) and paragraph 69.

In the return of income, the ITR12, for the trust, the amount of income, derived by reason of, or in consequence of; or the amount of a capital gain that can be attributed to a donation, settlement or other disposition, will reduce the income and capital gain in the trust. It is deemed to be income, or a capital gain of the donor and must be accounted for in the return of income of the donor.

The only difference is that the section 10B(2) exemption is not available to the donor, or the paragraphs 64B exclusion.

4.7.6 Attribution of income as well as of capital gain

Paragraph 73 of the Eighth Schedule contains a unique principle, whereby a capital gain that is attributed to a donor, under the attribution rules in the Eighth Schedule, can be reduced by the amounts of income, which were in terms of the application of section 7, deemed to have accrued to the donor.

The legislation:

"73. Attribution of income and capital gain

(1) Where both an amount of income and a capital gain are derived by reason of or are attributable to a donation, settlement or other disposition, the total amount of that income and gain –

(a) that is deemed in terms of section 7 to be that of a person other than the one to whom it accrues or by whom it is received or for whose benefit it is expended or accumulated; and

(b) that is attributed in terms of this Part to a person other than the one in whom it vests,

shall not exceed the amount of the benefit derived from that donation, settlement or other disposition.

(2) For purposes of this paragraph, the benefit derived from a donation, settlement or other disposition means the amount by which the person to whom that donation, settlement or other disposition was made, has benefited from the fact that it was made for no or an inadequate consideration, including consideration in the form of interest.

Paragraph 73 applies where both an amount of income is derived by reason of or are attributable to a donation, settlement or other disposition and it was explained as follows[79]:

> *"Where an amount of income as well as a capital gain has been derived from or is attributable to a donation, settlement or other disposition made by a person, the amount of that income as well as that capital gain might be subject to the attribution rules embodied in section 7 and the proposed paragraphs 68 to 72, respectively. This might result in the taxation of both amounts in the hands of the person who made the donation, settlement or other disposition. The proposed paragraph 73 limits the total amount of the income and gain that can be taxed in the hands of that person to the amount of the benefit derived from that donation, settlement or other disposition by the person to whom it was made. The quantified benefit to the latter person from, for example, an interest-free or low interest loan will therefore determine the extent to which any resulting income and capital gain can be attributed to the person who provided that benefit."*

In the rest of the guide, with respect to the other section 7 and attribution (donations) rules, paragraph 73 was already mentioned, and applied in some of the examples. The following example[80] explains the application of paragraph 73(1) and 73(2):

Facts:
On 1 July 1997 Wayne sold a residential building to the Wayne Family Trust for R1 million.

The purchase price was funded by an interest-free loan from Wayne. Had the trust funded the acquisition by obtaining a bond from a bank, it would have paid interest at the rate of 15% a year.

The property was let from the date of acquisition until the date of disposal and the following rental income was derived:
1998: R95 000, 1999: R100 000, 2000: R105 000, 2001: R110 000, 2002: R110 000, 2003: R120 000.
The market value of the property on valuation date was R1,2 million, and this was adopted by the trust as the valuation date value. On 28 February 2003 the trust sold the property for R1,5 million and reinvested the funds in another project. The trust did not distribute any portion of its income or capital gain to the beneficiaries of the trust.

[79] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001.

[80] Example 2 – Attribution of capital gain vesting in non-resident – see page 652 of the Comprehensive Guide to Capital Gains Tax (Issue 9)

Result:
The net rental income derived by the trust, the amount deemed back to Wayne under s 7(5) and the balance that could not be deemed back because the income was insufficient is summarised below.
The maximum amount that can be attributed to Wayne each year is as follows:

- 1998 year of assessment (1 July 1997 to 28 February 1998): R1 000 000 × 15% × 8 / 12 = R100 000
- Subsequent years of assessment: R1 000 000 × 15% = R150 000

Year ended 28 February	Net rental income	Amount attributed to Wayne under s 7(5)	Balance of benefit [15% × R1 million x period less amount attributed under s 7(5
	R	R	R
1998	95 000	95 000	5 000
1999	100 000	100 000	50 000
2000	105 000	105 000	45 000
2001	110 000	110 000	40 000
2002	110 000	110 000	40 000
2003	120 000	120 000	30 000
			210 000

The capital gain derived by the trust is as follows:

Proceeds	R1 500 000
Less: Base cost	R(1 200 000)
Capital gain	R300 000

The portion of this gain to be attributed to Wayne under paragraph 73 is R46 667, which is determined as follows:

2002 R40 000 × 5 / 12 =	R16 667
2003	R30 000

The remaining portion of the capital gain of R300 000 − R46 667 = R253 333 will be taxed in the trust. The continuing donation of interest before 1 October 2001 has not been taken into account in determining the quantum of the capital gain to be attributed to the donor. It is considered that since the capital gain relates to the post-1 October 2001 period, only the donation of interest during that period should be taken into account.

4.7.7 The trust is taxed

Once it was identified all the instances where someone other than the trust is taxed on the income that accrued to a trust or a capital gain that was determined in the trust, the remaining amounts will be taxed in the trust.

Using some of the previous example's detail:
Income to be taxed in the trust

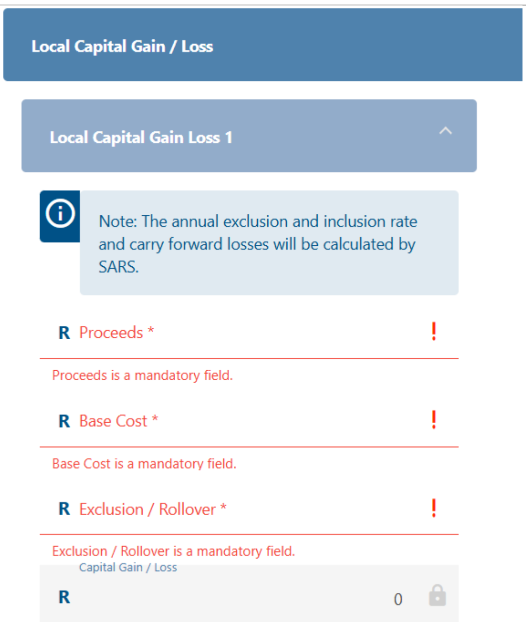
Description	Notes	Amounts in ZAR

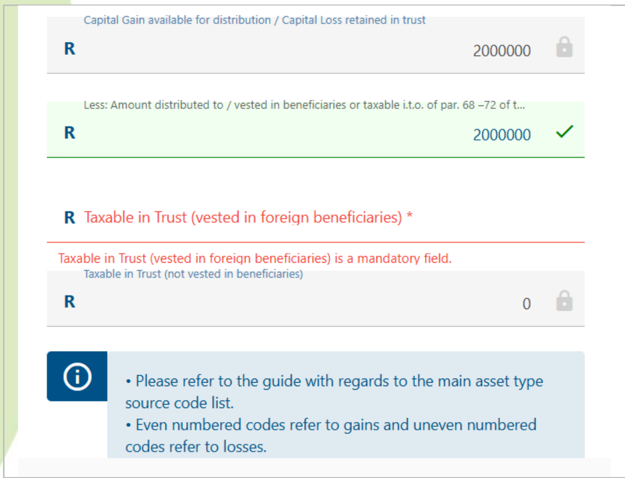
Income Rental income		360 000
Accounting fees		0
Electricity, rates and taxes		60 000
Insurance		28 000
Repairs	Section 11(d)	15 000
Other expenses Bank charges Internet (banking and meetings of trustees)	Section 11(a)	200 1 000
Trustee's remuneration	At 10% of the gross rental but shared equally between the three trustees of the trust.	36 000
		219 800
Amounts vested in beneficiaries or deemed to have accrued to the donor	It is assumed that the trustees decided not to vest any income in the beneficiaries	0
Taxable in the trust		219 800

If the full amount was vested in a beneficiary not resident in the RSA, then

Amounts vested in foreign beneficiary	It is assumed that the trustees decided not to vest any income in the beneficiaries	219 800
Taxable in the trust		219 800

With respect to capital gains

	Proceeds Base cost Exclusion / Rollover Capital gain / Loss	2 750 000 750 000 0 2 000 000

 Capital Gain available for distribution / Capital Loss retained in trust R 2000000 Less: Amount distributed to / vested in beneficiaries or taxable i.t.o. of par. 68 –72 of t... R 2000000 R Taxable in Trust (vested in foreign beneficiaries) * Taxable in Trust (vested in foreign beneficiaries) is a mandatory field. Taxable in Trust (not vested in beneficiaries) R 0 • Please refer to the guide with regards to the main asset type source code list. • Even numbered codes refer to gains and uneven numbered codes refer to losses.	Capital gain available for distribution	2 000 000
	Less: amount distributed to / vested in beneficiaries ...	0
	Taxable in trust (vested in foreign beneficiaries)	2 000 000

Of course, if no part of the capital gain was vested in a beneficiary of a trust, or was attributed to a donor, the full capital gain will be taxed in the trust.

4.8 Section 7C

This section, which is another provision aimed at a perceived tax avoidance relating to trusts and the funding of trusts.

There are three instances where section 7C applies:

- a loan is provided to the trust;
- a loan is provided to a company where the trust holds an interest in the company;
- subscribes for preference shares in a company where the trust holds an interest in the company; or
- an individual acquires a claim to a loan.

4.8.1 The reason for section 7C

As with the other section 7's, referring to them colloquially as such, section 7C also creates a fiction. It differs from section 7 in that it does not deem income to have accrued to someone else. It creates a deemed donation, and it can be argued that it should have been added to Part V, of Chapter II of the Act that deals with donations tax.

Section 7C was inserted into the Act, by the Taxation Laws Amendment Act, No. 15 of 2016, with effect from 1 March 2017. In the Explanatory Memorandum on the Taxation Laws Amendment Bill of 2016, issued 15 December 2016, National Treasury explained that:

- At issue is the avoidance of estate duty and donations tax when a person transfers wealth through the use of an interest free loan or a loan with interest below market rates.
- Interest foregone in respect of low interest loans or interest free loans that are made to a trust will be treated as an ongoing and annual donation made by the natural person to the trust on the last day of the year of assessment of that trust.

And the Explanatory Memorandum then provides the following reasons for changing the Act

“At issue is the avoidance of estate duty and donations tax when a person transfers wealth through the use of an interest free loan or a loan with interest below market rates. These loans are either used to facilitate the transfer of assets or assist the trust to acquire an asset. This is done in order to avoid donations tax as no donation arises on the sale of an asset or on advancing loan funding to a trust.

Coupled with the above, in some instances the lender reduces or waives the loan capital which is supposed to be paid back to him/her (whether as settlement for an outstanding asset disposal consideration or the settlement of loan funding that was advanced to a trust for its own use). This further avoids estate duty through the reduction or waiver of the asset base of the lender in respect of the loan capital.

Due to the fact that the loan is an interest free loan or a loan with interest below market rates, no interest is paid to the seller or interest paid is less than market rates, the seller will not be liable for income tax on the interest that is forgone. This results in a further reduction of the tax base.”

The statement above, namely that “the seller will not be liable for income tax on the interest that is forgone”, is not correct. As was explained elsewhere in this guide, when section 7 applies, the donor, being the “person who forgoes the interest”, will in fact be taxed as income, which amount may be equal to the interest forgone. It then is possible, in fact it is very likely, that both section 7 and section 7C may apply, and that the donor will have to include in his or her gross income, amounts of income attributed to the donation, as well as the amount of the deemed donation.

The explanation of the reasons for the change, then continues as follows:

“Interest foregone in respect of low interest loans or interest free loans that are made to a trust will be treated as an ongoing and annual donation made by the natural person to the trust on the last day of the year of assessment of that trust. For purposes of this anti-avoidance measure, interest foregone will be determined as the difference between the interest charged by the lender or holder of the loan and the interest that would have been payable by the trust had the interest been charged at the official rate of interest.”

As was explained, in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017 (15 December 2017), *“in order to make these types of tax avoidance schemes less attractive to taxpayers, the anti-avoidance measure under section 7C came into effect on 1 March 2017 and applies to all new loans, advances or credit and loans, advances or credit that were already in existence on the date it came into effect.”*

There are three instances where section 7C applies:

- a loan to the trust;
- a loan to a company where the trust holds an interest in the company;
- preference shares;
- acquires a claim.

4.8.2 Steps to follow to determine if section 7C will apply

The following steps must be followed to determine if section 7C applies, and to calculate the donations tax if it does:

Step 1: Was any loan (advance or credit) provided to a trust?
It must be remembered that it does not matter when the actual loan was made. Section 7C looks at the year of assessment and the question really is, did the trust, at any time during the year of assessment, owe an amount to any of the persons listed in step 2 in respect of a loan (advance or credit).

Step 2: With respect to the person who provided the loan:

Step 2.1.1:	Is the person who provided the loan a natural person?
Step 2.1.2:	If the person did not personally provide the loan, did the person subsequently acquire a claim to an amount owing by a trust in respect of a loan?
Step 2.2.1:	If the person is not a natural person, is the person who provided the loan a company?
Step 2.2.2:	If the person did not personally provide the loan, did the person subsequently acquire a claim to an amount owing by a company in respect of a loan?
Step 2.3.1:	Did a company provide the loan to the trust?
Step 2.3.2:	Was this at the instance of a person who is a connected person in relation to the trust?
Step 3:	Did a person subscribe for a preference share in a company in which 20 per cent or more of the equity shares are held (whether directly or indirectly) or the voting rights can be exercised by a trust that is a connected person in relation to that natural person or to that company, whether alone or together with any person who is a beneficiary of that trust?

Comments
It is very important to note that, whilst the trust is a party to the loans, directly or indirectly, these questions are to be answered with reference to the person who provided the loan and not in respect of the trust. As will be seen, section 7C will have no impact on the trust, or the beneficiaries of the trust. It is true that the trustees of the trust, would have been parties to the contract (or agreement) when the loan, with favourable interest rates and repayment terms, was initially made.

Let us start with explaining when section 7C will apply.

4.8.3 When does section 7C apply?

Section 7C(1) of the Act, prescribes when the section will apply. It is copied below for ease of reference:

> *"This section applies in respect of any loan, advance or credit that—*
> *(a) a natural person; or*
> *(b) at the instance of a natural person, a company in relation to which that person is a connected person in terms of paragraph (d)(iv) of the definition of connected person,*
> *directly or indirectly provides to –*
> *(i) a trust in relation to which –*
> *(aa) that person or company; or*
> *(bb) any person that is a connected person in relation to the person or company referred to in item (aa),*
> *is a connected person; or*
> *(ii) a company if at least 20 per cent of—*
> *(aa) the equity shares in that company are held, directly or indirectly; or*
> *(bb) the voting rights in that company can be exercised,*
> *by a trust referred to in paragraph (i) whether alone or together with any person who is a beneficiary of that trust or the spouse of a beneficiary of that trust or any person related to that beneficiary or that spouse within the second degree of consanguinity*."

Discussion of section 7C(1):
The phrase "*any loan, advance or credit*", in section 7C, is the critical phrase.

For purposes of the explanation that follows, the word "loan" will be used, *in lieu* of the phrase *"loan, advance or credit"*, the phrase that is used in the whole of section 7C.

It is clear from section 7C(1), that this phrase is used with reference to the person who provided the loan. And that the person who provided a loan, must be a natural person. The section would also apply where the loan is provided by a company, but then it must be at the instance of a natural person. In other words, where a trust owes money provided to it by a financial institution, such as a bank, section 7C could not apply.

However, it is also not any natural person who must have provided the loan. Section 7C would only apply if the natural person who provided the loan is a person who is a connected person in relation to the trust, or in relation to a company under certain circumstances.

Loans provided to trusts are commonly referred to as *"loans by a trustee of the trust to the trust"*. This is of course a total disregard of the capacity the individual acted in, when the loan was made. Colloquially speaking, the question is *"which hat did the person wear when the loan was made?"*. There of course is nothing preventing a trustee, to advance money on loan to a trust that he or she is a trustee of. But from a section 7C point of view, if the trustee is not a connected person in relation to the trust, section 7C will not apply.

Let us start with some comments about a connected person, with section 7C specifically in mind.

From the definition, in section 1(1) of the Act, and for purposes of the Act, *""**connected person**" means <u>in relation to a natural person</u>* –
(i) *any relative; and*
(ii) *any trust (other than a portfolio of a collective investment scheme) of which such natural person or such relative is a beneficiary; ..."*
(Paragraph (a)(ii) of the definition of "connected person" in section 1(1) of the Act).

And *"**connected person**" means in relation to a company, any person, other than a company as defined in section 1 of the Companies Act that alone or together with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of –*
(aa) *the equity shares in the company; or*
(bb) *the voting rights in the company*; ..."
(Paragraph (d)(iv) of the definition of "connected person" in section 1(1)).

The person other than the company, in this instance, being the natural person.

And *"**relative**", in relation to any person, means the spouse of that person or anybody related to that person or that person's spouse within the third degree of consanguinity, or any spouse of anybody so related, and for the purpose of determining the relationship between any child referred to in the definition of "child" in this section and any other person, that child shall be deemed to be related to the adoptive parent of that child within the first degree of consanguinity."*

The definition then *"**connected person**"*

(b) in relation to a trust (other than a portfolio of a collective investment scheme)—
(i) any beneficiary of such trust; and
(ii) any connected person in relation to such beneficiary;
(bA) in relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme), any other person who is a connected person in relation to such trust; ..."

What is most commonly found in practice, is that the natural person who advanced the loan, is a relative, within the first degree of consanguinity, and consequently a connected person in relation to the trust. Practically applied, in terms of section 7C(1), of the Tax Act, section 7C will then apply "*in respect of the loan, advance or credit that the individual "directly or indirectly provides(d) to a trust"* because the person who provided the loan is a connected person in relation to which the trust (by virtue of being a relative of a beneficiary, or the beneficiaries of the trust).

Example:
Example 7[81] – Connected person in relation to a trust

Facts: C is the founder of A Family Trust of which B Family Trust is the only beneficiary. The beneficiaries of B Family Trust are C, C's son D and C's stepchild E. Are C, D and E connected persons in relation to A Family Trust under paragraph (b)(ii)?

Question:
If C, the founder of the trust, provided a loan to the A family trust, would section 7C(1) apply?

Answer:
In order to answer this, for the purposes of section 7C(1), it must be determined if C, who is a natural person, is a connected person in relation to the A Family Trust. And that involves determining, in the first instance, if any relative of C, is a beneficiary of the A Family Trust.

From the facts provided, it is clear that no relative of C is a beneficiary of the A Family Trust. It is the B Family Trust, who is a beneficiary of the A Family Trust and who is a 'connected person' in relation to the A Family Trust. This follows from paragraph (b)(i), of the definition of connected person.

The beneficiaries of the B Family Trust are C, C's son D and C's stepchild E. And these individuals are therefore, also in terms of paragraph (b)(i), of the definition of connected person, persons who are connected persons in relation to the B Family Trust.

SARS, in the example, concludes as follows:

"C, D and E are therefore connected persons in relation to A Family Trust under paragraph (b)(ii), since they are connected persons in relation to the beneficiary of A Family Trust, namely B Family Trust."

That is correct. In conclusion, section 7C(1) will apply in this instance, because C, the natural person who provided the loan, is a connected person in relation to the A Family Trust, or the person who received the loan, or is obliged to repay the loan and who incurred interest in respect of a loan.

[81] The example, #7, was copied from Interpretation Note 67 (Issue 4).

But there is another requirement and that relates to the interest incurred by the trust on the loan. That can lead to the deemed donation. Which would only be so if there is “foregone interest” according to the Explanatory Memorandum. This will be explained later.

4.8.4 The loan is provided by a company

An example – loan at the instance of

> A trustee of a trust asked the following question:
>
> > I am a trustee of the BB Family Trust. The founder of the trust, Mrs BB, holds the entire interest in a close corporation, the BB Close Corporation (BB CC), and is also a trustee of the trust. The BB CC advanced a loan to the trust to fund the acquisition of immovable property that the trust will use to derive rental income for the benefit of the beneficiaries of the trust, who are the children of the founder (BB).
>
> My question is whether section 7C applies to BB CC or Mrs BB. Mrs BB is of the opinion that, because she did not advance a loan to the CC, section 7C cannot apply.

Some initial comments on the facts
A close corporation is, by definition, a company for purposes of the Income Tax Act.

It is important to remember that the purpose of the loan, or the reason why the loan was provided to the trust is irrelevant for the purposes of section 7C.

Section 7C applies to any loan, provided by a company, to a trust, if the company provided the loan at the instance of a natural person, who is a connected person in relation to that company in terms of paragraph (d)(iv) of the definition of connected person in section 1(1) of the Act, and who also is a connected person in relation to the trust. This is in terms of section 7C(1) of the Act.

In conclusion, section 7C would apply to this loan, if the BB CC (the company) provided the loan to a trust, in relation to which Mrs BB is a connected person. The beneficiaries of the trust are the relatives of Mrs BB, and consequently, Mrs BB is a connected person in relation to Mrs BB. However, there is a further requirement. Section 7C would only apply if the loan was provided by BB CC at the instance of Mrs BB.

The phrase ‘*at the instance of*’ appears in the Income Tax Act in a number of places. It is also used for purposes of donations tax and significantly, for deemed donations (section 58). It then also appears in the Estate Duty Act, in relation to domestic insurance policies.

There is no definition of the phrase, and it must therefore take its ordinary meaning. The South African Concise Oxford Dictionary, provides the following meaning for the phrase “at the instance of”:

- *formal* at the request or instigation of.
- Origin: Middle English: From Latin *instantia* ‘presence, urgency’, from instare ‘be present, press upon’.

In the SARS “External Guide Estate Duty Implications on Key Man Policies”, the following is said:

> *"'At the instance' of a person is defined in the dictionaries as 'at the request or suggestion' of a person. A policy will be effected[82] at the instance of the deceased if the proposor (sic) would not have effected the policy had he not been requested by the deceased to do so."*

In the context of the loan provided by BB CC, the company would not (or could not) have provided the loan to the BB Family Trust, unless Mrs BB authorised the loan, or initiated the payment. As a member of the CC, she would have been the person who contracted with the trust and had instigated the granting of the loan or initiated it.

Conclusion on the facts:
It follows that section 7C will apply to the loan made by BB CC, the close corporation. Because it was made at the instance of Mrs BB, who is a connected person in relation to the close corporation, as required (not (by virtue of her membership in, but in terms of paragraph (d)(iv)) and who is also a connected person in relation the trust (the BB Family Trust).

Note: The intention of the example was to provide a simple practical explanation of the application of section 7C to a loan provided by a company. See the later discussion in this guide, where section 7C may not apply in instances where the debt arose by virtue of any share held in the company.

4.8.4.1 The words: "loan, advance or credit"

The Income Tax Act was amended, effective from 1 January 2013, in order that *"the various concepts utilising the term debt (e.g. debt instruments, loans and advances) be unified within a single term."* It was stated that "the term "debt" will be used throughout the Income Tax Act", and that *"all other related terms will be dropped."*

As was explained, in 2012, the term "debt" will bear its ordinary meaning. And also, that *"debt encompasses a sum owed by one party (the debtor) to another party (the creditor). Typically, a debt is created when the creditor lends a sum of money to a debtor. The debt is granted with expected repayments that may (or may not) include interest for the use of the sums loaned. Debt can come in many forms, including a personal loan, an advance (e.g. on salary), a note, a bond, a debenture, a bank deposit or any other claim of money requiring repayment."*

It then is interesting that the term "debt" was not used in section 7C. The legislator used three words, namely, "loan, advance, or credit". This must have been intentional, and when section 7 is being interpreted, one must not use the term debt, but one of the three words. In this part, the word "loan", would be used, but the three words would be intended.

The ordinary (or dictionary) meaning of the three words:

<u>Advance</u>
The South African Concise Oxford Dictionary gives the following meaning, verb, (4.) hand over (payment) to (someone) as a loan or before it is due, or as a noun, (3) an amount of money advanced.

[82] Affect is usually a verb, and it means to impact or change. Effect, on the other hand, is usually a noun that you would use to indicate the result of a change.

Credit
The South African Concise Oxford Dictionary gives the following meanings for the word credit: noun

1. the ability of a customer to obtain goods or services before payment, based on the trust that payment will be made in future. Money lent or made available under such agreement
2. an entry in an accounting record of an amount received

Loan
The South African Concise Oxford Dictionary gives the following meaning of loan as a noun, *“a thing that is borrowed, especially a sum of money that is expected to be paid back with interest; the action of lending”.*

And for the word “lend” (lending), (2) allow (a person) the use of (a sum of money) under an agreement to pay it back later, typically with interest.

All of the above, share some common principles, namely, an agreement and a deferral of the obligation to make payment, whilst the money is available for use by the other party.

Section 7C uses the word “provide” for this.

4.8.4.2 The person must provide

With respect to the meaning of the word “provide”, the South African Concise Oxford Dictionary gives the following two meanings:

- Verb -
  - 1 make available for use; supply (provide someone with)
  - 3 stipulate in a will or other legal document.

It often, in interpreting tax legislation is necessary to refer to other legislation. In terms of section 4, of the National Credit Act, this Act 6, this Act *“applies to every credit agreement between parties dealing at arm's length and made within, or having an effect within, the Republic (of South Africa)”*. Whilst the parties to a trust may not always be dealing at arm’s length, in fact it often is not the case, the definition of a “credit provider”, is relevant and may be the reason why the word “provide” was used in section 7C. According to section 1 of that Act, *““**credit provider**”, in respect of a credit agreement to which this Act applies, means-*

“(c) the party who extends credit under a credit facility;
(d) the mortgagee under a mortgage agreement;
(e) the lender under a secured loan;
(h) the party who advances money or credit to another under any other credit agreement;”

The National Credit Act defines, in section 8(4), describes a credit transaction as follows:

“An agreement, irrespective of its form but not including an agreement contemplated in subsection (2), constitutes a credit transaction if it is any other agreement, other than a credit facility or credit guarantee, in terms of which payment of an amount owed by one person to another is deferred, and any charge, fee or interest is payable to the credit provider in respect of-
(i) the agreement; or
(ii) the amount that has been deferred.”

All the agreements, to which the Act applies, are subject to interest, but it is submitted that, with respect to the word "provide" in section 7C, the National Credit Act can well be referred to, in order to interpret the phrase, *"directly or indirectly provides"*.

Whilst in terms of some trust deeds, the trustees may not have a mandate to enter into a loan agreement, or to only enter into secured agreements, if they have the general power, to enter into a loan agreement, the terms of the agreement should be in writing. It is submitted that the recording thereof, in the minutes of the meeting where this was approved, is not sufficient and that there should be a separate agreement (contract), signed by the person providing the funds to the trust.

In conclusion, the natural person, for the purposes of section 7C, would have provide(d) a loan, advance or credit, to the trust (or company), if the payment of the amount owed by the trust or company, is deferred. And that would be so, if the agreement is subject to a charge, fee or interest payable to the natural person (or company) or not.

Section 7C also applies in an instance where the person to whom the trust (or company) must make the repayment of the loan, did not originally provide the loan, but subsequently acquired the loan.

4.8.4.3 Acquired

Section 7C(1A) of the Act, is relevant here, and was with effect from 19 July 2017. With respect to the effective date of this provision, the Explanatory Memorandum stated as follows:

> *"The ... amendment will come into effect on 19 July 2017 and applies in respect of any amount owed by a trust or a company in respect of a loan, advance or credit provided to that trust or that company <u>before, on or after that date</u>."*

Section 7C(1A) reads as follows:

> *"If a person acquires a claim to an amount owing by a trust or a company in respect of a loan, advance or credit referred to in subsection (1), that person must for purposes of this section be treated as having provided a loan, advance or credit to that trust or company—*
> *(a) on the date on which that person acquired that claim; or*
> *(b) if that person was not a connected person on that date in relation to—*
> *(i) that trust; or*
> *(ii) the person who provided that loan, advance or credit to that trust or company,*
>
> *on the date on which that person became a connected person in relation to that trust or person, that is equal to the amount of the claim so acquired*."

The proposal, that lead to the introduction of section 7C(1A), was stated as follows:

> *"... where a person that is a connected person in relation to a trust acquires a loan claim to an amount owing by that trust in respect of a loan, advance or credit that was originally advanced by a natural person or a company (at the instance of a natural person) to that trust, <u>the person who acquires that claim will be deemed to have advanced the amount of that claim as a loan on the date that person acquired that claim</u>."*

It is not clear why the word "advanced" was used here. The words used in the legislation is that the person who acquired the claim (the loan), will be deemed to have provided the loan.

The following reason was given[83] for section 7C(1A):

> *"Transfer of loan claims to current or future beneficiaries of trusts*
> *Under this avoidance scheme, taxpayers enter into an arrangement under which the loan claim of the natural person who made the loan, advance or credit to the trust (or the natural person at whose insistence a company made a loan to a trust) is transferred to another natural person. The natural person that the loan claim is transferred to is usually a current beneficiary of the trust or a future beneficiary of the trust to which the loan, advance or credit is made, such as a child or a spouse. <u>By subsequently transferring the loan claim</u>, taxpayers argue that this breaks the link between the natural person who advanced the loan and the loan. Because of this, the natural person to whom the loan claim is transferred does not account for the deemed ongoing and annual donation as that natural person did not advance the loan to the trust."*

The following is an example of a transfer of the loan claim that is not done in order to avoid tax.

The facts
A natural person, on 1 September 2000, provided a loan of R8 million to a trust. This individual died during the current year of assessment. In terms of the individual's last will and testament, the sole heir of the deceased, inherited the loan. The sole heir of the deceased is also a beneficiary of the trust.

The question is whether the heir, acquired the loan, for purposes of section 7C(1A).

Comments on the facts and the answer to the question
The date of death, of the first mentioned individual, and the date the heir acquired the claim, will typically not be in the same year of assessment. However, it is irrelevant when (in which year of assessment) the original loan was made to the trust, and also when the other individual (the heir in this instance) acquired the claim to the loan. In principle (at common law), the heir would only acquire the loan after the Liquidation and Distribution account became final.

The wording in section 7C(1A) does not explain how the loan was acquired. The South African Concise Oxford Dictionary, with respect to the word acquire, as a verb, is "come to possess". The origin of the word, Middle English, from Latin: *acquirere*, 'get in addition'. The heir "acquires" the claim, if the heir obtained possession of the loan. Because of the last will and testament, the heir became entitled to the loan (property in the estate) and became the owner of the loan on the date the L & D account became final.

It is the heir that would be entitled to receive payment of the loan, should the trustees in the future decide to, or are obliged to make a payment in respect of the loan. The loan would also be property of the heir.

In conclusion, the heir would be treated, in terms of section 7C(1A) of the Act, to have provided the loan to that trust.

4.8.5 A loan or credit from a beneficiary

A beneficiary of a trust is by virtue of being a beneficiary, a connected person in relation to that trust.

[83] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017 (15 December 2017)

If such a beneficiary, who is a natural person, provided a loan to the trust, then section 7C would apply, and if the rate of interest payable by the trust, is less than the official rate of interest, then there would be a deemed donation.

In practice it happens often that an amount of income, or a capital gain is vested in a beneficiary, and is not immediately paid out (or distributed) to the beneficiary.

The question then arises, if section 7C may apply to this, for the period starting at the date of vesting, until it is paid.

Interesting to note that, if the amount is just left unpaid, the beneficiary's claim to receive payment will prescribe after a period of three years.

The following clauses (paragraphs) appear in a trust deed. [Joan Cynthia Griessel NO & others v De Kock (334/18) [2019] ZASCA 95 (6 June 2019)]

5.2 The Trustees shall have the power, in their entire discretion from time to time and at any time to pay to, or to apply the whole of any part of the income of the trust fund for the general advantage or anyone or more of the beneficiaries as the Trustees may decide, and in such proportions and from such source as the Trustees may determine, and any income so paid or applied <u>shall accrue to the beneficiary</u>.

9. VESTING

The right of any beneficiary to payment of any income or capital under this trust shall, unless the Trustees otherwise determine, vest in such beneficiary <u>only on the date of such payment or transfer</u>. "Payment" and "transfer" shall include all forms of transfer of possession or ownership of trust assets, but <u>shall not include the crediting of</u> a loan account in the name of the trust or <u>a loan account which a beneficiary has with the trust</u>.

Comment about the two clauses

There seems to be a contradiction; when the trustees decide, to pay or apply, the amount of income or capital accrues to the beneficiary. However, in terms of clause 5.2, the right of the beneficiary (which right arises when it accrues), in terms of clause 9, only vests in the beneficiary when it is paid.

We do not know if this was just bad drafting in a trust deed that otherwise is well drafted, but it is not clear what the intention was here.

The common law position, is that the crediting of a loan account in fact, constitutes payment of the amount. As was said, by Judge Heher, in CSARS v Scribante Construction (Pty) Ltd, *"… the <u>crediting of the loan accounts constituted an actual payment</u> as if the dividends had been deposited into an account held by a shareholder at a banking institution."* Judge Savage, in a case before the tax court (VAT 1247), said that it *"follows ... that the crediting of C's loan account by the appellant in the context of the funding arrangement between the two companies <u>amounted to payment of "consideration"</u> in relation to the supply of goods and services invoiced."*

It must be remembered that, should there be no intention of making payment to the beneficiaries, and the vesting was done mainly to get a tax benefit (arising from the lower rates of tax, on inclusion rate, that may apply to the beneficiaries), it may well be an impermissible tax avoidance arrangement. If the intention is for the money to remain in the trust, the beneficiaries must donate it back to the trust or enter into a loan agreement.

Example:
The trustees, during a year of assessment, disposed of immovable property held by the trust.

The trustees, acting in terms of the discretionary mandate (obtained from the trust deed), decided to vest the capital gain, as determined for purposes of the Eighth Schedule to the Act, in a beneficiary of the trust.

With respect to the payment of the amount so vested, they advised the beneficiary as follows:
An amount equivalent to the amount of the capital gain, multiplied by the inclusion rate of 40% (applicable to you), multiplied by the marginal tax rate of 45%, will be paid to you before the end of February. You must add the capital gain vested in you, in your estimate of taxable income for provisional tax purposes.

The balance of the amount due to you, will only be paid once the trustees concluded an agreement for the acquisition of a replacement asset. Should the trustees not be able to pay for the acquisition, from their own funds, the trustees may request that this money be used to pay the deposit. The deposit, once finance is obtained, will be refunded to you.

If the trustees were able to replace the asset, the balance of the capital gain, was paid to the beneficiary in October the next year.

The trustees passed the following journal entry, in the books of account of the trust:

Account description	Debit amount	Credit amount
Date of transaction: 31 January 2**4		
Trust capital (retained income)	R1 200 000	
Beneficiary A		R1 200 000
Amount of a capital gain vested in Beneficiary A		
Date of transaction: 10 February 2**4		
Beneficiary account	R216 000	
Bank		R216 000
Payment (R1,2 million * 40% *45%) = R216 000		
Date of transaction: 31 October 2**4		
Beneficiary account	R1 200 000	
Bank		R1 200 000
Payment of balance (R1 200 000 less R216 000)		

Apart from the notification received from the trustees, the trust and the beneficiary did not enter a loan agreement with respect to this, or whether this amount will be subject to interest during the period of the deferral of the obligation to make payment.

Question: The question is whether section 7C will apply to this amount, carried as a current liability in the trust accounts.

Loan:
It is submitted, for there to be a loan, that the beneficiary and the trustees must have entered into a loan agreement. In this agreement, the repayment terms, and whether or not the agreement is subject to interest, should be dealt with. And very important, the trustees should be authorised to enter into such an agreement – put differently, the trust deed must give the trustees that power.

Trust deeds would typically, with respect to the powers of trustees, contain a clause authorising the trustees to borrow money. If the trustees are not authorised to borrow money, which is not all that uncommon to find, then the trustees will not be able to enter into an agreement to do so. They generally will have a wide power vested in them. A typical clause, from a trust deed, (taken from "Volume 10: Butterworths Forms and Precedents (1990)" reads as follows:

> Trustee's powers
> In addition to the powers vested in them by law the trustees shall have the widest possible powers without prejudice to the generality of the aforegoing they may exercise the following powers:
>
> 7.11 to borrow money:
> in their sole and absolute discretion, to borrow money for the purposes hereof at such time or times, at such rate of interest or other consideration for any such loan and upon such terms and conditions as they may deem desirable. Such borrowings may be made from any suitable person or persons and, should they consider it advisable so to do, the trustees may secure the payment of any such loan by pledging or mortgaging the trust assets or any part thereof or by any other security device. Any such loan or loans may be extended, renewed or repaid from time to time as the trustees may deem to be in the best interest of the trust.

From the minutes of the vesting event (the decision by the trustees), it is clear that the trustees did no more than vest the amount of income, a capital gain in this instance, in the beneficiary. This constitutes *dies cedit*, or the entitlement of the beneficiary to the amount. Distribution of the amount (or asset) vested, or *dies venit*, must then follow, and was deferred in this instance. Other than an amount that will be paid to the beneficiary, who is a provisional taxpayer, and to be used by the beneficiary to meet his or her obligation to SARS, there is no indication of when the trustees will actually pay the balance to the beneficiary.

Section 7C (or the Income Tax Act) does not define the word 'loan' or 'advance' and they must take their ordinary meanings (see above). The amount vested (by the trustees) in the beneficiary did not arise from an action taken (or initiated) by the beneficiary. It arose from an action (the decision) by the trustees, acting within their mandate obtained from the trust deed, to vest the amount in question in a beneficiary (the discretionary beneficiary). It is clear that it does not arise from an agreement between the trustees and the beneficiary (in terms of a loan agreement, or as an advance).

The issue then is whether it is a credit. The word 'credit' is also not defined (for purposes of section 7C or otherwise). The ordinary meaning of the word 'credit', when used as a verb, is to "add (an amount of money) to an account" and one can accept that a credit can then arise from an accounting entry. It is often seen that trustees reflect these amounts owing to beneficiaries as loans, without there being any agreement to that effect between the trust and the beneficiary. This is simply not proper accounting, by the trustees, and crediting to a loan account, constitutes payment.

He or she must keep regular accounts of all his or her transactions on behalf of the beneficiary, not only of disbursements, but also the receipts, and to render such accounts to the beneficiary at all reasonable times *'without any suppression, concealment, or overcharge; keep accounts up to date and allow for the inspection of his or her books.'*

5. VESTING

The right of any beneficiary to payment of any income or capital under this trust shall, unless the Trustees otherwise determine, vest in such beneficiary only on the date of such payment or transfer. "Payment" and "transfer" shall include all forms of transfer of possession or ownership of trust assets, but shall not include the crediting of a loan account in the name of the trust or a loan account which a beneficiary has with the trust.

However, if we look at the meaning of 'credit' when used as a noun (or mass noun), we see the following meanings:

- the ability of a customer to obtain goods or services before payment, based on the trust that payment will be made in the future.
- the money lent or borrowed under a credit arrangement.
- An entry recording a sum received, listed on the right-hand side or column of an account. The opposite of debit.

One can conclude that the mere recording of the amount vested in the account of the beneficiary, will be a credit. Judge Mbha (in case 12680) said that:

> *"It is accepted generally that the meaning of words in a statute is derived from the common law. The basic rule of interpretation is that the meaning must, unless a statute provides otherwise, or unless it would result in an absurdity, be taken to be the ordinary meaning of the word which can be found in a dictionary of established authority."*
>
> *"If there is any doubt about the ordinary meaning of a word used in a particular context, certain rules must be applied. There are two rules relevant to this matter: A word included in the group of words must be regarded as being of the same type as the other words in that group (eiusdem generis); on the other hand, if a word is not included in the group, it must not be regarded as subject to the same prescriptions as that group (exclusio alteris)."*

On that basis, the common meaning shared by the three words, loan, advance or credit, is that there must be an agreement.

The beneficiaries, in this instance, did not advance (or lend) money to the trust. What happened is that the trustees vested the 'income' or 'capital gain' but did not pay (or distribute) the amount so vested to the beneficiaries.

Nevertheless, can it be said that the beneficiary provided credit to the trust?

It is submitted that the phrase *provides to a trust*, requires that the connected person, the beneficiary in this instance, agree that the amount (the loan, advance or credit) is made available to the trust (trustees) in order to be used by the trustees for purposes of the trust.

In order to conclude on the credit in the books of account of the trust, one must therefore determine how the trustees used the money.

To strengthen the argument, where the amounts were, by agreement, in terms of the trust deed, or otherwise, to be kept separate from the other assets or investments of the trust, that no credit (or loan or advance) was provided. This would be because there was no intention of the parties, the trustees and the beneficiaries, that the trustees can use the money (or amount in question).

Because the vested amounts are to be kept separate from the other property of the trust, the income (or gains) derived from the assets accrue to the beneficiaries. These amounts (income or gains) must be declared as such in the returns of income (ITR12's) submitted by the beneficiaries.

The above interpretation is in line with Binding Private Ruling (BPR) 350. In that ruling, the beneficiary also played *"no role in the decision ... made by the trustees to defer the enjoyment of the vested amount."* And the beneficiary did *"not make any loan or credit to the trust and will not conclude any agreement with the trustees in this regard."*

The ruling was then:

> *"Section 7C will not apply to the proposed transaction.*
> *Any subsequent income earned on the vested amount, or such income as will be apportioned to the vested amount, to which enjoyment has been withheld, will accrue to the beneficiary and must be included in the gross income of the beneficiary."*

And, as was explained in the BPR, the trustees *invested "the vested amount on behalf of the beneficiary for"* the benefit of the beneficiary. And that the *"income arising from such investment will accrue to the beneficiary and not to the trust. The trustees will keep accurate records of the vested amount, to which enjoyment has been withheld, so as to track and identify the amount so vested and the income that it yields. Any assets acquired on behalf of the beneficiary with the vested amount will be accounted for and recorded by the trustees in the financial records of the trust."*

5.1.1 The deemed donation

As was explained, in *"every year of assessment of the trust that the interest free or low interest loan remains outstanding, the amount of the deemed donation made by the natural person to the trust is determined as the difference between the interest charged on the loan, advance or credit and the interest that would have been payable by the trust had the interest been charged at the official rate of interest, as defined ..."*

<u>A loan to a trust</u>
In this part, the deemed donation that arises from a loan to a trust will be explained. The possible exclusion, or instances where such interest forgone on a loan would not result in a deemed donation, would also be dealt with.

In terms of section 7C(3), and in respect of any loan (advance or credit) to which section 7C applies, "*<u>if a trust … incurs</u> ... <u>no interest in respect of a loan</u> … or interest at a rate lower than the official rate of interest, <u>an amount equal to the difference between the amount incurred by that trust … during a year of assessment as interest in respect of that loan</u> ... <u>and the amount that would have been incurred</u> by that trust … at the official rate of interest <u>must</u> ... <u>be treated as a donation made to that trust</u> by the person … on the last day of that year of assessment of that trust."*

Simply put, where an individual, who is a connected person in relation to a trust, provided a loan to the trust, and the trust incurs either no interest on that loan, or the trust incurs interest at a rate lower than the official rate of interest, then the individual would be deemed to have made a donation to the trust.

The legislation is clear, that it is *"for purposes of Part V of Chapter II"*, that this will "*be treated as a donation made to that trust by the"* individual who provided the loan. It does not treat the trust as having received a donation and is merely to bring the amount of the (deemed) donation into the cumulative value of other property donated by the individual, during the year of assessment, in order to arrive at the amount in respect of which the donations tax is levied. This donations tax is payable by the person who provided the loan.

This of course would be unless section 7C does not apply, which it would not if section 7C(5) applies. This will be discussed shortly.

What is the "official rate of interest"?
"Official rate of interest" is defined in section 1(1) of the Act and that definition is copied below for ease of reference:

> "For purposes of the Income Tax Act, and also for purposes of section 7C, (*unless the context otherwise indicates*), "***official rate of interest***" *means*—
> *(a)* *in the case of a debt which is denominated in the currency of the Republic, a rate of interest equal to the South African repurchase rate plus 100 basis points; or*
> *(b)* *in the case of a debt which is denominated in any other currency, a rate of interest that is the equivalent of the South African repurchase rate applicable in that currency plus 100 basis points:*

Provided that where a new repurchase rate or equivalent rate is determined, the new rate of interest applies for the purposes of this definition from the first day of the month following the date on which that new repurchase rate or equivalent rate came into operation."

The context in which the phrase "*official rate of interest*", is used in section 7C, cannot be seen to indicate otherwise – it must take its defined meaning. The definition of "official rate of interest" was not always found in section 1(1), but the following explanation was given when the phrase would have to be used.

> *"In order to counter the tax benefit as a result of the use of zero or low interest loans, the Act contains various anti-avoidance rules that deal with the taxation of a difference between the amount of interest actually incurred and the amount of interest that would have been incurred at the official rate. These anti-avoidance provisions include the following:*
> - *Section 7C of the Act which applies in respect of zero or low interest free loan advanced to a trust by a connected person of that trust. The official rate of interest is used under this provision to quantify a donation that arises from advancing a zero or low interest loan to a trust.*
> - *Section 64E(4) of the Act where the official rate of interest is used to quantify a deemed dividend in respect of a zero or low interest loan made by a company to a shareholder by virtue of a share.*
> - *Seventh Schedule where the official rate of interest is used under this provision for fringe benefit determination in respect of a zero or low interest free loan between an employer and employee."*

The above extract, confirms that it is the official rate of interest, as is defined in section 1(1) of the Act, that must be used in order to calculate the deemed donation for purposes of section 7C.

As was explained, in 1985, that the official rate of interest, *“serves as a standard in determining the benefit arising from an interest-free or low-interest loan.”* The official rate of interest is also used to determine ‘market-related interest[84]’, for purposes of the deemed dividend arising from the official rate of interest.

The official rate of interest is published by SARS[85], and regularly updated, on their website. It is Table 3, that contains the *“Rates at which interest-free or low interest loans are subject to income tax”*, from 01 March 1985. And is updated by SARS whenever the SA Reserve Bank adjusts the repo rate.

In South Africa, the South African Reserve Bank (SARB) lends money to South African banks at a rate known as the repo rate. The repo rate is set by SARB's Monetary Policy Committee. The rate changes so that inflation can stay within the 3% to 6% range in line with SARB's mandate.

The foreign repurchase rates, or the rate in respect of a debt which is denominated in any currency other than ZAR, are not published by SARS. But the repurchase rate, or “repo rate”, for other countries, is also the interest rate at which the Central Bank of that country, lends to banks in the country.

It is common for persons who are party to a loan agreement, denominated in a foreign currency, to use the LIBOR rate, or other similar rates, in order to determine an arm’s length rate. It is important to note that such a rate, such as the LIBOR rate, is not *“the equivalent of the South African repurchase rate”* – it is more in the nature of a benchmark rate used by some of the world's leading banks when they charge each other for short-term loans. A rate, such as LIBOR, cannot be used to determine the official rate of interest for purposes of section 7C.

Once it has been determined that section 7C applies, and that there is a deemed donation, one must then test to determine if any one of the exclusions do not apply. If it does, there is no need to calculate the amount of the deemed donation. If there is no exclusion, then the amount of the deemed donation must be determined. The exclusions are found in section 7C(5), and will be dealt with later on in this guide.

Calculation of the amount of the deemed donation

It is section 7C(3) of the Act, that prescribes how the amount of the donation must be calculated. For ease of reference, section 7C(3) is copied here:

> *“If a trust or company incurs—*
>
> *(a) no interest in respect of a loan, advance or credit referred to in subsection (1), (1A) or (1B); or*
>
> *(b) interest at a rate lower than the official rate of interest,*
>
> *an amount equal to the difference between the amount incurred by that trust or company during a year of assessment as interest in respect of that loan, advance or credit and the amount that would have been incurred by that trust or company at the official rate of interest must, for purposes of Part V of Chapter II, be treated as a donation made to that trust by the person referred to in subsection (1)(a), (1A) or (1B) on the last day of that year of assessment of that trust or company.”*

[84] See section 64E(4)(d), for the definition of ‘market-related interest’.
[85] https://www.sars.gov.za/legal-counsel/legal-counsel-publications/tables-of-interest-rates/

Section 7D of the Act, prescribes how the amount of interest must be calculated, and it reads as follows:

> *"Where it must be determined, for the purposes of this Act, what amount would have accrued or been incurred as interest in respect of any loan, debt, advance or amount of credit provided to a person or an amount owed by a person had that interest accrued or been incurred at a specific rate of interest, that amount must be determined –*
>
> *(a) without regard to any rule of the common law or provision of any Act in terms of which—*
>
> *(i) the amount of any interest, fee or similar finance charge that accrues or is incurred in respect of a debt may not in aggregate exceed the amount of that debt; or*
>
> *(ii) no interest may accrue or be incurred in respect of a debt once the amount that has accrued or been incurred as interest is equal to the amount of that debt; and*
>
> *(b) as simple interest calculated daily."*

Section 7D was introduced into the Act, not only for purposes of calculating the amount of interest for purposes of section 7C – it was also for the purposes of calculating the deemed dividend, or taxable benefits where there were low interest loans. The reason for it was explained as follows:

> *"It has come to Government's attention that some taxpayers are relying on the "in duplum" rules to circumvent the above-mentioned anti-avoidance rules.*
>
> *The above-mentioned anti-avoidance rules that deal with the tax consequences of zero or low interest loans in employer-employee relationships; shareholder-company relationships and natural connected person-trust relationships were introduced for purposes of determining the tax benefit derived from a zero or low interest loan between connected parties, on the difference between the amount of interest actually incurred and the amount of interest that would have been incurred at the official rate. They are meant to override all instances where interest is either not levied or levied at a rate below the market value, irrespective of whether the "in duplum" rule applies or not. It is proposed that clarification be made in the Act so that anti-avoidance rules dealing with zero or low interest free loans should apply in spite of the application of either the statutory "in duplum" rule or the common law "in duplum" rule."*

This is best explained by way of an example.

Individual A, advanced in terms of a loan agreement, an amount of R2 million to the A Family Trust. The individual is a connected person in relation to the trust, and the rate of interest that applies to the loan was fixed at 4%. The payment terms agreed on, were that Individual A had to give 12 months' notice, before the trust would have to make any payment.

None of the exclusions in section 7C(5), apply to this loan.

What is the amount of the deemed donation, for purposes of section 7C(3) of the Act? For the 2024 year of assessment?

Additional facts:
From Table 3:

Date from	Date to	Rate
01.02.2023	31.03.2023	8.25%
01.04.2023	31.05.2023	8.75%
01.06.2023	Until change in Repo* rate	9.25%

The total amount of interest, that would have been payable if calculated at the official rate of interest, is:	Amount (ZAR)
For the period 1 March 2023 to 31 March 2023 31/366 *R2 million * 0,0825	13 975.41
For the period 1 April 2023 to 31 May 2023 61/366 *R2 million * 0,0875	29 166.67
For the period 1 June 2023 to 29 February 2024 274/366 *R2 million * 0,0925	138 497.27
Total	181 639.35
The interest actually incurred by the trust	
R2 000 000 * 0,04	80 000.00
Amount of the deemed donation	101 639.35

Comments relating to the calculation above
This amount, or the value of the deemed donation, is added to the cumulative value of the other donations made by Individual A The section 56(2)(b) amount (the R100 000) is then "deducted" from the aggregate for the year, to arrive at the amount on which the donations tax must be paid.

In a sense, the section 7C loan is the last donation a person will have made for the year of assessment, as it is deemed to have been made on the last day of February.

It is not correct to work on year end balances only.

It is irrelevant, if Individual A provided the loan to the trust, a number of years earlier. It cannot be argued that, because of the *in duplum* principle, the obligation to "pay" interest stopped when the unpaid interest equalled the capital amount due in terms of the agreement.

Section 7C does not deem the trust to have incurred interest, or interest to have accrued to Individual A. And section 7D then prescribes that the above calculation must be done on simple interest calculated daily. That is irrelevant to the calculation of the interest incurred by the trust, but relevant to the official rate of interest. That is why, in the example, it was done for the number of days, and the interest for March 2023, not being added to the capital amount, when the next period was calculated.

And also, why the comment that opening, or closing balances, may not be used, was made. In the example, the calculation was done to the day the official rate change. If the amount of the loan, during the year of assessment, decreased because the trustees had made a payment to the individual, or the amount of the loan increased, because Individual A advanced (provided) more money to the trust, then the calculation of the interest at the official rate of interest must be done to the date of the change.

From the definition of official rate of interest, it is clear that the debt can be denominated in a foreign currency, and that the rate of interest will then be the equivalent of the South African repurchase rate.

The Act, prior to an amendment which came *"into operation on, and applies in respect of years of assessment commencing on or after"* 1 January 2024.

Section 7C(3A), was added to the Act, and deals with, what essentially prescribes how the donation should be calculated when the debt is denominated in a foreign currency. Section 7C(3A) reads as follows:

> *"Where the amount to be treated as a donation in terms of subsection (3) is denominated in any currency other than that of the Republic, the person referred to in subsection (1), (1A) or (1B) must, for purposes of that subsection, translate that amount to the currency of the Republic by applying the average exchange rate for the year of assessment in respect of which that amount is treated as a donation."*

It was explained as follows:

> *"Determination of the deemed donation in respect of debt denominated in foreign currency*
> *Where the provisions of section 7C of the Act apply, any interest foregone in respect of low interest or interest free loans, advances or credit owed by any trust or company is deemed to be a donation that is subject to donations tax. The deemed donation is calculated as the amount by which the official rate of interest exceeds any amount of interest incurred in this regard. However, in instances where the low interest or interest free loan, advance or credit owing by any trust or company is denominated in foreign currency, the provisions of the anti-avoidance measure do not provide guidance to taxpayers on how and when this amount should be translated to South African rands."*

SARS publishes the "Average exchange rates for a year of assessment", see Table A. In practice, SARS may not, by the end of March of the year following the end of the year of assessment (the last day of February on which the donation was deemed to have been made), have updated the table. The person who provided the loan to the trust will then have to calculate the average exchange rate for the year.

It was already mentioned that there are certain prescribed instances where section 7C does not apply.

5.1.2 The exclusion from section 7C

When a natural person, provided a loan to a trust, and section 7C applies to this loan (in terms of section 7C(1)), there may well not be a deemed donation. That would be so when section 7C(5) applies. Section 7C(5) describes the instances where section 7C would then not apply.

Section 7C(5) was added to section 7C, because it was recognised that *"trusts are used for a myriad of other purposes other than that of estate planning"* and therefore that "various exclusions" from the application of section 7C, needed to be provided for.

5.1.2.1 Residence

The most common of these "various exclusions", is where the loan financed a primary residence (owned by the trust) and is found in section 7C(5)(d). It reads as follows:

> *"Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) if ... that*

trust or company used that loan, advance or credit wholly or partly for purposes of funding the acquisition or improvement of an asset and—

(i) the natural person referred to in subsection (1)(a) or (b) or the spouse of that person used that asset as a primary residence as contemplated in paragraph (b) of the definition of 'primary residence' in paragraph 44 of the Eighth Schedule, where that primary residence and the land on which it is situated (including unconsolidated adjacent land) do not exceed two hectares are together used mainly for domestic or private purposes, throughout the period during that year of assessment during which that trust or company held that asset; and

(ii) the amount owed relates to the part of that loan, advance or credit that funded the acquisition or improvement of that asset ..."

Section 7C(5)(d), as it was initially introduced into the Act, applied only if the loan funded the acquisition of the property. It was explained as follows in the Explanatory Memorandum:

> *"A loan made by … a natural person to a trust will be excluded to the extent to which that loan was used by that trust to fund the acquisition of a residence that is used by that person or that person's spouse as a primary residence."*

It has come to Government's attention that this exclusion in respect of a primary residence does not fully encompass what constitutes a primary residence in terms of the Eighth Schedule to the Act when it was intended that the meanings should be aligned.

Exclusion of primary residence from the application of the anti-avoidance measure
It is proposed that the exclusion for the acquisition of a primary residence be clarified by also including funding of improvements to the primary residence and by applying the limitations in paragraph 46 relating to the land on which the primary residence is situated to the primary residence. In addition, it is clarified that the exclusion applies to funding used to both acquire and improve a primary residence.

It added the land, the land on which the residence is situated, and improvements to the residence.

According to section 3(2), of Act No. 17 of 2023 (the Taxation Laws Amendment Act, 2023), this amendment to section 7C(5)(d), came *"into operation on 1 January 2024 and applies in respect of years of assessment commencing on or after"* 1 January 2024.

No further detail was given. But one can accept that this does not allow a natural person to go back to previous years, and to reduce the amount of the deemed donation, by excluding amounts that funded improvements.

The question is, with respect to loans provided to the trust in years of assessment prior to (and including) the 2024 year of assessment, whether the amount of the loan, qualifying for the inclusion can be increased with the amount that financed the acquisition of the land and the improvements affected to the property.

It is submitted that it can be done, and that the amount of the donation, determined on the last day of February (and the amount of interest calculated by applying the official rate of interest on a daily basis), must be the amount of the loan that funded the acquisition of the property, the land on which the property is situated (limited to the 2 hectares), and the cost of improvements made to the property since acquisition. Where the improvement was made during the year of assessment, and this was funded by way of a loan from an individual (connected), it would be an example of where the amount used for the calculation, changed during the year, and the increased loan amount must be used going forward, and until the loan amount again changed, or there was a change in the official rate of interest.

The "*natural person referred to in subsection (1)(a)"* is the person who is a connected person in relation to the trust and who provided the loan to the trust.

It is clear that, whilst the exclusion initially only applied to the extent that the trust used the loan wholly or partly "*for purposes of funding the acquisition of the asset*" (the primary residence), since the above amendment, it no longer limits the purpose (or funding) to the residence only.

In addition to the requirement relevant to the purpose to which the trust in question used that loan, section 7C(5)(d) also requires that *"the natural person who provided the loan (or the spouse of that person) used that asset as a primary residence … throughout the period during that year of assessment during which that trust … held that asset"*. In respect of the periods not used as prescribed, the calculation on a daily basis, of the official rate of interest, must exclude the periods of non-qualifying use.

The asset must be a '*primary residence*' as mentioned above. In terms of paragraph 44, of the Eighth Schedule to the Income Tax Act, *"'**residence**' means any structure … which is used as a place of residence by a natural person, together with any appurtenance belonging thereto and enjoyed therewith"*.

And '***primary residence****' "means a residence –*
(a) in which a natural person or a special trust holds an interest; and
(b) which that person or a beneficiary of that special trust or a spouse of that person or beneficiary –
  (i) ordinarily resides or resided in as his or her main residence; and
  (ii) uses or used mainly for domestic purposes;"

Factually, with respect to the residence acquired by the trust, Mr Novick ordinarily resides in it as his main residence and uses the residence mainly for domestic purposes. The requirement of section 7C(5)(d)(i), that the person used that asset as a primary residence as contemplated in paragraph (b) of the definition of 'primary residence' in paragraph 44 of the Eighth Schedule throughout the period during that year of assessment during which that trust held that residence, is therefore met.

The next most common loans that section 7C applies to, and in respect of which an exclusion is available, is a loan made by a company, at the instance of the individual (connected person).

<u>Conclusion</u>:
As Individual A, the lender or person who provided the loan to the trust, is a connected person in relation to the A Family trust, and Individual A used the asset held by the trust throughout the year (or period) of assessment, as a primary residence, and the loan provided by individual A financed the acquisition of that asset (the primary residence), section 7C(5)(*d*) will apply.

This means that section 7C(3) will not apply and the fact that the trust incurs no interest on the loan will not result in Individual A being treated as having made a donation to the trust.

5.1.2.2 Loan provided to a company

This can apply in two instances:

- The natural person, provided a loan to the company, and the trust holds shares in the company;
- A company, at the instance of the natural person, provides the loan to the trust.

The wording of the exclusion, is found section 7C(5)(g), and reads as follows:

> *"Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) if ... that trust or company used that loan, advance or credit wholly or partly for purposes of funding the acquisition or improvement of an asset and ... that loan, advance or credit is subject to the provisions of section 64E(4) ..."*

It is not intended to explain section 64E(4) in detail in this guide, but the following is necessary to know. Where the loan is made by the natural person to the company, section 64E(4) cannot apply.

When will the loan be subject to section 64E(4)?

Section 64E(4) applies if *"any amount is owing to a company by—*

(i) a person that is—

(aa not a company;

(bb) a resident; and

(cc) a connected person in relation to that company;

(ii) a person that is-

(aa) not a company;

(bb) a resident; and

(cc) a connected person in relation to a person contemplated in subparagraph (i),

in respect of a debt, that company must … be deemed to have paid a dividend if that debt arises by virtue of any share held in that company by a person contemplated in subparagraph (i)."

A debit loan in the books of the company. The loan to the trust would be a loan to a person that is not a company. The trust must be tax resident in the RSA.

The trust would be a connected person in relation to the company, if the trust (trustees) *"alone or together with any connected person in relation to* the trust*, "holds, directly or indirectly, at least 20 per cent of –*

(aa) the equity shares in the company; or

(bb) the voting rights in the company;"

(Paragraph (d)(iv) of the definition of "connected person" in section 1(1) of the Act)

In this respect, and as stated in the SARS practice generally prevailing,

> *"All connected persons in relation to a trust are connected persons in relation to one another.*
>
> *The beneficiary of a trust and a company in which the trust holds at least 20% of the equity shares or voting rights are connected persons in relation to each other, since they are both connected persons in relation to the trust ... Beneficiaries of the same trust are likewise connected to one another under paragraph (bA), since they are all connected persons in relation to the trust (see Example 8)."*

Example 8, in Interpretation Note 67, is duplicated below:

Facts:

B Family Trust and AC CC are beneficiaries of ABC Family Trust.

Are B Family Trust and AC CC connected persons in relation to each other under paragraph (bA)?

Result:

B Family Trust and AC CC are both beneficiaries of, and connected persons in relation to, ABC Family Trust under paragraph (*b*)(i). B Family Trust and AC CC are therefore connected persons in relation to each other under paragraph (*b*A), since they are both connected persons in relation to ABC Family Trust.

Some comments about the above example:

It is important to note, in order to determine if the trust and the CC are connected in relation to each other, that it is irrelevant who the members of the CC are. The natural person who provided a loan, to the CC, would be a connected person in relation to the CC, by virtue of being a member of the CC, and section 7C can apply to that loan.

We, however, are concerned with a loan made by a company to a trust.

Example 2[86] – Amount of dividend deemed to have been paid

Facts:

Company H's year of assessment ends on the last day of February. Company H advanced a loan of R20 million on 1 March year 1 at a rate of interest of 2% to LJ Trust, which was formed in South Africa. The 'official rate of interest' was 8%. The loan was repaid on 1 March year 2. LJ Trust and Company H are connected persons in relation to each other. The loan was advanced to LJ Trust by virtue of the shares LJ Trust held in Company H.

Comment on the facts:

For purposes of section 7C, and relevant to the loan of R20 million, it is important to determine if the loan, were provided by Company H to the LJ Trust, at the instance of a natural person who is a connected person in relation to the trust.

Whilst the facts state that the *"loan was advanced to LJ Trust by virtue of the shares LJ Trust held in Company H"*, the percentage interest held by the trust is not stated. For purposes of the example, it is accepted that the LJ Trust held all the issued equity shares (and voting rights) in Company H (Pty) Ltd. And that an individual, LJ, was appointed (by the trustees of the trust) as the managing director of Company H. And then also, that it was at LJ's instance that the amount of the loan was advanced to the trust. This is not uncommon to find this in practise.

Is the individual a connected person in relation

For purposes of section 7C(1), in terms of section 7C(1)(b), if the loan was provided *"at the instance of a natural person"* by a company, the natural person must be a person who *"is a connected person in terms of paragraph (d)(iv) of the definition of connected person"* in relation to the company. As all the shares are held by the LJ Trust, LJ is not a connected person in relation to H Company (in terms of paragraph (d)(iv)).

[86] Comprehensive Guide to Dividends Tax (Issue 5)

But because the loan was provided by H Company, a company in respect of which at least 20% of the equity shares are directly held by the LJ Trust, section 7C will apply – see section 7C(1)(ii).

Very important, when section 64E(4) applies, and with respect to section 7C, both determinations are done on the last day of the year of assessment. This of course is unless the financial year of the company ends on a day, other than the last day of February, which is when the section 7C calculation the last day of February. Whilst the calculation of the deemed donation, for purposes of section 7C, is the same as the calculation of the deemed dividend for purposes of section 64E(4), it is advisable to determine if section 7C applies and to do the dividend calculation, before section 7C is considered.

SARS, gives the following **result** for the dividend tax calculation:
Company H is deemed to have paid a dividend under s 64E(4)(*a*). The amount of the dividend is deemed to consist of a distribution of an asset *in specie* under s 64E(4)(*b*)(i).

The amount of the dividend deemed to have been paid under s 64E(4)(*b*)(ii) is R1,2 million [R20 million × 6% (8% − 2%)]. Dividends tax payable by Company H on the dividend *in specie* is R240 000 (R1,2 million × 20%).

Conclusion:
Whilst section 7C, would apply to this loan, based on section 7C(1), because section 64E(4) applies, and the dividends tax became payable, section 7C does not apply. It is interesting to note that amount of tax, albeit from two different taxes, is the same.

In terms of section 64E(4)(b), of the Act, the "*amount of the dividend that is deemed to have been paid in terms of paragraph (a) must -*
(i) *be deemed to consist of a distribution of an asset in specie; and*
(ii) *for the purposes of subsection (1), be deemed to be equal to the greater of-*
(aa) *the market-related interest in respect of that debt, less the amount of interest that is payable to that company in respect of that debt for that year of assessment; or*
(bb) *nil*.
For the purposes of this subsection, 'market-related interest', in relation to any debt owed to a company means the amount of interest that would be payable to that company on the amount owing to that company in respect of that debt for a period during a year of assessment if the debt had been owed for that period at the official rate of interest."
(Section 64E(4)(d))

The "connected in relation to the company", test differs from the trust
The making of the loan by the company, where the Companies Act was observed, does not constitute a distribution by the company.

Reason for:
The shifting of value from a company without a dividend declaration could alternatively stem from some other originating link, such as salary to shareholder-employees, payment for an asset or use thereof, or as an indirect gift by a controlling shareholder.

This is substantially the same calculation that is required to be made for the deemed donation.
And essentially will result in the same amount being subject to donations tax, and to dividends tax.

5.1.2.3 The special trust exclusion

"Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) ... if that trust is a special trust as defined in paragraph (a) of the definition of a special trust" – see section 7C(5)(c).

5.1.2.4 The public benefit organisation exclusion

"Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) ... that trust or company is a public benefit organisation approved by the Commissioner in terms of section 30(3) or a small business funding entity approved by the Commissioner in terms of section 30C – see section 7C(5)(a)."

5.1.2.5 The vested right exclusion

"Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) ... that loan, advance or credit was provided to that trust by a person by reason of or in return for a vested interest held by that person in the receipts and accruals and assets of that trust and—

(i) the beneficiaries of that trust hold, in aggregate, a vested interest in all the receipts and accruals and assets of that trust;

(ii) no beneficiary of that trust can, in terms of the trust deed governing that trust, hold or acquire an interest in that trust other than a vested interest in the receipts and accruals and assets of that trust;

(iii) the vested interest of each beneficiary of that trust is determined solely with reference and in proportion to the assets, services or funding contributed by that beneficiary to that trust; and

(iv) none of the vested interests held by the beneficiaries of that trust is subject to a discretionary power conferred on any person in terms of which that interest can be varied or revoked;"

Example:
A trust holds a participatory interest in a collective investment scheme (CIS) in securities.

These assets include a wide range of local and international shares, companies listed on an exchange, bonds, property and money market instruments.

The beneficiaries do not have a vested right to the trust capital, but the trustees have a discretion, with respect to the income derived from the collective investment scheme, to vest the income, in the year it accrues to the trust, in the beneficiaries of the trust. Any part of the income not so vested, is added to the trust capital (or trust fund).

The collective investment scheme does not pay the amounts to the trust. Rather, the amounts are used to acquire further participatory units for the trust.

Should the trustees need cash, for whatever reasons, and want to utilise a part of the income so applied by the CIS, they will instruct the CIS, to dispose of a number of participatory units.

Facts for the current year of assessment:

The collective investment scheme, as was obtained from the IT3(b), distributed the following amounts, and used it to acquire further units for the trust.

The amounts of income capitalised to the investment are:
- Dividends
- Foreign dividends
- Interest
- REIT distributions

The dividends were retained in the trust, because it was exempt from the normal tax, and the 20% dividends tax was withheld by the CIS.

With respect to the above, at a meeting of the trustees during the last week of February of the year of assessment, took a decision to vest 25% of the total accruals in each one the four beneficiaries of the trust. All the beneficiaries are residents of the RSA. The trustees did not distribute any of this to the beneficiaries, but merely passed a journal entry, debiting the beneficiaries and crediting the following income items; foreign dividends, interest and REIT distributions.

The credits were reflected as loans from the beneficiaries and no interest was added to the balance as long as the amount remained outstanding. The loan is property in the estate of the beneficiary. On the face of it, section 7C may well apply here.

If the trustees, instead of merely passing the journal entry, instructed the CIS to transfer a number of participatory units, which is held in the name of the trust, to each one of the beneficiaries (at 25%) thereof and to hold these units in the name of the beneficiaries, then the beneficiaries would not have provided a loan or credit to the trust. The trust would then hold property, which vested in a beneficiary, on behalf of the beneficiary in trust.

The credit to the loan of each beneficiary would then be represented by these investments, and all income distributions would be capitalised to these investments. Consequently, the amounts will accrue to the beneficiaries, and not to the trust. The trust in that sense will merely be the agent for the beneficiaries, and the property is not held as trust property. In such an instance section 7C would not apply. It would be better to reclassify the description, or not to use the word loan.

5.1.2.6 The section 31 exclusion

"Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) ... (e) that loan, advance or credit constitutes an affected transaction as defined in section 31(1) that is subject to the provisions of that section ..."

The reason for this exclusion, was explained[87] as follows:

The interaction between section 7C and section 31

[87] Explanatory Memorandum on the Taxation Laws Amendment Bill 17B OF 2016 (15 December 2016)

"This anti-avoidance[88] measure seeks to curb the unfair advantage of using loans that are not subject to interest at market rates have. Similarly, the transfer pricing rules in the Act also apply to counter the mispricing of cross-border loan arrangements. In order to ensure that there is no overlap or double taxation in respect to low or no interest loans made to foreign trusts, the anti-avoidance measure under section 7C will not apply to a loan that is subject to the transfer pricing rules in section 31 of the Act."

It is not possible to explain section 31 of the Act in this guide. However, the application of the exclusion will be explained. One very important observation must be made before that is done.

Section 31 does not, as does section 64E(4) for instance, use the official rate of interest, if the debt is denominated in ZAR, or in a foreign currency. What section 31 requires, is that the taxpayer must determine the arm's length interest rate.

The current practice generally prevailing, deals with this as follows:

"6.2 Determining the arm's length interest rate of intra-group loans

The following paragraphs present different approaches to pricing intra-group loans. As in any other transfer pricing situation, the selection of the most appropriate method should be consistent with the actual transaction as accurately delineated, in particular, through a functional analysis (see Chapter II of the OECD Guidelines).

6.2.1 Comparable uncontrolled price method (CUP method)

Once the actual transaction has been accurately delineated, arm's length interest rates can be sought based on consideration of the credit rating of the borrower or the rating of the specific issuance taking into account all of the terms and conditions of the loan and comparability factors. The arm's length interest rate for a tested loan can be benchmarked against publicly available data for other borrowers with the same credit rating for loans with sufficiently similar terms and conditions and other comparability factors.

6.2.3 Cost of funds

In the absence of comparable uncontrolled transactions, the cost of funds approach could be used as an alternative to price intra-group loans in some circumstances."

Once the arm's length interest rate is determined, the taxable income or tax payable by any person that derives a tax benefit must be calculated as if that agreement had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.

The tax benefit is derived by the connected person who provided the loan to the trust. And results from the fact that no interest accrued to the connected person on the loan, or the interest that accrued is lower than the interest that would have accrued, had an arm's length interest rate been agreed on.

Section 31(3) then deems that benefit as the amount of that difference, if the connected person (an individual) is a resident (of the RSA) and the other person (the trust) is a not a resident, "*to be a donation made by that resident to that other person, on the last day of the period of six months following the end of the year of assessment in respect of which that adjustment is made"*.

[88] Section 7C

The transfer pricing rules in the Act apply to counter the mispricing of any transaction, operation, scheme, agreement or understanding (including cross-border loan arrangements). In terms of a trust, the transfer pricing rules determine that any cross-border loan arrangement between a person that is a resident and any other person that is not a resident (including a foreign trust) would be an affected transaction subject to tax if that cross-border loan arrangement is different from any term or condition (including interest rates) that would have existed had those persons been independent persons dealing at arm's length.

To avoid the possibility of an overlap or double taxation, the trust anti-avoidance measures specifically exclude a low- or no-interest loan arrangement that constitutes an affected transaction that is subject to the transfer pricing rules contained in the Act.

National Treasury was of the view that the above-mentioned exclusion does not effectively address the interaction between the trust anti-avoidance measures and transfer pricing rules where the arm's length interest rate is less than the official rate on these cross-border loan arrangements. An amendment to section 7C(5)(e) of the Act was then proposed to ensure that the exemption of the trust anti-avoidance measure in respect of a loan, advance or credit that constitutes an affected transaction, as defined in the transfer pricing provisions, only applies to the amount or portion thereof, owing by that trust in respect of that loan, advance or credit, to the extent of an adjustment being made on that amount or part thereof in terms of the transfer pricing provisions.

According to the Bill, tabled during October 2024, this amendment comes into operation on 1 January 2025 and applies in respect of years of assessment commencing on or after that date.

The amendment deleted the following words, *"that is subject to the provisions of that section"*, and replaced it with the following: *"to the extent of an adjustment made in terms of section 31(2)"*.

The section will then read as follows:

> *"Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) ... that loan, advance or credit constitutes an affected transaction as defined in section 31(1) to the extent of an adjustment made in terms of section 31(2)."*

Conclusion

Section 31 therefore results in a donations tax liability for the RSA resident connected person on the interest foregone. The only difference is that the interest foregone, is calculated as the difference between an arm's length interest rate and the rate that applies to the loan agreement. Section 7C, applies to the difference between the amount of interest calculated at the official rate of interest and the amount of interest incurred by the trust. The exclusion (in section 7C) is necessary, otherwise the RSA individual connected person, would have had to pay donations tax on substantially the same amount.

5.1.2.7 Employee share trusts

In order to ensure that employee share schemes are not negatively affected, it is proposed that a specific exclusion for employee incentive schemes should be provided. However, certain requirements must be met for the exclusion to apply. These requirements are introduced in order to ensure that owners of businesses do not abuse the exclusion to transfer wealth to family members that are in the employ of the business.

In the first instance, it will be required that the trust should be a trust that is created solely for purposes of giving effect to an employee share incentive scheme in terms of which that loan, advance or credit was provided by a company to that trust for purposes of funding the acquisition, by that trust, of shares in that company or in any other company forming part of the same group of companies as that company. Secondly, shares (or other equity instruments that relate to or derive their value from shares in a company) may only be offered by that trust to someone by virtue of that person being in the full-time employment of a company or holding the office of director of a company. Lastly a person that is a connected person in terms of paragraph (d)(iv) of the definition of "connected person" in relation to a company or any other company forming part of the same group of companies as that company (i.e. a person that holds at least a 20 per cent interest either individually or collectively with connected persons) may not participate in that scheme.[89]

5.1.2.8 Waiver of loans

Under the heading; "Denial of tax deduction or losses", it was stated[90] that *"there is also concerns around the cancellation or waiver of loan accounts that are assets of the lenders."* Section 7C introduced a limitation on this and that was explained as follows:

> Often, lenders that advance low interest or interest free loans will cancel or waive the loan. This results in the diminution of the asset base of the lender for estate duty purposes. To counter such practices that avoid estate duty, no deduction, loss, allowance or capital loss may be claimed in respect of interest free loans or low interest loans made to trusts.

It is section 7C(2), that contains the limitation and it reads as follows:

> *"No deduction, loss, allowance or capital loss may be claimed in respect of—*
> *(a) a disposal, including by way of a reduction or waiver; or*
> *(b) the failure, wholly or partly, of a claim for the payment,*
> *of any amount owing in respect of a loan, advance or credit referred to in section 7C(1)."*

It is interesting that this was needed, as paragraph 39, and paragraph 56, of the Eighth Schedule would in any event have ringfenced a capital loss that arose from such a waiver, and it is unlikely that it would not have been a donation.

5.2 Determining taxable income for the trust, the donor, or the beneficiaries

5.2.1 General comments

The trust is a taxpayer as any other and the same rules, relating to gross income, exemptions, deduction, and capital gains that apply to other taxpayers, apply to the trust as well. There are just two deductions that require special mention.

It was already said that SARS requires gross income, income derived from trading activities, and capital gains to be accounted for in the return of income for the trust, and that is irrespective of whether the

[89] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017 (15 December 2017)
[90] In the Explanatory Memorandum on the Taxation Laws Amendment Bill 17b of 2016 (15 December 2016)

taxable amounts are attributed to a donor or vested in a beneficiary. And that the beneficiary accounts for the income, net of allowable deductions, and for the capital gains.

5.2.2 Exemptions

With respect to exemptions, a trust qualifies for the section 10(1)(k) exemption in respect of RSA source dividends, and with respect to foreign dividends it qualifies for the section 10B exemption.

Exemptions are applied at beneficiary, or donor level, in respect of income vested in beneficiaries or deemed to be that of the donor. There are two instances where the beneficiary will not enjoy the full exemption. The first is where the trust holds an interest of at least 10% in the foreign company. If the trust were to vest the foreign dividend in the beneficiaries of the trust, they will not qualify for the section 10B(2)(a) full exemption, but for the section 10B(3) partial, of formula based, exemption.

And then where section 7(8)(a) applies – see discussion earlier in this guide.

Whilst dividends (other than dividends paid or declared by a headquarter company) received by or accrued to any person qualifies the exemption, in terms of section 10(1)(k)(i), remember that this exemption does not apply to dividends (other than those received by or accrued to or in favour of a person that is not a resident or a dividend contemplated in paragraph (b) of the definition of 'dividend') distributed by a company that is a REIT, or a controlled company as defined in section 25BB. This applies to both the trust and the beneficiaries (or donor).

Section 10(1)(k)(i)(ee) of the Act, however, applies to trusts and in terms thereof the exemption from income tax will not apply, to "*any dividend received by or accrued to a company in consequence of-*

- *any cession of the right to that dividend; or*
- <u>*the exercise of a discretionary power by any trustee of a trust*</u>*,*

unless that cession or exercise results in the holding by that company of all of the rights attaching to a share."

Where the exemption does not apply, the trust (or beneficiary) will receive the dividend as normal income and be subject to tax thereon at 45%.

5.2.3 Exclusions for capital gain purposes

Paragraph 80(1) and (2) were amended to exclude attribution to a person, organisation, entity or recreational club contemplated in paragraph 62(a) to (e).

The effect will be that the capital gain will remain in the trust unless subject to attribution back to a donor under paragraphs 68 to 72.

In the case of the vesting of an asset under paragraph 80(1), the trust must disregard the capital gain or capital loss on the donation under paragraph 62. However, this is not the case under paragraph 80(2), since paragraph 62 only applies when an asset is disposed of to the exempt or partially exempt entity. Thus, any capital gain or loss arising from the disposal of an asset to a third party must be accounted for by the trust.

5.2.4 Apportionment of dual-purpose expenses

Carrying on of a trade and for purposes of trade

The crucial requirement, in order for any taxpayer (the trust) to make a deduction of any expense incurred, is that the taxpayer must be able to meet the burden of proof that a trade was being carried on, and that the amount of the expense was incurred in the production of the income derived from the trade.

The definition of trade is a wide one and it is accepted, for purposes of this article, that the taxpayers are in fact carrying on a trade.

In Warner Lambert (SA) v CSARS, Judge Conradie stated the law as to whether a deduction can be made when he said that *"deductible expenditure has certain characteristics: it must be incurred in the production of income (section 11(a)) and will not be allowed as a deduction against gross income if it is not laid out or expended for the purposes of trade."* This is referred to as the positive and the negative test.

The negative test is found in section 23 of the Income Tax Act. It provides for deductions not allowed in determination of taxable income. These deductions would normally qualify for deduction under another provision of the Act, but the section then prohibits the making of the deduction. Section 23(g) is the one relevant to dual-purpose expenses and it reads as follows:

> *"No deductions shall in any case be made in respect of the following matters, namely ... any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;"*

This subsection previously had a "*wholly or exclusively laid out or expended*" requirement, but this was replaced with the phrase "*to the extent to which such moneys were not*". This amendment was made in 1992 and is explained as follows in that year's Explanatory Memorandum:

> *"Subclause (b) of clause 20: Section 23(g) of the principal Act prohibits the deduction of any amount of expenditure which was not wholly and exclusively laid out for the purposes of trade. Nevertheless, it has been the long-standing practice of Inland Revenue, which has in the past been accepted by the courts, to allow an apportionment of expenditure which is incurred partly for purposes of trade and partly for purposes other than trade."*

Judge Schutz, in CIR v Sunnyside (Pty) Ltd, said that the *"effect of the amendment was that moneys expended for a dual purpose may be apportioned so that that portion laid out for the purposes of trade may be deducted."* In other words, the use of the words "*to the extent*" in section 23(g) allowed for an apportionment of the expenditure (or monies claimed) to be made. The principle is that the apportionment is then made to determine the portion of the expense that qualifies to be deducted.

Section 23(g) then does not totally prohibit the making of a deduction but apportions the deduction and then prohibits the making of a deduction of a part of the expense that were not laid out or expended for the purposes of trade.

Judge Conradie, in Warner Lambert (SA) v CSARS, gave the following other examples:

> *"Money spent by a taxpayer in order to advance the interests of the group of companies to which it belongs is not regarded as expenditure in the production of income. The link between the*

> *expenditure and the production of income is too tenuous. This has been firmly established in Solaglass Finance Company (Pty) Ltd v Commissioner for Inland Revenue."*
>
> *Moneys expended by a taxpayer from motives of pure liberality also fail to qualify as expenditure in the production of income."*

But a very important point made by Judge Conradie is that *"it is quite easy to mistake the purpose of an act for its consequences."* One must therefore not look to the consequences of the act, the expenses incurred, to determine whether it was incurred for purposes of trade, but one must determine the purpose of the taxpayer in incurring the expenditure.

Apportionment is then required, and it is the taxpayer who must do this, when the expenditure in question can't be directly attributed to a trade purpose. In other words, there is another reason.

Expenses partly incurred to produce exempt income

This is the most common instance where SARS queries dual-purpose expenses. It is relevant to all taxpayers, companies, individuals and specifically to trusts. The amounts that will commonly not be income, include dividends (derived as a holder of shares in an RSA resident company) and interest derived by a natural person (the exempt amounts - R23 800 or R34 500) or amounts derived from tax free investments. And then also dividends, fully exempt, and foreign dividends, either fully or partly exempt.

Section 23(f) reads as follows:

> *"No deductions shall in any case be made in respect of the following matters, namely—*
>
> *(f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one."*

Where amounts received or accrued do not constitute 'income' (as defined), it would often mean that they are not derived from the carrying on of a trade (for instance, dividends will often be derived from a passive investment). Section 23(f) doesn't contain the "to the extent that" words that section 23(g) contains, but our courts have held that an apportionment is also appropriate where the expenses were incurred partly to produce exempt income.

Under section 23(q), *"no deductions shall in any case be made in respect of … any expenditure incurred in the production of income in the form of foreign dividends"*. In these circumstances, where the taxpayer holds shares in a foreign company, the expenses would normally be directly attributed to the investment, but it may well also be that the expenses were incurred for a dual-purpose here. An apportionment would then also be required to determine the portion that can't be deducted. The fact that the foreign dividend may then be partially exempt from normal tax, is then irrelevant.

If the expenses are directly incurred to produce exempt income, the deduction thereof will be disallowed in full. It is quite common however, in trust, that the expenses cannot be attributed to the production of amounts of income, which does not qualify for an exemption.

The principle of apportionment

The Income Tax Act, however, does not prescribe how apportionment must be done.

The issue of the apportionment of expenses was recently considered by the Supreme Court of Appeal in the case reported as CSARS v Mobile Telephone Networks Holdings (Pty) Ltd. The thrust of the argument advanced on behalf of SARS was that in terms of section 11(a) read with section 23(f) of the Income Tax Act the audit fees are deductible only to the limited extent originally allowed by SARS (or to such other extent as this court may allow). Mobile Telephone Networks Holdings (Pty) Ltd derived a relatively small amount of income from trading and a substantial amount from dividends.

In this case, Judge Ponnan commented as follows:

> *"Where - as here - expenditure is laid out for a dual or mixed purpose the courts in South Africa and in other countries, have, in principle, approved of an apportionment of such expenditure…"*

Judge Conradie, in Warner Lambert SA (Pty) Ltd v CSARS, said

> *"For although the doctrine of dominant purpose may swing the verdict one way or the other in the capital versus revenue contest, it is inapplicable in any contest between expenditure for trade or for other purposes …"*

Judge Ponnan, in the MTN case, continued by saying that:

> *"Over time, the courts have applied various formulae to achieve a fair apportionment."*
>
> *"Apportionment is essentially a question of fact depending upon the particular circumstances of each case (Local Investment Co v Commissioner of Taxes (SR) 22 SATC 4). As Beadle J put it in Local Investment Co (at II):*
>
> > *"It does not seem possible to me to lay down any general rules as to how the apportionment should be made, other than saying that the apportionment must be fair and reasonable, having regard to all the circumstances of the case. For example, in one case an apportionment based on the proportion which the different types of income bear to the total income might be proper, as was done in the Rand Selections Corporation's case, supra. In another case, however, such an apportionment might be grossly unfair;"*

The important principle here is that "the apportionment must be fair and reasonable, having regard to all the circumstances of the case." It is therefore a fact specific determination that must be made.

It seems that SARS favours the apportionment on the basis of gross income – they argued that in the MTN case.

In line with the practice generally prevailing, see also Interpretation note 64, states (in paragraph 7.2) that:

> *"The use of a fixed percentage of the general expenditure for the purpose of allocating it to a particular source of income is not acceptable. General expenditure must be allocated to the various sources of income on a logical, fair and reasonable basis. For example, depending on the facts, it may be acceptable to allocate the general expenses pro rata by applying the ratio that a particular source of receipts and accruals bears to the total receipts and accruals derived by the entity."*

Trustees of trusts have a unique apportionment problem, so to speak. They normally derive their receipts and accrual from various sources and these sources often include dividends, foreign dividends and interest. They then also incur dual purpose expenses and here it may well be more appropriate to apportion on the basis of the gross amounts that accrued to the trustees.

It is very important for the beneficiaries, discretionary or otherwise, of a trust as well. In principle, section 25B(3) of the Act, allows them to a make a deduction or claim an allowance in the determination of the taxable income derived by way of any amount vested in them by the trustees. Where a portion of the expense may not be deducted, under section 23(f), 23(g), or 23(q), they must be informed of this.

If the trustees in a trust do not use a reasonable method to apportion, or it is not possible to get to such a method, the trust may well have to use the above fixed percentage method. And apportion the expenses accordingly and not make a deduction of the expenses incurred to produce income amounts.

5.2.5 Assessed losses

Section 20, of the Act, also applies to trusts. But section 25B also contains rules relating to assessed losses in trusts.

An example of the application of section 25B relating to losses:
A trust owns a fixed property and derives rental from lease agreements relating to this property. It is not possible to vest a loss in a beneficiary of a trust.

The rental loss, that arises in the trust under section 25B(4), *"is deemed to be a deduction or allowance which may be made in the determination of the taxable income of the trust during that year"*. The sum of those deductions and allowances is then *"limited to the taxable income of that trust during that year of assessment as calculated before allowing any deduction or allowance under this subsection"* – section 25B(5).

This 'rental loss' is essentially a balance of assessed loss carried forward and will be used in the next year of assessment, against amounts vested in beneficiaries.

The balance of assessed loss, or the section 25B(4) amount, will be set-off against the taxable capital gain – see section 20 of the Act. Or against other taxable income retained in the trust. Should the trustees dispose of the fixed property, and realise a capital gain, the assessed loss will reduce the taxable capital gain.

When section 25B(4) – (7) was introduced *"trusts have become widely used*

- *for income splitting, thereby reducing the marginal rate at which the income is ultimately taxed; and*
- *for channelling losses, incurred as a result of the deduction of expenditure and allowances, via trusts to their beneficiaries, who then set off these losses against their income."*

And this was addressed by limiting the expenses that can be made by a beneficiary, and by locking the assessed loss in the trust from year to year.

5.2.6 Amounts vested and distributed to beneficiaries

It is commonly asked whether the amount vested in a beneficiary qualifies as a deduction is arriving at the taxable income of the trust.

The answer is simple, the amounts vested in a beneficiary are not expenditure actually incurred. And if it were such expenditure, it would not have been incurred to produce the income that accrues to the trust.

The income tax consequences of these amounts will be discussed in more detail, but for purposes of explaining this, the following example is used.

Facts:
The trustees of a trust *mortis causa*, decided to book and pay for an air-ticket for a beneficiary of the trust, and to also pay for a week's accommodation in Cape Town for the beneficiary. The beneficiary of the trust requested the trustees to do this in order for the beneficiary to attend the annual Jazz Festival held in Cape Town.

The amounts of income that accrue to the trustees, consists of net rental income derived from the letting of immovable properties owned (acquired by inheritance) by the trust. And the trustees wanted to make a deduction of the cost of the air-ticket and accommodation, to reduce the taxable income in the trust arising from the income retained in the trust.

The following is a short extract of a clause in the trust deed:

> The income of the trust shall be applied by the trustees in such amounts and in such manner, for the benefit of the children and for their ... reasonable pleasures, as the trustees may determine in their absolute discretion.

Discussion
The tax consequences of vesting of income will be discussed in more detail later in this guide. The purpose of the example is to answer the question asked by the trustees.

The reasons why no deduction can be made, are the following:
It is clear from the facts that the purpose of the amounts paid by the trustees, was not to produce the income of the trust.

Whilst the trust is carrying on a trade, the letting of any property, the amount would not qualify for a deduction under section 11(a).

It actually also does not represent expenditure, as envisaged in section 11(a)
As will be explained in this guide, the decision by the trustees to vest an amount of income in a beneficiary of the trust, is not expenditure incurred by the trust.

When the trustees exercised their discretion and applied income of the trust for the benefit of a child (who is a beneficiary of the trust), they vested an amount (or amounts) of income in the beneficiary.

In terms of section 25B, but also because the trust is (colloquially speaking) a conduit, this means that the amounts paid for the accommodation and the ticket did not accrue to the trust but accrued to the beneficiary. In a sense, it cancels out the receipt by the trustees.

And, again as will be explained later, the beneficiary will have to include these amounts in his (or her) gross income for the year.

A common mistake is made in drawing up the financial statements to actually make a deduction of amounts incurred for the benefit of beneficiaries of the trust, from the total income that was received by the trustees (in the comprehensive statement of income).

From an income tax point of view, the trustees are actually not entitled to, or there is no receipt, with respect to amounts of income that vests in the beneficiaries. The trustees are mere agents.

5.2.7 Use of trust property

An extract from a clause in a trust deed

> One of the powers listed under sub-clause 12.5 is to allow any beneficiary free use and enjoyment of any property controlled by them or forming part of the trust fund, whether movable or immovable, upon such conditions. if any. as to maintenance, insurance. rates and taxes and other expenses as they may deem fit.

The question in the ITR12T:

> Trust Participants
> Specify the number of persons or beneficiaries who during this year of assessment participated in any one or more of the following:
>
> - Had the right of use of asset(s) retained in this trust

And then, where the accounting profit / loss is determined:

> Add: Expenses incurred in respect of the right of use of trust assets by beneficiaries / other persons

Example:
The trust erected a primary residence mainly with bond finance and some donor loan which has subsequently been repaid.

The donor, who is also a beneficiary, occupies the house.

First comment:
If the trustees carried on other trading activities, such as rental, the expenses incurred related to the house occupied and used by the beneficiary, cannot be deducted. They are not incurred to produce income, and consequently cannot be deducted.

If the ‘donor’ occupies the house as a beneficiary, the principle at law is that the free use of the asset will only have tax implications for the beneficiary if it involves the vesting of income. In other words, it is only to the extent that the granting of the right to occupy constitutes a vesting of income that there will be tax consequences – both for the beneficiary and the trust. In other words, if the trustees were to use rental income derived from other properties, to pay the interest on the bond, and the municipal charges (land tax), it would effectively have vested income in the beneficiary of the trust, and the beneficiary would be taxed on that income – section 25B(2) applies.

This accepts that the trustees have discretionary powers with regard to income distributions. The payment of an expense, such as rates and taxes of the property, is a vesting event if the beneficiaries benefit from using the house.

In practice, typically where a trust does not have money to pay the expenses, the trustees would enter into an agreement with the beneficiary that he or she uses the property but reimburse the trust for the expenses it incurred with respect to the property.

6. Duties of the trustees of a trust

6.1 Completing the returns of income

The trustees, as representative taxpayer, must ensure that the trust is registered as a taxpayer and then to submit returns of income, or provisional tax, by the respective due dates.

The trustees must ensure that proper accounting is done and that the trust return is a trust and correct return. Not only with respect to the trust, but also with respect to the beneficiaries of the trust.

A trustee cannot be taxed on the income, or capital gains, of a trust. But it must be remembered that, see section 12, of the Trust Property Control, Act, *"trust property shall not form part of the personal estate of the trustee except in so far as he* (or she) *as trust beneficiary is entitled to the trust property"*.

6.2 Third party reporting (to SARS).

6.2.1 Beneficial ownership

The reporting of beneficial owners of trusts to SARS, must not be confused with the reporting to the Master's office.

Judge Rogers, for the majority, in Independent Community Pharmacy Association v Clicks Group Ltd and Others [2023] ZACC 10, said the following:

> *"To sum up, in South African law the expression "beneficial ownership" is imprecise. The exact legal rights enjoyed by the "beneficial owner" depend on the circumstances. Unless a person is in law the owner, to call them a "beneficial owner" merely conveys that they have personal rights against the owner entitling them to some or all of the benefits which accrue to the actual owner. "Beneficial ownership" is not a species of ownership. The rights comprehended by the expression are located in the field of personal rights, not real rights."*

Beneficial ownership information to be recorded by trustee

3C. (1) A trustee must keep a record of the following information relating to each identified beneficial owner of the trust, in the register contemplated in section 11A(1) of the Act:

(a) The full names;
(b) date of birth;
(c) nationality;
(d) an official identity document number or passport number, indicating the type of document and the country of issue;
(e) citizenship
(f) residential address;
(g) if different from residential address, the beneficial owner's address for service of notices;
(h) other means of contact;
(i) if the person is a registered taxpayer in the Republic, the persons tax number;
(j) the class or category of beneficial ownership under which the person falls;
(k) the date on which the person became a beneficial owner of the trust; and
(l) where applicable, the date on which the person ceased to be a beneficial owner of the trust.

11A. Beneficial ownership

(1) A trustee must—

(a) establish and record the beneficial ownership of the trust;

(b) keep a record of the prescribed information relating to the beneficial owners of the trust;

(c) lodge a register of the prescribed information on the beneficial owners of the trust with the Master's Office; and

(d) ensure that the prescribed information referred to in paragraphs (a) to (c) is kept up to date.

(2) The Master must keep a register in the prescribed form containing prescribed information about the beneficial ownership of trusts.

(3) A trustee must make the information contained in the register referred to in subsection (1)(c), and the Master must make the information in the register referred to in subsection (2), available to any person as prescribed.

(4) The prescribed requirements referred to in this section must be prescribed after consultation with the Minister of Finance and the Financial Intelligence Centre, established by section 2 of the Financial Intelligence Centre Act, 2001 (Act No. 38 of 2001).

6.2.2 Tax as provisional taxpayer

The definition of a provisional taxpayer:

"For the purposes of this Schedule, unless the context otherwise indicates –

"provisional taxpayer" means –

(a) any person (other than a company) who derives income by way of –

(i) any remuneration from an employer that is not registered in terms of paragraph 15; or

(ii) any amount which does not constitute remuneration or an allowance or advance contemplated in section 8(1); …"

(Paragraph (a) of the definition of 'provisional taxpayer' in paragraph 1 of the Fourth Schedule).

In terms of section 1(1) of the Income Tax Act, and in that *"Act unless the context otherwise indicates*

- *"**income**" means the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II;*
- *"**gross income**", in relation to any year or period of assessment, means –*
  (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
  (ii) …

during such year or period of assessment, excluding receipts or accruals of a capital nature, …"

The taxation of trusts and its beneficiaries:
Where the beneficiaries have vested rights to the income of a trust, all the receipts of income by the trust will be deemed to be that of the beneficiary of the trust. The trust will therefore never derive "income" and consequently will not be a provisional taxpayer.

Section 25B(2) deals with instances where a beneficiary has acquired a vested right to any amounts *"received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust"*, in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant deed of trust. It then deems that amount *"to have been derived for* *the benefit of that beneficiary"*. Essentially, it treats it the same as the instance where the beneficiary has a vested right to the income.

From a provisional tax point of view, it will mean that, in years of assessment where the full amount of all receipts or accruals was not vested by the trustees, the trust will be a provisional taxpayer. If not, in other words, where all the amounts are vested, it will not be a provisional taxpayer.

The same would apply if all the income in the trust is attributed to a donor – the trust is not a beneficiary. But where the trustees vested income in beneficiaries of the trust, who are not RSA tax residents, then the trust will have income, and taxable income. Consequently, such a trust will have to request provisional tax returns and submit the bi-annual estimates of taxable income and make payments of provisional tax.

<u>Capital gains:</u>
In the first instance it is important to mention that, whilst income tax is imposed on taxable income, for purposes of provisional tax, the provisional tax payments are based on estimates of taxable income.

The SARS practice generally prevailing in Interpretation Note01, states that:

- *"... a provisional taxpayer is required to submit a return to the Commissioner which includes <u>an estimate of the total taxable income</u> (estimate) that will be derived by the taxpayer in the relevant year of assessment ...*
- *Taxable income is equal to gross income less exempt income less all amounts allowed to be deducted or set off <u>plus all amounts</u> included or deemed <u>to be included in taxable income</u> under the Act, <u>for example, the amount of taxable capital gains</u>."*

Put differently, if the person is a provisional taxpayer, then the person must estimate taxable income, for purposes of the estimate. And, if that provisional taxpayer, then had (or anticipated) a taxable capital gain, that estimated taxable capital gain must be included in the estimate of taxable income.

A trust, who is not a provisional taxpayer does not become a provisional taxpayer merely because the trust disposed of an asset which resulted in a taxable capital gain. This is because the amount of a taxable capital gain is not income.

It is interesting to note, albeit for purposes of a penalty, that the basic amount, for purposes of provisional tax estimates (and the underestimation thereof), specifically excludes a taxable capital gain included in the actual assessment made in respect of the most recent (or previous) year of assessment.

<u>The principles of the taxation of taxable capital gains</u>
It is paragraph 80, of the Eighth Schedule, that codified the conduit principle with respect to capital gains, but it introduced certain limitations, or instances where there would be no flow through even where the capital gain was vested by the trustees in a beneficiary.

Relevant to a trust, paragraph 80(2) of the Eighth Schedule to the Income Tax Act may be applicable, and it reads as follows:

> "... *where a trust determines a capital gain in respect of the disposal of an asset in a year of assessment during which a beneficiary of that trust (… who is a resident has a vested right <u>or acquires a vested right (created by the exercise of a discretion) to an amount derived from capital</u>*

<u>gain</u> but not to the asset disposed of, an amount that is equal to so much of the amount to which that beneficiary of that trust is entitled in terms of that right—

(a) must be disregarded for the purpose of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account as a capital gain for the purpose of calculating the aggregate capital gain or aggregate capital loss of that beneficiary."

With respect to the beneficiaries, who are not resident in the RSA, and the capital gains that were vested in them, the position is that the capital gain is effectively deemed to remain in the trust and will be taxed in the trust.

If follows that, with respect to the amount of a capital gain, that arose in a trust (when the trustees disposed of the assets) and which was vested, following the exercise of a discretion by the trustees of the trust, in a beneficiary who is not resident in the RSA, the capital gain will be "taxed" in the trust.

This amount is not included in the gross income of the trust, because it is of a capital nature, and consequently will not be income as defined. Paragraph 80(2) differs from section 25B(2), in that the capital gain is not retained in the trust, it is merely deemed to be a capital gain made by the trust that must be taxed in the trust.

It, however, is not the amount of the capital gain that will be taxed, but it is the amount of a taxable capital gain, which is an amount equal to 80% of the amount of the net capital gain of the trust (which in this instance is also the amount of the capital gain), that will be taxed in the trust.

This does not make the trust a provisional taxpayer and SARS cannot impose a penalty for underestimation, as no estimate of taxable income was required – because the trust did not derive any income during the 2023 year of assessment.

6.2.3 The withholding taxes

If a trust had to pay interest, or a royalty, to a foreign person, the trust must withhold from that amount the respective withholding tax at a rate of 15%. The tax so withheld must be paid together with the prescribed return.

These payments are not payments to a beneficiary of these amounts, that accrued to the trust and were vested in the foreign beneficiary. If so, it will be subject to tax in the trust.

If the person is a resident of a treaty country, and qualifies for an exemption, or lower rate, the foreign person must submit a declaration to the trust. Who will then apply the lower rate.

6.2.4 Donations tax

Whilst donations made to a trust be it the founder of the trust or someone else, is subject to donations tax, donations made by the trust is exempt from donations tax.

This is in terms of section 56(1)(l) of the Act and applies if such property is disposed of under and in pursuance of any trust.

As was explained

A donation that is made by a trustee to the beneficiary of a trust would ordinarily attract donations tax. But such a donation is exempted from the tax by section 56(1)(*l*), which exempts *"property which is disposed of under a donation if such property is disposed of under and in pursuance of any trust"*. In Welch's Estate Marais J observed that *"the obvious purpose of [the exemption] is to avoid donations tax being levied twice upon what was in essence one donation by the donor"*. In the same vein he said later:

> *"Section 56(1)(l) seems to be intended to protect the donor and the trustee from the levying yet again of donations tax upon the ultimate disposal by the trustee of the corpus to the beneficiary who gives nothing in return for it. Its apparent purpose is simply to avoid taxing twice what is in reality one donation traceable to the initial act of the donor in settling assets upon the trust".*

In essence the trust is a conduit, as far as donations tax is concerned.

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