

THE UNIVERSITY OF THE WESTERN CAPE

FACULTY OF LAW

TITLE

‘TAXATION OF A TRUST: THE IMPACT OF STATUTORY ANTI-TAX AVOIDANCE MEASURES ON THE EFFECTIVENESS OF THE DISCRETIONARY FAMILY TRUST AS AN ESTATE PLANNING VEHICLE IN SOUTH AFRICA.’

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STUDENT: Yolande Viola Petersen

STUDENT NO: 2413985

DEGREE: LLM (Mercantile Law)

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SUPERVISOR: Mr Fareed Moosa (University of the Western Cape)

CO-SUPERVISOR: Prof Francois Du Toit (University of the Western Cape)

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PLAGIARISM DECLARATION

I declare that '*Taxation of a trust: The impact of statutory anti-tax-avoidance measures on the effectiveness of the discretionary family trust as an estate planning vehicle in South Africa*' is my own work, that it has not been submitted before for any degree or assessment at any other university, and that all the sources I have used or quoted have been indicated and acknowledged by means of complete references.

Full name: Yolande Viola Petersen

Signed:

Date

KEYWORDS AND EXPRESSIONS

Capital gains tax

Discretionary Family Trust

Estate Duty

Estate planning

Tax

Tax avoidance

Trust

ABBREVIATIONS

All SA – All South African Law Reports

CGT – Capital gains tax

CIR – Commissioner for Inland Revenue

Commissioner- Commissioner for South African Revenue Service

DA- Divorce Act 70 of 1979

Doctrine- ‘Substance over form’ doctrine

EDA-Estate Duty Act 45 of 1955

IRC- Inland Revenue Commissioner

ITJ- Insurance and Tax Journal

ITA – Income Tax Act 58 of 1962

JBL- Juta’s Business Law

JEPL-Journal for Estate Planning Law

POEM- Place of effective management

SALJ – The South African Law Journal

SA Merc LJ- South African Mercantile Law Journal

SARS- South African Revenue Service

SA-South Africa

SIR- Secretary for Inland Revenue

Stell LR – Stellenbosch Law Review

TAA-Tax Administration Act 28 of 2011

TLAA- Taxation Laws Amendment Act 5 of 2001

TPCA – Trust Property Control Act 57 of 1988

TSAR- Tydskrif vir die Suid- Afrikaanse Reg

ABSTRACT

The utilisation of trusts has become a popular trend among taxpayers, especially high net worth individuals¹ (hereafter HNWI) who wish to reduce potential estate duties. The SARS Strategic Plan stated that there is a ‘compliance risk posed by HNWI and the use of trusts to conceal their income’.² The SARS Strategic Plan announced that trust reform would be prioritised. Minister of Finance, Pravin Gordhan (hereafter Gordhan) referred in his 2012/2013 budget speech³ to various measures proposed to protect the tax base and limit the scope for tax leakage and avoidance. Gordhan reiterated the state’s position regarding the abuse of trusts by indicating that reforms will be made regarding the taxation of both local and offshore trusts which have long been a problem for global tax enforcement due to their flexibility and flow-through nature.

National Treasury and SARS are concerned about trusts, largely because of the income-splitting opportunities that trusts afford taxpayers. There are envisaged tax amendments which will impact South Africa’s (hereafter SA) trust landscape and could derail many carefully drafted trust structures.

It will thus be important for estate owners to consider these envisaged tax amendments when they come into operation, in order to ascertain the full extent of the implications and then it can also further be determined what the impact of these

¹ Income in excess of R7 million, alternatively R75 million in assets. South African Revenue Service (hereafter SARS) Strategic Plan (2012/13- 2016/17) 19 available at <http://www.sars.gov.za> (accessed 6 November 2013) (hereafter SARS Strategic Plan).

² SARS Strategic Plan 19.

³ 2012-2013 budget speech 22 available at <http://www.sars.gov.za> (accessed 6 November 2013) (hereafter budget speech).

changes will be on the effectiveness of the discretionary family trust as an estate planning vehicle in SA in the future.

The purpose of this thesis is to determine the impact of the current statutory anti-tax avoidance provisions on the effectiveness of the discretionary family trust as an estate planning vehicle in SA, especially due to the fact that the trust form has been abused in the past for tax avoidance purposes.

CHAPTER 1

INTRODUCTION

1.1 GENERAL INTRODUCTION

‘An estate plan is an arrangement for the use, conservation and transfer of one’s wealth. The process by which an estate plan is created is called estate planning. This process involves much more than merely preparing the estate owner’s last will and testament. A well thought out estate plan concerns itself with the creation of an estate where none would otherwise exist, the increase of an existing estate to meet the needs of the owner and its family and the preservation and protection of the estate from unnecessary taxes and costs.’⁴

Estate owners⁵ who are ordinarily resident⁶ in SA are subject to estate duty on death levied at a rate of 20 per cent⁷ on the value of their property,⁸ subject to certain exemptions and exclusions.⁹ Estate planning in SA involves primarily structuring an estate owner’s affairs in such a manner as to minimise this estate duty liability, either

⁴Van der Westhuizen WM ‘The multidisciplinary nature of estate planning as a science’ (2002) *JEPL* 4 5.

⁵ The Income Tax Act 58 of 1962 (hereafter ITA) uses the term ‘natural person’ which is part of the definition of ‘resident’ in s 1 of the ITA.

⁶ In *Cohen v CIR* 13 SATC 362 371, the court held that a person’s ordinary residence is his usual or principal residence and it would be described more aptly, in comparison to other countries as the person’s real home. See also *CIR v Kuttel* 54 SATC 298. *H v COT* 24 SATC 738.

⁷ The First Schedule of the Estate Duty Act 45 of 1955 (hereafter EDA) states that the rate of estate duty shall be 20 per cent on the dutiable amount of the estate. See also Estate Duty available at <http://www.sars.gov.za> (accessed 6 November 2013). This is the rate at the time of writing this thesis.

⁸ Section 3 (2) of the EDA. The term ‘property’ will be dealt with in chapter 4 of this thesis.

⁹ Section 3 (2) of the EDA.

upon his¹⁰ death or upon the death of his heirs *inter alia* by drafting an appropriate will and by setting up a local or offshore *inter vivos*¹¹ or testamentary trust.¹²

Estate planning in SA is not only done in order to avoid or minimise estate duty liability, but also to minimise or avoid the capital gains tax (hereafter CGT) which is imposed upon death.¹³

Discretionary trusts are those under which the trustees have the discretion to distribute trust income and/or trust capital to the beneficiaries.¹⁴ It is primarily discretionary trusts, whether *inter vivos* or testamentary in nature, which are used in estate planning in SA. A discretionary *inter vivos* family trust is a popular vehicle for estate planning purposes because the trust assets are regarded as separate from those of the founder¹⁵ as well as from those of an individual trust beneficiary.¹⁶ One reason for this is that a vested right¹⁷ to trust capital and/or trust income clearly falls within the definition of property for estate duty purposes. On the other hand, a contingent right to trust capital and/or trust income or a *spes* (as some courts have presented the position of a trust beneficiary under a discretionary trust prior to the exercise of the trustees'

¹⁰ In this thesis, references to the masculine gender will include the feminine gender, unless the context indicates otherwise.

¹¹ Formed during the estate owner's lifetime.

¹² Formed in terms of the last will of the estate owner. A discussion on testamentary trusts is not within the ambit of this thesis.

¹³ Geach W & Yeats J *Trusts: Law and Practice* (2007) 280 (hereafter Geach (2007)).

¹⁴ Under a vesting trust trustees have no discretion as to whether to distribute the trust income and/or trust capital to trust beneficiaries. A discussion on the vesting trust is not within the ambit of this thesis.

¹⁵ The person who forms the trust by making over or bequeathing property to trustees.

¹⁶ A person who has certain rights in terms of a trust deed in respect of trust property. Exactly what those rights are must be ascertained from the reading of the trust deed. See Honiball M & Olivier L *The taxation of trusts in South Africa* (2009) 198 (hereafter Honiball & Olivier (2009)).

¹⁷ In *Jewish Colonial Trust Ltd v Estate Nathan* 1940 AD 163 175 the court held that when it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right- that he has all rights of enjoyment in such right, including the right of enjoyment.

discretion)¹⁸ falls outside a dutiable estate.¹⁹ In the case of *Badenhorst v Badenhorst*²⁰ (hereafter *Badenhorst* case) which dealt with an *inter vivos* discretionary family trust, the court indicated pertinently that the trust was created to protect the family against creditors and to avoid estate duty.²¹

A family trust usually comes about where the trustees and the beneficiaries of a trust are the same persons, usually related to one another and to the founder.²² In the case of *Van der Merwe NO and Another v Hydraberg Hydraulics CC and Another; Van der Merwe and Another v Bosman and Another*²³ (hereafter *Van der Merwe* case) the court held that family trusts are designed to secure the interests and protect the property of a group of family members, usually identified in the trust deed by name or by descent or by degree of kinship to the founder.²⁴ In *Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk*,²⁵ Harms JA drew attention to this ‘newer type of family business trust’ where, for estate planning purposes or to escape the constraints imposed by corporate law, assets are put into a trust ‘while everything remains as before’. The court held in the *Parker* case that the primary responsibility for compliance with formalities and for ensuring that contracts lie within the authority conferred by the trust deed, lies with the trustees.²⁶ Where they are also the beneficiaries of the trust, the debasement of the trust function that may result, means

¹⁸ *Stern & Ruskin v Appleson* 1951 3 SA 800 (W) 805D-E.

¹⁹ Du Toit F *South African Trust Law: Principles and Practice* 2ed (2007) 159 (hereafter Du Toit F *South African Trust Law* (2007)).

²⁰ 2006 (2) SA 255 (SCA).

²¹ *Badenhorst* case 363. This case will be discussed in chapter 3 of this thesis.

²² *Land and Agricultural Bank of South Africa v Parker and Others* 2005 (2) SA 77 (SCA) 87F- 88B (hereafter *Parker* case).

²³ 2010 (5) SA 555 (WCC) 568.

²⁴ *Parker* case 88.

²⁵ 2004 (3) SA 486 (SCA) paragraph 24.

²⁶ *Parker* case 89.

all too often that the trustee duties are breached. This situation may need legislative attention in the future.²⁷

There is nothing wrong in law or principle with a discretionary family trust if it is properly administered by independent trustees.²⁸ The court held in the *Van der Merwe* case that the independent trustee's position can never prevail against trustees, who if they vote together will always constitute a majority. In theory, the trust could operate with a real functional separation between control and benefit, if additional independent trustees were to be appointed, thereby overriding the otherwise controlling majority of the initially appointed beneficiary trustees or their successors.²⁹

In practice, this sort of trust is often the alter ego of the founder and/or trustee-beneficiary of the trust. In the past a few family disputes went to court where the founder and/or trustee-beneficiary generally treated the trust assets as his own.³⁰ The assets under the trust may, in law, be regarded as those of the founder and/or trustee-beneficiary and dealt with accordingly.³¹ It also happens in practice that the trustees do not act jointly in terms of the trust deed. The case of *Steyn and Another v Blockpave (Pty) Ltd*³² (hereafter *Steyn* case) concerned a classic family feud. In this case a trustee was left out of the decision making of the trust. The trustee was not consulted about the issue that was decided upon at the meeting of the other two

²⁷ *Parker* case 89.

²⁸ *Parker* case 90.

²⁹ *Van der Merwe* case 568.

³⁰ Geach (2007) 13.

³¹ In the *Badenhorst* case the court took into consideration the assets of the trust of the dominant trustee (husband) when the redistribution order was made in terms of s 7(3) of the Divorce Act 70 of 1979 (hereafter DA).

³² 2011 (3) SA 528 (FB).

trustees.³³ The court held that the trust required the full and complete participation of all its trustees in order to function legally. The trustees have to decide, participate and act together as one, in dealing with the affairs of the trust, even when they are not all agreed, or even where they are not all present at the same time. Internal dissent among the trustees on a particular point has to be buried, once the majority vote has been taken. Externally, all the trustees have to present a united front, in spite of earlier dissension.³⁴ The court also held that the only permissible way in which a trust communicates with the world is through its resolutions and there was no proper resolution taken by the entire complement of the trust body in this case.³⁵ The *Steyn* case also highlights the fact that the specified minimum number of trustees must hold office and make decisions on behalf of the trust. The fact that a trustee resigned functionally paralysed the trust. The court also held in the *Van der Merwe* case that trustees must act jointly in the discharge of their functions; moreover, that this is not a matter of ‘internal management’, but a matter of capacity.³⁶

In order to avoid trust assets being regarded as the assets of someone rather than those of the trust, it is advisable to ensure that there is indeed a making over of trust assets to trustees, and that the trustees actually do manage and control assets on behalf of the trust beneficiaries in accordance with the terms and conditions of the trust deed. Due to the abuse of the trust form by founders, beneficiaries and/or trustees, trusts are increasingly coming under scrutiny by the courts.

There are also certain limits to estate planning which taxpayers cannot exceed. Tax avoidance refers to a situation where a taxpayer, within the provisions of legislation,

³³ *Steyn* case 531.

³⁴ *Steyn* case 532.

³⁵ *Steyn* case 534.

³⁶ *Van der Merwe* case 567.

arranges his tax affairs so that his tax liability is minimised or completely avoided.³⁷ It is on this basis that it is necessary to determine what the impact is of statutory anti-tax avoidance measures on the discretionary family trust as an estate planning vehicle in SA.

1.2 PURPOSE OF RESEARCH

The purpose of the research is to determine the impact that statutory anti-tax avoidance measures have on the effectiveness of the discretionary family trust as an estate planning vehicle in SA. This question is posed due to the fact that the SA legislature introduced a number of legislative amendments ostensibly aimed at making trusts an unattractive tool for tax avoidance. For purposes of this thesis the focus will be mainly on the statutory anti-tax avoidance measures relating to trusts in which ownership of the trust assets have been transferred to the trustees. The research will be based on a study of case law, scholarly articles and legislation.

1.3 RESEARCH QUESTION

The SA legislature has introduced amendments to make the trust an unattractive tool for tax avoidance. In light of the many legislative developments regarding particularly the taxation of trusts, the specific research question to be answered in this thesis is: what is the impact of the statutory anti-tax avoidance measures on the effectiveness of the discretionary family trust as an estate planning vehicle in SA?

³⁷ Tsatsawane K 'Tax avoidance' (2001) *JBL* 8 (hereafter Tsatsawane K (2001) *JBL*).

1.4 RESEARCH OUTLINE

When devising any estate plan, the various statutory anti-tax avoidance provisions must be taken into account. While there are currently no general anti-tax avoidance provisions applicable to the avoidance of estate duty, there are other anti-tax avoidance measures which could potentially apply, like s 7 of the ITA in relation to income and paragraphs 68 to 72 in the Eighth Schedule of the ITA in relation to capital gain. These provisions will be discussed in this thesis.

Chapter one is the introduction to this study.

Chapter two of the thesis serves as background to the study where consideration will be given to the definition of a trust. The fiduciary nature of the trustee office as well as the position of the contingent trust beneficiary will be discussed briefly. The relevant duties which the provisions of the Trust Property Control Act 57 of 1988 (hereafter TPCA) imposes on trustees in relation to the administration of the trust property will also be overviewed.

Chapter three will consist of the ‘substance over form’ doctrine (hereafter the doctrine). The focus will be mainly on how our courts have changed their view over the years with regards to the application of the doctrine. It will further be determined in this chapter when courts are prepared to ‘pierce the veneer of the trust’.

Chapter four will consist of the statutory anti-tax avoidance measures which relate to the taxation of a trust, in particular income and capital gain. The effect of s 3(3)(d) of the EDA on the discretionary family trust will also be discussed.

Chapter five is the concluding chapter of this study. The impact of the statutory anti-avoidance measures on the discretionary family trust will be stated, taking into account all the information that was analysed in this study.

CHAPTER 2

BACKGROUND TO STUDY

‘The essential notion of trust law, from which the further development of the trust form must proceed, is that enjoyment and control should be functionally separate. The duties imposed on trustees, and the standard of care exacted of them, derive from this principle. And it is the separation that serves to secure diligence on the part of the trustee, since a lapse may be visited with action by beneficiaries whose interests conduce to demanding better. The same separation tends to ensure independence of judgement on the part of the trustee- an indispensable requisite of office-as well as careful scrutiny of transactions designed to bind the trust, and compliance with formalities (whether relating to authority or internal procedures), since an independent trustee can have no interest in concluding transactions that may prove invalid.’³⁸

1.INTRODUCTION

This chapter introduces the statutory definitions of trusts in terms of the TPCA and the ITA. These definitions are central to this study due to the fact that the impact of the statutory anti-tax avoidance measures on the effectiveness of the discretionary family trust for estate planning will be determined.³⁹ The *Parker* case is important for estate planning and a discussion will later follow with regards to the above-stated

³⁸ *Parker* case 87.

³⁹ ‘Trust’ is not defined in the EDA.

separation of control and enjoyment.⁴⁰ The fiduciary nature of the office of the trustee will be introduced in this chapter. The duties that are imposed on trustees relating to trust management will also be introduced in this chapter.

2. THE TRUST: STATUTORY DEFINITIONS

Trusts are governed largely by common law. In 1988 the legislature introduced the TPCA to regulate certain aspects of SA trust law. The TPCA is by no means an attempt to codify the SA law of trusts. The TPCA is devoted to establishing a firmer control over trustees and their stewardship of the trust by the Master of the High Court.

The TPCA contains a statutory definition of ‘trust’. The definition conforms to the definition in the Hague Convention on the Law Applicable to Trusts and their Recognition of 10 January 1986⁴¹ (hereafter Hague Convention). Under the Hague Convention, a trust is defined in article 2 as:

‘the legal relationship created inter vivos or on death by a person

(the settlor), when assets have been placed under the control of a trustee

for the benefit of a beneficiary or for a specified purpose.’

Under the TPCA a trust is defined in s 1 as:

⁴⁰ See chapter 3 of this thesis.

⁴¹ Hague Convention on the law applicable to trusts and their recognition of 10 January 1986 available at <http://www.hcch.net> (Convention of 1 July 1985 on the law applicable to trusts and on their recognition) (accessed 9 August 2012).

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

- (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or*
- (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument.*

but does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965.⁴²

The above definition provides for two categories of trusts. The first is the so-called ownership trust (described in paragraph (a) of the definition) where the trustee is vested with ownership of the trust property. The trustee must, however, exercise the powers of control and disposal inherent in such ownership for the benefit of the trust

⁴²66 of 1965.

beneficiaries or in order to achieve the objectives of the trust as stated in the trust instrument.⁴³

The second category is the so-called *bewind* trust (described in paragraph (b) of the definition)⁴⁴ where the trust beneficiaries are vested with ownership of the trust property, while the powers of control and disposal over the property are vested in the trustee. These powers of control and disposal must be exercised for the benefit of the trust beneficiaries or in order to achieve the objectives of the trust as stated in the trust instrument.

Section 1 of the ITA defines ‘trust’ as:

‘Any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person.’

The definition of ‘trust’ in s 1 of the TPCA gives legislative expression to what Cameron JA in the *Parker* case called the ‘core idea’ of the trust, namely the functional separation of the trustee’s ownership (or control) over trust property from the enjoyment derived from such ownership (or control) through the bestowal of trust benefits on the trust’s beneficiaries or through the achievement of the trust’s object, as stated above.⁴⁵

⁴³ *Estate Kemp v Mc Donald’s Trustee* 1915 AD 498.

⁴⁴ Olivier L ‘Trusts: Traps and pitfalls’ (2001) *SALJ* 224 226 (hereafter Oliver L ‘Trusts: Traps and pitfalls’ (2001)).

⁴⁵ *Parker* case 86.

When comparing the definition of ‘trust’ in the TPCA and ITA it is clear that the objective of the trust is of utmost importance. The objectives of the trust can only be achieved if the provisions of the trust instrument, trust deed or will are adhered to. This submission accords with the *Parker* case where the court held that the trust deed is a trust’s constitutive charter. The trustees can only act in terms of the provisions of the trust deed. Moreover, the trust estate cannot be bound if the trustees act outside of the provisions of the trust deed.⁴⁶

3. THE FIDUCIARY NATURE OF TRUSTEESHIP AND ITS IMPLICATIONS FOR CONTINGENT TRUST BENEFICIARIES

One of the principal characteristics of the office of the trustee is that it is fiduciary in nature.⁴⁷ Stated differently, a trustee occupies a fiduciary position⁴⁸ or holds trust property in a fiduciary capacity.⁴⁹ Whatever description is used, the essential notion is that a trustee owes a fiduciary duty to trust beneficiaries.⁵⁰

In the *Doyle* case the court held with regard to an *inter vivos* trust:

‘[W]hile the [trust] contract is alive, it appears to me to be unquestionable that a trustee occupies a fiduciary office. By virtue of that alone he owes the utmost good faith to all beneficiaries, whether actual or potential. Obligations towards contingent beneficiaries may

⁴⁶ *Parker* case 84.

⁴⁷ *Doyle v Board of Executors* 1999 (2) SA 805 (C) 813 A-B (hereafter *Doyle* case).

⁴⁸ *Doyle* case 812J.

⁴⁹ *Doyle* case 808D.

⁵⁰ Du Toit F ‘The fiduciary office of trustee and the protection of contingent trust beneficiaries’ 2007 *Stell LR* 469 471 (hereafter *Du Toit F (2007) Stell LR*).

*well end because the contract is lawfully revoked. It does not follow that the trustee never held those duties during the subsistence of his office.*⁵¹

Two considerations in particular are important in establishing the existence, nature and extent of a trustee's fiduciary duty. First, the main focus of a trustee's fiduciary duty is the manner in which he administers the trust property. Secondly, the trustee should administer the trust property to the advantage of the trust beneficiaries since they are beneficially interested in such proper administration.⁵² It is settled law that a trustee must, as a *bonus et diligens paterfamilias*, conduct trust administration with the utmost good faith and in the best interests of the trust beneficiaries.⁵³

A trust beneficiary who, in terms of the trust instrument, enjoys an immediate right to trust benefits (whether income and/or capital), is vested with a personal right to claim payment of such benefits from the trust's trustee when it becomes distributable.⁵⁴ If a trust instrument provides that a trust beneficiary's acquisition of a personal right to claim payment of trust benefits is contingent upon the occurrence of an uncertain future event, a personal right to claim trust benefits will only vest in such beneficiary if and when the contingency has taken place.⁵⁵ Before the occurrence of the contingency, the beneficiary is said to enjoy a so-called 'contingent right' to trust benefits and such a beneficiary is often called a 'contingent beneficiary' or 'potential beneficiary'.⁵⁶

⁵¹ *Doyle* case 812I- 813B.

⁵² *Jowell v Bramwell-Jones* 1998 (1) SA 836 (W) 891B -894E.

⁵³ *Doyle* case 813B.

⁵⁴ *Tjimstra NO v Blunt-Mackenzie & Others* 2002 (1) SA 459 (T) 468.

⁵⁵ *Webb v Davis* 1998 (2) SA 975 (SCA) 981I-J.

⁵⁶ *Doyle* case 813B.

In *Potgieter and Another v Potgieter NO and Another*⁵⁷ (hereafter *Potgieter* case) a trust deed was varied by way of a formal agreement between the founder and the trustees. The changes brought about to the original trust deed were substantial, including a change to the trust's name and a change whereby the appellants who had been capital beneficiaries were no longer the only capital beneficiaries but were reduced to members of a class of potential beneficiaries. The court held that the fact that the appellants enjoyed no vested rights to either income or capital, did not mean that their consent was not required when a decision to vary the trust deed was taken.

As Brand JA said:

*'They were clearly contingent beneficiaries only, but that does not render their acceptance of these contingent benefits irrelevant.'*⁵⁸

Every trust beneficiary enjoys a personal right against the trustee for the proper administration of the trust in accordance with the demands of his fiduciary office because, according to *Gross v Pentz*⁵⁹ (hereafter *Gross* case), every trust beneficiary holds an interest in a trustee's proper trust administration.⁶⁰ In the *Potgieter* case the court held that our law affords also the contingent beneficiary the right to protect his or her interest against maladministration by the trustee.⁶¹

The fact that the contingent beneficiary is also entitled to the proper administration of the trust property enhance the trust as an estate planning vehicle due to the fact that

⁵⁷ 2012 (1) SA 637 (SCA).

⁵⁸ *Potgieter* case paragraph 28.

⁵⁹ 1996 (4) SA 617 A.

⁶⁰ *Gross* case 628 I-J.

⁶¹ *Potgieter* case 649.

the trustee should take special precaution when dealing with the trust property due to the fiduciary duty that he has to all the beneficiaries of the trust.

4. **SOME DUTIES IMPOSED ON TRUSTEES RELATING TO TRUST MANAGEMENT**

The legislature has introduced several provisions in the TPCA in order to ensure proper and prudent trustee conduct in trust management. Examples of provisions of the TPCA with this aim are:

- Section 10 of the TPCA provides that whenever a person receives money in his capacity as trustee, he should deposit the money in a separate trust account at a banking institution or building society. The trustee is thus not allowed to deposit the money into his personal bank account.
- Section 11 of the TPCA provides for the registration and identification of trust property. The trustee must clearly indicate in his bookkeeping the property which he holds in his capacity as trustee. The trustee must also make any account or investment at a financial institution identifiable as a trust account or trust investment.
- Section 12 of the TPCA provides that the trust property shall not form part of the personal estate of the trustee except in so far as the trust beneficiary is entitled to the trust property.
- Section 17 of the TPCA provides that a trustee shall not without the written consent of the Master destroy any document which serves as proof of the

investment, safe custody, control, administration, alienation or distribution of trust property before the expiry of a period of five years from the termination of the trust.

These provisions enhance the trust as estate planning vehicle because they serve to establish a permanent constructive record of trustee actions regarding trust management. These provisions are particularly important due to the fact that cases will be discussed later in this thesis where the trustees treated the trust property as their personal property.

5. SUMMARY

The definitions of a 'trust' in terms of the ITA and the TPCA were introduced in this chapter. These definitions give legislative expression to the principal idea of a trust, namely the separation of control (ownership) from the enjoyment derived from the benefits of the trust property by the trust beneficiaries. It was highlighted that the trustee owes a fiduciary duty to the trust beneficiaries, and this duty extends also to contingent trust beneficiaries. The relevant provisions of the TPCA which impose on a trustee certain duties which he must implement in the administration of the trust estate were discussed. These provisions are indicative of the legislative control over trustees and aim to ensure proper trustee conduct in the administration of the trust.

CHAPTER 3

THE 'SUBSTANCE OVER FORM' DOCTRINE (HEREAFTER THE DOCTRINE) AND ABUSE OF THE TRUST FORM

1. INTRODUCTION

*'Within the bounds of any anti-avoidance provisions in the relevant legislation, a taxpayer may minimise his tax liability by arranging his affairs in a suitable manner. If, for example, the same commercial result can be achieved in different ways, he may enter into the type of transaction which does not attract tax or attracts less tax. But, when it comes to considering whether by doing so he has succeeded in avoiding or reducing tax, the Court will give effect to the true nature and substance of the transaction and will not be deceived by its form.'*⁶²

The doctrine will be discussed in this chapter. Cases will be discussed in which courts applied the doctrine in order to determine whether transactions were entered into for tax avoidance purposes. Cases will be discussed in which courts had to decide whether the parties to an agreement had the intention to enter into that agreement in the form alleged by them or whether they used the agreement as a disguise for something else. The purpose of this discussion is to point out the general simulation issue and how the principles pertaining to tax avoidance can be used to determine the possible invalidity of a transaction of a trust. Cases will be discussed where the courts did not declare the trusts as invalid or shams but explored the possibility to 'pierce the veneer of the trust'. This is important for estate planning purposes because if the

⁶² Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR 1996 (3) SA 942 (A) 950I-952C (hereafter Erf 3183/1 Ladysmith case).

vener of the trust is pierced, the trust property may be regarded as the personal property of the estate owner. This will have the effect that the estate owner's estate may be liable for estate duty.

2. THE DOCTRINE

Tax avoidance refers to a situation in which a taxpayer, within the provisions of the tax statute, arranges his affairs so that his tax obligation is minimized or completely avoided.⁶³ Although a taxpayer may manage his affairs to the best of his advantage, his management will not withstand the scrutiny of the courts if it relies on simulated schemes or transactions in which the real underlying intention of the parties differs from their apparent intention.⁶⁴ In the *Erf 3183/1 Ladysmith* case the taxpayer sought to rely upon the following rule in *Inland Revenue Commissioner (hereafter IRC) v The Duke of Westminster*⁶⁵ (hereafter *Duke of Westminster* case).

*'Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be.'*⁶⁶

The issue in the *Erf 3183/1 Ladysmith* case was whether the taxpayer, a property owning company, was liable to pay tax because an accrual of income had occurred within the meaning of paragraph (h) of the definition of 'gross-income' in s 1 of the ITA. Deciding that such an accrual had taken place, the Commissioner of SARS

⁶³ Tsatsawane K (2001) 8.

⁶⁴ Chadwick I 'How far can the taxpayer go in 'ordering his affairs'? (1998) 6 *JBL*.

⁶⁵ [1936] AC 1 (HL).

⁶⁶ *Duke of Westminster* case 19.

(hereafter Commissioner) taxed the appellant accordingly. The court had to determine the applicability of the two principles on which both the taxpayer and the Commissioner relied. As stated above, the taxpayer relied on the principle that a taxpayer is entitled to arrange his affairs so as to remain outside provisions of a particular statute. The Commissioner relied on the principle that the courts should not be deceived by the form of a transaction but should examine its substance. The approach of our courts have always been, as it was held in the case of *Dadoo Ltd and Others v Krugersdorp Municipal Council*⁶⁷ (hereafter *Dadoo* case) that the real intention carries more weight than a fraudulent pretence.⁶⁸ The court in the *Erf 3183/1 Ladysmith* case held that parties may well arrange their affairs so as to avoid a particular statute, but the court will not be deceived by the form of a transaction. It will examine the true nature and substance of the transaction.⁶⁹

Many South African cases developed the doctrine over more than a century. In *Zandberg v Van Zyl*⁷⁰ the court laid the basis of the doctrine:

'Not frequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a court is asked to

⁶⁷ 1920 AD 530.

⁶⁸ *Dadoo* case 547.

⁶⁹ *Erf 3182/1 Ladysmith* case 952.

⁷⁰ 1910 AD 302.

*decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is, not what it purports to be.*⁷¹

A fundamental shift from this position emanates from the judgement in the case of *Commissioner v NWK Ltd*⁷² (hereafter *NWK case*). The *NWK case* expands the traditional understanding and application of the doctrine. It focuses on a substance and form different from those in the older cases relating to the doctrine. It also has considerable implications for tax structures and the Commissioner's course of action against taxpayers who seek to evade tax.⁷³

The salient facts in the *NWK case* were that over a period of 5 years, the respondent, *NWK Ltd*, claimed deductions from income tax in respect of interest paid on a loan to it by Slabs Trading Company (Pty) Ltd (hereafter *Slab*), a subsidiary of First National Bank (hereafter *FNB*), in the sum of R96 415 776.⁷⁴ In 2003 however, the appellant, the Commissioner, issued new assessments and disallowed the deductions.⁷⁵ The basis for the revised assessments by the Commissioner was that the loan was not a genuine contract. It was part of a series of transactions entered into between *NWK*, *FNB* and its subsidiaries. The court held that the series of transactions were all designed to disguise the true nature of the transaction between *NWK* and *FNB*. The court held this due to the fact that during 1998, *FNB* offered a 'structure finance facility' of R50 million to *NWK*, repayable in 5 equal annual capital and interest payments over 5 years ending on 28 February 2003.⁷⁶ *NWK* accepted the offer on the terms proposed

⁷¹ *Zandberg v Van Zyl* 1910 AD 302 309.

⁷² 2011 (2) SA 67 (SCA).

⁷³ Legwaila T 'Modernising the 'substance over form' doctrine: CSARS v *NWK Ltd* (2012) SA *Merc LJ* 116 121 (hereafter *Legwaila T* (2012)).

⁷⁴ *NWK case* 68.

⁷⁵ *NWK case* 68.

⁷⁶ *NWK case* 69.

by *FNB* because it wished to take advantage of the tax benefits. The court held that the intention to perform in accordance with the terms of the contract is questionable. The court further held that there must be some substance and commercial reason in the contract, not just an intention to achieve a tax benefit.⁷⁷ The court further held that the loan for R96 415 776 was a transaction designed to disguise the real agreement between the parties, which was a loan of R50 million.⁷⁸

The *ratio decidendi* in the *NWK* case is found in the following extract:

‘In my view the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably, where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to the transaction on the terms agreed. The test should thus go further, and require an examination of the commercial sense of the transaction: of its real substance and purpose. If the purpose of the transaction is only to achieve an object that allows the evasion of tax, or of a peremptory law, then it will be regarded as simulated. And the mere fact that parties do perform in terms of the contract does not show that it is not simulated: the charade of performance is generally meant to give credence to their simulation.’⁷⁹

The crux of the *NWK* judgment is that a transaction will be regarded as simulated if lacking in commercial sense. The mere fact that a transaction was implemented in

⁷⁷ *NWK* case 80.

⁷⁸ *NWK* case 88.

⁷⁹ *NWK* case 80.

accordance with its terms would not preclude a finding that it was simulated.⁸⁰ It will be found to be simulated if there was no real commercial reason for it other than the additional tax benefit obtained.

In *Bosch and Another v Commissioner*⁸¹ (hereafter *Bosch* case), the court had an opportunity to consider the judgment of the *NWK* case.

The court held:

*‘...there is nothing in the careful judgement of Lewis JA which supports the argument that the reasoning as employed in NWK was intended to alter the settled principles developed over more than a century regarding the determination of a simulated transaction for the purposes of tax.’*⁸²

The court held that without an express declaration to that effect, *NWK* should be interpreted to fit within a century of established principle. The minority judgment in the *Bosch* case delivered by Waglay J however stated that the *NWK* case is a dramatic reversal of what has been a consistent view of what constitutes a simulated transaction. *NWK*, considered in its entirety, does in fact lay down the rule that any transaction which has its aim of tax avoidance will be regarded as a simulated transaction irrespective of the fact that the transaction is for all purposes a genuine transaction.⁸³ Before one is bound to a precedent setting judgment and is obliged to follow it, the judgment must be clear and unequivocal, it must be plain, unmistakable and explicit in its rejection of previous judgments which it seeks to reverse, and it

⁸⁰ Legwaila T (2012) 123.

⁸¹ 2013 (5) SA 130 (WCC).

⁸² *Bosch* case 151.

⁸³ *Bosch* case 158.

must be applicable to the facts in the matter before the court confronted with its possible application. Waglay J further stated that while he does not believe that the reversal must be express, the reasoning should demonstrate a departure from previous binding judgments. The *NWK* case does not in his view do so. It does not provide any reasons why the settled law should not be followed.⁸⁴ Waglay J is thus of the opinion that the *NWK* case cannot be read to serve as a precedent in a case where evasion is not the issue. In any event, any transaction which has its purpose as tax evasion is unlawful. The *NWK* case cannot therefore be authority for setting aside a transaction as simulated by reason of being a vehicle of tax evasion as this is automatic in terms of the law.⁸⁵ Waglay J further on the other hand held that if the words ‘evasion of tax’ are substituted with ‘avoidance of tax’, then the dictum goes against the accepted practice in our law which permits transactions aimed at tax avoidance. Furthermore, the confusion created by the judgment militates against it serving as a precedent binding upon the lower courts.⁸⁶

Moosa submits that the court failed in the *NWK* case to indicate whether, in relation to the objective of securing a tax advantage, the business reason must be a dominant purpose. It also provided no basis by which the business sense of a contract is to be tested.⁸⁷ Moosa further submits that this is to be determined on a case by case basis and that, in this context, a transaction will pass the muster of the test if it is commercially expedient or facilitates the carrying on of the taxpayer’s trade.⁸⁸

⁸⁴ *Bosch* case 159.

⁸⁵ *Bosch* case 159.

⁸⁶ *Bosch* case 159.

⁸⁷ Moosa F C:SARS v *NWK* Ltd-a tax planning sham(e)?’ *ITJ* (2012) Vol.27 8 (hereafter Moosa F *ITJ* (2012)).

⁸⁸ Moosa F *ITJ* (2012) 8.

The fundamental change brought about by the *NWK* case pertains to the extent to which the court recalibrated the test for simulation.⁸⁹ The *NWK* case has the potential to change the landscape of our jurisprudence in so far as concerns a taxpayer's right to plan his financial affairs in a manner which will yield the most beneficial tax advantage. The judgment reflects a marked shift towards a stricter approach to the evaluation of contracts designed to create a tax benefit. Its effect is so pervasive that it extends to all transactions concluded in the ordinary course of carrying on a trade, including contracts of employment.⁹⁰

SARS welcomed the decision of the court in the *NWK* case.⁹¹ The media release after the judgment stated that SARS is of the view that a simulated transaction generally involves an element of misrepresentation or non-disclosure. The media release further stated that SARS is aware that a number of other taxpayers have entered into simulated transactions, including compulsory convertible loans similar to the one at issue in the *NWK* case, with the effect of artificially reducing their tax liabilities. In the media release SARS stated that they would commence with audits of these taxpayers and that additional tax and interest were likely to be levied in issuing assessments in respect of the simulated transactions.

It is evident that the doctrine of *stare decisis* will enable SARS to use the principles crystallised in the *NWK* case as a weapon in its arsenal to combat the tax

⁸⁹ Moosa F *ITJ* (2012) 6.

⁹⁰ Moosa F *ITJ* (2012) 8.

⁹¹ 'SARS media release- Supreme Court Judgment' dated 15 December 2010 available at <http://www.sars.gov.za> (accessed 17 November 2013).

consequences flowing from a contract which it perceives not to be in the best interest of the *fiscus*.⁹²

For estate planning purposes, should estate owners and/or trustees of discretionary family trusts be cognisant of the fact that if the court determines that the reason why a transaction was entered into was for the purpose to avoid liability for tax, the court may regard the transaction as simulated. Tax liability may then possibly follow. The principle of the *NWK* case can, for example, be applied in a situation where shares are sold to a discretionary family trust at their market value but the selling price is left outstanding on loan account. The estate owner and/or donor may further also be held liable in terms of the general anti-avoidance provisions, which are contained in s 80A to s 80L of the ITA. This transaction would not pass the commercial rationality test as it was set out in the *NWK* case.

The *NWK* case provides SARS with so wide a power to attack transactions that seek to save, reduce or defer tax.⁹³ It must be borne in mind that transactions that trustees of a discretionary family trust enter into may especially be scrutinised by our courts due to the fact that the trustees are simultaneously the principal beneficiaries and have an interest in obtaining loans.⁹⁴

⁹² Moosa F *ITJ* (2012) 8.

⁹³ Vorster H 'NWK and purpose as a test for simulation' Volume 60 No. 5 May 2011 *The Taxpayer* 83.

⁹⁴ *Parker* case 89.

3. 'PIERCING THE VENEER OF THE TRUST'

In order to understand the applicability of the doctrine to trusts, it is necessary to look at the basic requirements for a valid trust.⁹⁵

The requirements for a valid trust are:⁹⁶

- The founder must intend to create a trust.
- The founder's intention must be expressed in a mode appropriate to create an obligation (such as a valid contract or will).
- The trust property must be defined with reasonable certainty.
- The trust object must be defined with reasonable certainty.
- The trust object must be lawful.

If one or more of these requirements are not met, then no trust is established. For a founder to have the intention to create a trust, he needs to have the intention to hand over to another the control of the property to be administered for the benefit of the beneficiaries.⁹⁷ In the following cases, however, the courts did not state that the trusts were shams or invalid. The trustees however abused the trust form. The courts, therefore, mentioned the possibility to 'pierce the veneer of the trusts'. In the situation where the trust form has been abused, there is still a valid trust but there is a justification for the courts to go behind the trust form.⁹⁸ There are practical implications when it is discovered that a trust is a sham, on the one hand, and when

⁹⁵ Olivier L & Honiball M *International Tax A South African Perspective* 4ed (2008) 269 (hereafter Olivier & Honiball (2008)).

⁹⁶ *Administrators, Estate Richards v Nichol and Another* 1996 (4) SA 253 (C).

⁹⁷ Olivier & Honiball (2008) 269.

⁹⁸ De Waal M *The Rabel Journal* (2012) 1096.

the trust form has been abused, on the other hand. When a trust is a sham, the ‘founder’ will remain owner of the ‘trust assets’. Consequently, neither the ‘trustees’ nor the ‘beneficiaries’ will acquire any rights with regard to these ‘trust assets’.⁹⁹ Matters are different in the abuse situation since both the trustees and beneficiaries will acquire rights with regard to the trust assets. This opens the door for the possibility that the court may go behind the trust form and order the application of the trust assets for a particular purpose.¹⁰⁰

The following cases, amongst others, dealt with situations where the courts explored the possibility to ‘pierce the veneer of the trust’ and also illustrate situations where the trust form was abused. In *Jordaan v Jordaan*¹⁰¹ (hereafter *Jordaan* case) the court had to decide whether the assets of the trusts of the divorced husband should be included in the distribution order. The court held that the defendant had in the past used the trusts for financial gain in his personal capacity. The court further held that the manner in which the trusts had been administered in the past was an important factor. It appeared from the financial statements and the evidence that a substantial amount of money flowed between the various trusts, without any formal decisions being taken by the trustees. The defendant had regarded the trusts as a vehicle whereby he could gain a financial benefit for himself.¹⁰² The court held that the assets of the trusts could be taken into account in the determination of the redistribution order in terms of s 7(3) of the DA.¹⁰³

⁹⁹ De Waal M *The Rabel Journal* (2012) 1097.

¹⁰⁰ De Waal M *The Rabel Journal* (2012) 1097.

¹⁰¹ 2001 (3) SA 288 (C).

¹⁰² *Jordaan* case 300E-G- 301B-C.

¹⁰³ *Jordaan* case 301D.

In the *Badenhorst* case the issue was whether when making a redistribution order in terms of s 7(3) of the DA, the assets of an *inter vivos* discretionary trust which was created during the marriage of the parties must be taken into account.¹⁰⁴ The court held that it was necessary to show that the party in question controlled the trust and that, but for the trust, he would have acquired and owned the assets in his own name.¹⁰⁵ The control had to be *de facto* and to determine whether a party had such control it was necessary to first analyse the terms of the trust deed and to consider how the affairs of the trust were conducted during the marriage.¹⁰⁶

The court considered the facts that the respondent seldom sought the approval of his co-trustees when making important decisions regarding the trust. He used the trust as a vehicle for his own business activities. He paid little regard to the difference between trust assets and his own assets. He could change the terms of the trust deed and could also discharge and appoint co-trustees on his own. The court also took into account the fact that he had the discretion to determine when trust income or trust capital could vest in a beneficiary.¹⁰⁷ Taking all these facts into account it was evident that the respondent was in full *de facto* control of the trust.¹⁰⁸ The court accordingly held, that the trust assets should have been added to the value of the respondent's estate.¹⁰⁹ It must be noted that the court did not expressly state that the trust was a sham because the relevant provision, s 7(3) of the DA, empowered the court to use its discretion to order the division of the assets of the one party as the court deemed fit. It must be noted that s 7(6) of the ITA can also be applied under these circumstances,

¹⁰⁴ *Badenhorst* case 258.

¹⁰⁵ *Badenhorst* case 260I- 261A.

¹⁰⁶ *Badenhorst* case 261B-C.

¹⁰⁷ *Badenhorst* case 367.

¹⁰⁸ *Badenhorst* case 261D-I.

¹⁰⁹ *Badenhorst* case 262F.

where the donor in his capacity as trustee can exercise the power of revocation of a donation without reference to the remaining trustees.¹¹⁰ A requirement is that the trustees should be deprived of their power to distribute income to the beneficiaries. The donor should be in *de facto* control of the discretionary family trust.

In the case of *BC v CC and Another*¹¹¹ (hereafter *BC* case) the wife sought an order in divorce proceedings against the husband directing *inter alia* that the value of the assets held by a trust established by the husband be taken into consideration in determining the accrual of his estate as provided in s 4 of the Matrimonial Property Act 88 of 1984. The court held that where the trust assets are *de facto* the assets of the spouse, the value of the assets held by the spouse on behalf of the trust may be taken into account in determining the accrual in the estate of the spouse concerned.¹¹²

In the case of *Rees and Another v Harris and Another*¹¹³ (hereafter *Rees* case) the court had to decide whether the assets of a trust could effectively be considered to be the assets of the trustee. The court held that in appropriate circumstances, the veneer of a trust can be disregarded in the same way as the corporate veil of a company. Consequently, where special circumstances exist to show that there has been an abuse of the trust by the trustee, the veneer must be disregarded.¹¹⁴ It follows that if a trust is used in an improper fashion by its trustees to commit fraud, the natural person behind the trust veneer can be held personally liable.¹¹⁵

The Tax Administration Act 28 of 2011 (hereafter TAA) also affects a discretionary family trust by providing that a representative taxpayer can be held personally liable

¹¹⁰ Geach (2007) 249.

¹¹¹ 2012 (5) SA 562 (ECP).

¹¹² *BC* case 565A.

¹¹³ 2012 (1) SA 583 (GSJ).

¹¹⁴ *Rees* case 590.

¹¹⁵ *Rees* case 591.

in terms of the TAA. Section 155 of the TAA states that a representative taxpayer is personally liable for tax payable in the representative taxpayer's representative capacity, if, while it remains unpaid the representative taxpayer alienates, charges or disposes of amounts in respect of which tax is chargeable; or the representative taxpayer disposes of or parts with funds or moneys which are in the representative taxpayer's possession or come to the representative taxpayer after the tax is payable, if the tax could legally have been paid from or out of the funds or moneys. This provision aims to prevent the trustee from alienating or disposing of amounts in respect of which tax is payable.

De Waal submits that before one can go behind the trust form, one should be satisfied that a valid trust has been created in the first place. In light of the above cases the trusts were not shams at all since valid trusts have been created. If it were shams, the question whether the courts could go behind the trust form would not be necessary.¹¹⁶ The effect of these cases is that the trust form may be disregarded and the personal estate of the estate owner will be larger than planned. The estate owner's estate may then possibly be liable for estate duty upon his death. The plan to create the discretionary trust for estate planning purposes would then be unsuccessful. The problem that could be encountered in practice is that it is difficult for SARS to be aware of situations when the trust form is disregarded or abused by an estate owner. The situation must be exposed to SARS by third party creditors (who are aware of the trust property actually being the personal property of the estate owner), disappointed beneficiaries or former and aggrieved spouses.

¹¹⁶ De Waal M *The Rabel Journal* (2012) 1085.

There are also cases where the courts have decided not to go behind the trust form. In these cases the emphasis however fell on the trustees' conduct in respect of the trust administration, their non-compliance with the terms of the trust deeds and the breaching of their fiduciary duties.¹¹⁷ The relevant cases are *Parker* and *Van der Merwe*. In short, both cases concerned the validity of legal acts performed by the trustees of the respective trusts. In the *Parker* case one of the issues was the validity of loan agreements which purported to bind the trust. The *Van der Merwe* case dealt with the issue of the validity of a contract for the sale of land. In both these cases it was held that the acts which the trustees performed were invalid because the trustees had acted in contravention of the basic trust law principles as well as the provisions of the respective trust deeds. In both these cases the courts considered going behind the trust form, but it did not actually happen.¹¹⁸ The court in the *Parker* case did not go behind the trust form because the trustees, by reason of incapacity, could not act on behalf of the trust. The trust did not validly petition the court nor was it at any stage properly before the court.¹¹⁹ In the *Van der Merwe* case the provisions of s 2(1) of the Alienation of Land Act 68 of 1981 made it impossible to go behind the trust form.¹²⁰

The 'piercing of the veneer of the trust' issue is particularly crucial for discretionary family trusts since generally, the trustees of the family trust are also the beneficiaries of the trust and/ or the founder of the trust is also a trustee of the trust. It is not wrong to be in that position but it is important that the legal separation in the ownership (control) of the trust property and the enjoyment derived from the trust property be

¹¹⁷ De Waal M *The Rabel Journal* (2012) 1093.

¹¹⁸ De Waal M *The Rabel Journal* (2012) 1093.

¹¹⁹ *Parker* case 92.

¹²⁰ *Van der Merwe* case 572 A-D.

maintained. It is also important that the trustees act in terms of the provisions of the trust instrument.¹²¹

A lesson that could be learned from the above cases is that, although a trustee can also be a beneficiary, the central notion is that the person entrusted with control exercises it on behalf of and in the interest of another.¹²²

4. SUMMARY

Taxpayers are entitled to arrange their affairs in order to remain outside the provisions of taxing statutes. Dishonest intentions of the taxpayer can however be challenged by the tax authorities and the courts will not be deceived by the form of such a transaction. The court may examine the true nature of the transaction and attach adequate tax implications to it. The problem in practice is that it may be difficult for SARS to become aware of the dishonest intention of the taxpayer unless it is raised with SARS by an interested party, for example a third party creditor, an aggrieved beneficiary and former spouse.

The courts will look at the commercial sense of transactions that were entered into and will further determine whether the main purpose of the transaction was to avoid liability for tax. The commercial sense of transactions can especially be scrutinised in the case of discretionary family trusts, due to the fact that the trustees are simultaneously the principal beneficiaries and will have an interest in the obtaining of loans. Each case should however be decided on its own merit. It must be noted that if

¹²¹ Means a written agreement or a testamentary writing or a court order according to which a trust was created.

¹²² *Parker case 86.*

the *NWK* case is authority for setting aside a transaction as simulated where the aim of the transaction is tax avoidance, then it goes against established law, which in principle allows transactions that avoid tax.

The courts can also decide to disregard the trust form and ‘pierce the veneer of the trust.’ This can happen if there is no separation between the ownership of the trust property and the enjoyment derived from the trust property. The cases that were discussed above should sound alarm bells for estate owners and trustees who transferred assets to a discretionary family trust with a view to avoid liability for tax and who conduct themselves in a manner similar to how the parties treated the trust assets in the above discussed cases. If the trust form is disregarded by the court it could have far-reaching tax consequences, particularly in relation to income tax and estate duty, with trust income and trust assets being regarded as the personal income and assets of an estate owner and/or trustee.

CHAPTER 4

STATUTORY ANTI-TAX AVOIDANCE PROVISIONS RELATING TO TRUSTS

In *Vestey's Executors v IRC*¹²³ (hereafter *Vestey's Executor's* case), Lord Normand said:

*'Parliament in its attempt to keep pace with the ingenuity devoted to tax avoidance may fall short of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden, and it is disappointing to the Inland Revenue. But the Court will not stretch the terms of taxing Acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statutes.'*¹²⁴

1.INTRODUCTION

The taxation of a trust is governed by s 25B of the ITA, in the absence of the operation of any of the anti-avoidance provisions in s 7 or sections 80A to 80L (general anti-tax-avoidance provisions in the ITA). Sections 80A to 80L of the ITA will be briefly discussed in this chapter due to the fact that it contains the general anti-avoidance provisions of the ITA. Sections 25B and 7 of the ITA will be discussed in this chapter since it particularly deals with the taxation of a trust. Furthermore, the provisions in the Eighth Schedule of the ITA relating to taxation of capital gains will be discussed. This chapter will be concluded by s 3(3)(d) of the EDA.

¹²³(1949) 1 All ER 1108 (HL).

¹²⁴ *Vestey's Executors* case 1120.

Due to the fact that this study is determining the impact of the statutory anti-tax avoidance measures on the discretionary family trust, it is also important to state the difference between tax avoidance and tax evasion. Tax avoidance refers to a situation in which a taxpayer, within the provisions of a tax statute, arranges his affairs so that his tax obligation is minimised or completely avoided. Tax avoidance is not tax evasion. Tax evasion is where a taxpayer unlawfully arranges his affairs in a way that he escapes from tax liability which he ought to pay.¹²⁵

2. GENERAL ANTI-AVOIDANCE PROVISIONS OF THE ITA

An estate plan must take cognisance of the so-called ‘general anti-avoidance provisions’. This was originally contained in s 103(1) of the ITA, which applied to any transaction entered into before 2 November 2006. For s 103(1) to be invoked there must be a transaction, operation or scheme, which has the effect of avoiding, reducing or postponing any tax referred to; which was entered into in an abnormal manner or created abnormal rights and obligations; and which was entered into solely or mainly for the purposes of obtaining a tax benefit. Section 103(1) was replaced as from 2 November 2006 by sections 80A to 80L of the ITA.. An ‘arrangement’ as defined in s 80L of the ITA is considered an impermissible avoidance arrangement if:

- its sole or main purpose was to obtain a tax benefit;¹²⁶

¹²⁵ Section 235 of the TAA states that a person who intent to evade or assist another person to obtain an undue refund under a tax Act, is guilty of an offence and, upon conviction, is subject to a fine or to imprisonment for a period not exceeding five years.

¹²⁶ Section 80A of the ITA. A ‘tax benefit’ is defined in s 80L to include ‘any avoidance, postponement or reduction of any liability for tax’.

- in the context of business or otherwise it was entered into or carried out in a means or manner which would not normally be employed for bona fide business purposes other than obtaining a tax benefit or in the context of business only, it lacks commercial substance.

There are three tainted elements namely, abnormality,¹²⁷ or a lack of commercial substance,¹²⁸ or misuse or abuse of the provisions of the ITA.¹²⁹

Section 80B of the ITA empowers the Commissioner to take certain action. A general remedy is provided in s 80B(f) of the ITA. The Commissioner may in terms of this general remedy determine the liability for tax as if the transaction had not been entered into or carried out, or alternatively, in such other manner as in the circumstances of the case, the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit. The Commissioner is also provided with specific remedies to impermissible tax avoidance arrangements. The specific remedies are contained in subsections 80B(1)(a) to (e). These specific remedies allow the Commissioner to, for example:

- disregard or combine any steps in the arrangement.
- deem different parties as one and the same person.
- re-allocate or re-classify any receipts or accruals, expenditure or rebates.

The Commissioner must, in terms of s 80B(2) of the ITA, make the necessary and appropriate adjustments to the applicable tax liabilities to ensure the consistent

¹²⁷ Sections 80A (a)(1), 80A(b) and 80A(c)(i).

¹²⁸ Section 80A(a)(ii).

¹²⁹ Section 80A(a)(ii).

treatment of all the parties to the arrangement. These adjustments are subject to objection and appeal. It is important to note that the provisions of s 80 of the ITA may be applied to any part of an arrangement or to the arrangement as a whole.¹³⁰

Section 80C of the ITA provides a general rule for determining whether an avoidance arrangement lacks commercial substance for the purpose of s 80A, as well as a non-exclusive set of characteristics that serve as indicators of a lack of commercial sense. The general rule is that an avoidance arrangement lacks commercial substance if it results in a significant tax benefit for a party but does not have a significant effect upon either the business risks or the net cash flow of that party.¹³¹ Examples of lack of commercial substance according to s 80C(2) include:

- Situations where the legal substance of a transaction differs from the legal form; or
- round trip financing is present;¹³² or
- a tax-indifferent party, as described in s 80E, is introduced as part of the arrangement; or
- elements are present that have the effect of offsetting or cancelling each other.

Section 80D of the ITA provides a description of round trip financing. This essentially relates to a transfer of funds between parties that results in a tax benefit and a significant reduction, offset or elimination of business risk.

¹³⁰ Section 80H of the ITA.

¹³¹ Section 80 (C).

¹³² Section 80D of the ITA.

The essential question that exists is whether this detailed structure that SARS has sought to put into legislation will materially alter the position which pertained under s 103 of the ITA. To answer this question, two key cases need to be considered. In *CIR v Conhage (Pty) Ltd*¹³³ (hereafter *Conhage* case) the court accepted the argument that a sale and lease back transaction could serve the dual purpose of providing the taxpayer with capital and still take advantage of tax benefits to be derived from the particular type of transaction. In the *Erf 3183/1 Ladysmith* case, the court was confronted with a property structure in which use was made of an independent pension fund to ensure that a land owner could ensure that a factory was constructed on its land in circumstances where the lessee could deduct the cost of construction without the land owner being taxed in terms of paragraph (h) of the definition of 'gross income'. The court examined the nature of the agreements and the intention of the parties thereto. It determined the true nature of the various agreements and held that the taxpayer had acquired a right to have improvements affected on his land. The court did not follow a 'substance over form' approach but followed established legal principle in examining the true intention of the parties as evidenced in the agreement.

These two decisions have clear implications for the new s 80A of the ITA. In the first place it would be doubtful that *Conhage* would be differently decided under s 80A. The transaction was held to have commercial substance because it constituted a lending agreement between arms length parties. Although a tax saving purpose was found to exist, the essence of the transaction was that of commercial lending. Hence, it is difficult to see how the commercial substance could be found to be lacking because it did not hold significant business risks for the borrower. The court in the

¹³³ 1999 (4) SA 1149 (SCA).

Conhage case thus examined the transaction from the perspective of a commercial rationale, or expressed in the language of the new section, the commercial substance of the transaction. Viewed in this manner, it is doubtful whether the new section would produce a different result in that the court would examine the test for commercial substance as did the court in *Conhage*.

In *Erf 3183/1 Ladysmith* the court did not embrace a 'substance over form' doctrine but it did affirm that the nature of a contract and thus the true nature of the arrangements could be tested not by its legal form alone but in terms of the intention of the parties which gave rise to the contracts. Viewed within the context of the new legislation, this judgment could be invoked by SARS to attack transactions where the true nature of the arrangements is obfuscated by a series of agreements.

Two further considerations operate in favour of the conclusion that, all the detailed provisions of section 80C to 80E of the ITA notwithstanding little material change will occur from the tax avoidance jurisprudence which developed in terms of s 103(1) of the ITA. First, the distinction between normality and purpose is retained. That means that a taxpayer can have a sole or main purpose of avoiding tax but still argue that nothing is abnormal in the transaction. Secondly, on the basis of s 80G of the ITA, the onus to prove abnormality still rest on SARS .

The *NWK* case casts some doubt on whether ss 80 A to 80L of the ITA will continue to have significant practical effect. The court extended the test for simulated transactions beyond that which was set out in the older cases. The dictum appears to confuse the concepts of tax evasion with tax avoidance. It also classified a transaction as simulated once it is designed to achieve a situation where less tax is payable than otherwise would be the case. This is an extremely wide notion of a simulated

transaction as previously understood. This extension provides SARS with so wide power to attack transactions that seek to save, reduce or defer tax so far as to render the application of ss 80 A to 80 L almost redundant.¹³⁴

The general anti-avoidance provisions of the ITA could apply to discretionary family trusts in the event of interest free loans being made to the trust by the founder. An interest free loan arrangement would not have any commercial substance. A discretionary family trust can also be held liable in terms of s 80C(2) if they enter into transactions where the legal substance differs from the legal form.

3. SECTION 25B OF THE ITA

Section 25B(1) of the ITA states:

‘Any amount received by or accrued to or in favour of any person during any year of assessment in his or 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 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.’

The obtaining by a trustee of the control of the trust assets that are to be held and utilised for the benefit of beneficiaries, cannot on general principles, qualify as a

¹³⁴ Emslie T ‘Simulated Transactions- NWK revisited’ Vol 60 No.2 2011 *The Taxpayer* 23.

receipt or an accrual in the trustee's hands.¹³⁵ A beneficiary may, also in addition, have a vested right or unconditional right to a trust asset or to the fruits of a trust asset.¹³⁶

In *Lategan v CIR*¹³⁷ the court held that an amount accrues as soon as a taxpayer becomes entitled to it. In terms of the entitlement principle, an amount accrues to a taxpayer when he becomes entitled to claim payment (personal right) even if only at a future date. This view was accepted in the case of *CIR v People's Stores (Walvis Bay) (Pty) Ltd.*¹³⁸ In *ITC 1552*¹³⁹ the court stated that in the income tax sense, a vested right was an accrued right.

The position is however somewhat more complex in the case of other trusts where beneficiaries only acquire vested rights upon the exercise of a discretionary power by the trustee(s) or upon the happening of some other uncertain event. Where trust beneficiaries acquire no unconditional rights to any trust asset acquired by the trustee, that asset can clearly not qualify as having accrued to or having been received by any beneficiary. The question of the status of such assets as well as whether they can be treated as having accrued to the trust, in spite of the fact that a trust is not a legal persona at common law, was finally settled in the case of *Friedman NNO v CIR: In Re Phillip Frame Will Trust v CIR*¹⁴⁰ (hereafter *Friedman case*).

¹³⁵ Swart G 'The taxation of trusts-superimposing new rules on old principles' 2002 *Acta Juridica* 102 110.

¹³⁶ *Greenberg v Estate Greenberg* 1955 (3) SA 361 (A) 364-65.

¹³⁷ 1926 CPD 203 209.

¹³⁸ 1990 (2) SA 353 (A) 367 C-D.

¹³⁹ (1989) 55 SATC 96 97.

¹⁴⁰ 1991 (2) SA 340 (WLD).

The *Friedman* case dealt with the issue whether a trust is a ‘person’ and therefore a taxable entity for purposes of the ITA.¹⁴¹ The court held that in the absence of any express provisions in the ITA constituting a trust a ‘person’, or taxable entity for purposes of the ITA, the court did not consider that any liability for tax in respect of the undistributed income of a trust was created by the ITA. If this is a lacuna in the ITA it is a matter which can obviously only be cured by legislation.¹⁴² Section 25B (1) was then introduced into the ITA.

A trust is currently defined as a ‘person’ for tax purposes. The treatment of a trust as a person is very different from the tax treatment of companies and close corporations.¹⁴³ This is because even though amounts may be received by a trust, these receipts may not be taxed in the trust at all but taxed in the hands of the beneficiaries of the trust.¹⁴⁴ In these circumstances, rather than be regarded as a person a trust would be described as a conduit or a channel through which income and capital gains flow through to the beneficiaries. In the case of *Armstrong v CIR*¹⁴⁵ the court held that the ‘conduit principle’ rests upon sound and robust common sense for treating the intervening trustee as a mere administrative conduit-pipe. The effect of the conduit principle is that double tax is avoided, as the income is not taxed in the hands of both the trustees and the beneficiaries. Section 25B(2) of the ITA provides that where trust income is vested in a beneficiary as a result of the exercise of a discretion by the trustees, the beneficiary will be taxed.

¹⁴¹ *Friedman* case 341.

¹⁴² *Friedman* case 344.

¹⁴³ Geach (2007) 133.

¹⁴⁴ Section 25B of the ITA.

¹⁴⁵ 1938 AD 343 348.

It is thus important to note that if the income is not vested in the beneficiary in a particular year, as is sometimes the case in a discretionary family trust, the trust will be taxed and not the beneficiary. The beneficiary of a discretionary family trust is thus only liable for income tax once the trust income is vested in him. Trusts other than special trusts are however subject to the maximum marginal rate of tax¹⁴⁶ and it would thus be advisable to vest the trust income in the beneficiaries in order for the income to be taxed in their hands and at a lower rate since the income will be split amongst the beneficiaries. This should however only be done if the estate owner wishes to preserve the income of the trust. A discussion will later follow as to when the 'donor' to a trust will be taxed and not the trust or the beneficiary.

Section 25B(3) of the ITA provides that any deductions or allowance that is available and taken into account in the determination of taxable income, shall to the extent to which such income is deemed under s 25B(1) to be the income of the beneficiary or the trust, be deemed to be a deduction or an allowance which may be made in determining the taxable income of the beneficiary or the trust as the case may be.

Under s 25B(4) trust deductions incurred by the trust and allowances to which the trust might have been entitled are limited to the amount of the income received from the trust. Section 25B(5) provides that any excess has to be claimed by the trust in the same year of assessment. Section 25B(6) provides that in the event of the trust not having sufficient taxable income to make use of the deductions and allowances, the beneficiary may claim the excess in the subsequent year of assessment. Where the trust is not subject to tax in South Africa, the excess may be carried forward to the subsequent year of assessment to be used by the beneficiary. In addition, it is provided

¹⁴⁶ An ordinary trust is taxed on 66 per cent of a capital gain at a rate of 40 per cent. 'Trusts' available at <http://www.sars.gov.za> (accessed on 6 November 2013).

that the limitations will not be applicable to a beneficiary who is not subject to tax in South Africa.¹⁴⁷

4. **COUNTER THE USE OF OFFSHORE TRUSTS**

Section 25B(2A) of the ITA provides that a SA resident¹⁴⁸ beneficiary will be taxed where he acquires a vested right to capital of a non-SA resident trust, and the capital arose from income received by or accrued to the trust; or receipts and accruals which would have constituted income if the trust had been a SA resident in a previous year of assessment during which such resident had a contingent right to such income or receipts and accruals. This section aims to counter the manipulation by trustees of the residency of a trust in order to avoid tax liability in SA.

For s 25B(2A) to operate, it is essential that the beneficiary in whom the capital is vested had a contingent right to the income in the year that it accrued to the trust.¹⁴⁹

The wording of s 25B(2A)(a)(ii) makes it clear that s25B(2A) applies to foreign amounts. Section 25B(2A) is however not only applicable to foreign amounts. It is clear from s 25B(2A)(i) that it also applies to SA source amounts. However, as in most instances such amounts will be ‘subject to tax’ in SA in terms of the other provisions of the ITA, it will be excluded by s 25B(2A)(b). It is clear from s 25B(2A)(b) that if the accumulated foreign amount has been subject to tax in SA in terms of s 7(5) or s 7(8) of the ITA it cannot be taxed again in terms of s 25B(2A). Double taxation is therefore averted. Accordingly, it will only be in those

¹⁴⁷Section 25 B(7) of the ITA.

¹⁴⁸ Section 1 of the ITA. As far as trusts are concerned, a resident trust is a trust established or formed in SA, or a trust that has its place of effective management in SA.

¹⁴⁹ Section 25 B(2A)(a) of the ITA.

circumstances where the pre-conditions for the operation of s 7(5) and s 7(8) have not been met that s25B (2A) will come into the picture. For example, there has been a donation, settlement or other disposition.. It is important to note that for s 25B(2A) to operate, it is not necessary for a ‘donation, settlement or other disposition’ be made to the trust, which is a requirement for the specific anti-avoidance provisions in s 7 to apply.

The formation of discretionary offshore trusts is becoming increasingly popular with SA residents, and there are a significant number of SA residents who have set up trusts offshore in which the majority of beneficiaries are resident in SA.¹⁵⁰ When a trust is set up in a low tax jurisdiction, this often results in some tax advantages that the founder’s country of residence may curtail. A trust is a taxable entity in SA. However, if a trust is formed in an offshore jurisdiction, SA cannot tax its income, unless it is distributed to resident beneficiaries. But if an offshore trust is effectively managed in SA, in that the trustees carry out the day-to-day management of the trust in the SA, SA may apply the residence basis of taxation to tax the worldwide income of that trust.

The meaning of place of effective management (hereafter POEM) was considered in the case of *Oceanic Trust Co Ltd NO v the Commissioner*¹⁵¹ (hereafter *Oceanic* case). Oceanic Trust is a Mauritian company registered and incorporated under the company laws of Mauritius with its principal place of business in Port Louis Mauritius. Oceanic Trust was the sole trustee of a trust, Specialised Insurance Solutions (Mauritius) (‘SISM’), which was established and registered on 23 November 2000 in

¹⁵⁰Mhlongo T ‘The efficacy of trusts in the current legislative climate’ (2002) *ITJ* Vol. 17 (2) 9.

¹⁵¹ 74 SATC 127.

Mauritius.¹⁵² SISM conducted business from its inception in 2000 until 2006. During the period of its business operations, SISM prepared financial accounts and rendered income tax returns to the revenue authorities in Mauritius.¹⁵³ SISM considered throughout that it only had tax obligations in Mauritius and that it did not have any tax obligations in SA. On 4 March 2006 SISM received a notice of audit in terms of s74A of the ITA from SARS informing it that SARS intended conducting an audit/inspection of SISM and requesting certain information from SISM.

SISM provided certain information to SARS and SARS thereupon issued a letter stating that it believed that it had a tax claim against SISM and asked for reasons why SISM should not be taxed. On 20 July 2009 SARS issued an assessment letter wherein it raised an assessment of income tax, additional tax and interest for the tax years 2000 to 2007 for R1.5 billion. One of the bases for the assessment was that SISM was a 'resident' in SA because it had its POEM in SA and that it derived income from a SA source which was not exempt from tax. A further, alternative basis for the assessment was that SISM derived income from a SA source and that it carried on business through a permanent establishment in SA within the meaning of s 10(1)(h) of the ITA.¹⁵⁴ SISM submitted that its management decisions would have been taken by its sole trustee (i.e. Oceanic Trust) and that such decisions would have been made in Mauritius.

The court held that the relevant key features relating to the POEM of an entity are the following¹⁵⁵:

¹⁵² *Oceanic Trust* case 128.

¹⁵³ *Oceanic Trust* case 128.

¹⁵⁴ *Oceanic* case 129.

¹⁵⁵ *Oceanic* case 146.

- the POEM is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made;
- the POEM will ordinarily be the place where the most senior group of persons (e.g. board of directors) make its decisions, where the actions to be taken by the entity as a whole are determined;
- no definite rule can be given and all relevant facts and circumstances must be considered to determine the POEM of an entity;
- although there may be more than one place of management, there may only be one POEM at any one time.

Unfortunately, the judge in the *Oceanic* case did not go on to conclude on whether or not the trust had its POEM in SA (and hence whether it was then a 'resident' as defined in SA). Despite this, the judgement is relevant in that it provides guidance to taxpayers as to the view likely to be adopted by a court in applying the POEM concept.

The court in the *Oceanic* case relied on the UK decision of *Commissioner for Her Majesty's Revenue and Customs v Smallwood and Another*,¹⁵⁶ which dealt with POEM as applied in a double taxation agreement.

SARS' approach to the term POEM¹⁵⁷ is the place where the company is managed on a regular or day to day basis by directors or senior managers of the company,

¹⁵⁶ (2010) EWCA Civ 778.

irrespective of where the overriding control is exercised, or where the board of directors meets. The focus is therefore on the location where policy and strategic decisions are executed and implemented by a company's senior management, rather than the place where the ultimate authority over the company is exercised by its board of directors or similar body.¹⁵⁸

In order to determine a legal person's POEM from a practical point of view, the three steps set out in Interpretation Note 6 need to be followed:¹⁵⁹

- If the management functions are executed at a single location, that single location will constitute the legal person's POEM;
- If all the management functions are executed from different locations, one would determine the location where the day to day management and commercial decisions taken by senior management are actually implemented. This will be the location where the actual business operations of the company are carried out; and
- If both steps above do not provide a definite answer, one would determine the 'place with the strongest economic nexus'.

In addition to the three steps above, SARS provides certain factors that need to be considered when determining a legal person's POEM. These factors include *inter alia*, where the business operations are actually conducted and where the centre of top

¹⁵⁷ Interpretation Note 6: Resident: Place of Effective Management (Persons other than natural person) issued on 26 March 2002 available at <http://www.sars.gov.za> (accessed 17 November 2013) (hereafter Interpretation Note 6).

¹⁵⁸ Interpretation note 6 3.

¹⁵⁹ Jonker J 'Place of effective management- A South African Perspective' (Unpublished LLM thesis, University of Pretoria, 2012).

level management is located. It is reiterated that these factors do not constitute an exhaustive list, but only acts as guidelines to be followed.

SARS has provided its view on the approach to locating the POEM of a company, while the *Oceanic* case provided guidance on the approach to locating the POEM in general. These approaches show a range of interpretations- the POEM is located where the company is managed on a regular day-to-day basis and operations are implemented, or where the shots are called, or where the Board of Directors meet on the business of the company, or where the central executive management is located. The different views illustrate two possible approaches, either through looking for the ‘directing mind’ of the company or looking at the rules of the company as found in its documents, the common law and legislation.¹⁶⁰ The first approach would attribute certain ‘human’ characteristics to the company by seeking to find the ‘mind’ which effectively manages it. The second approach would scrutinise the company’s founding document and the relevant law to determine which person or body is empowered to ‘effectively manage’ the company in terms of its rules. The first approach can also be referred to ‘*de facto*’ POEM, while the latter can be referred to as the ‘legal POEM’. In applying the first, an attempt would be made to find the directing mind of the company, in locating where the shots are called. If the approach is based on examining the rules, it would commence by looking at the company’s founding documents, the case law relating to its actions and decisions and the relevant legislation by which it is governed.¹⁶¹

¹⁶⁰ Gutuza T ‘Has recent United Kingdom case law affected the interplay between ‘place of effective management’ and controlled foreign companies?’ 2012 *SA Merc LJ* 424 427 (hereafter Gutuza T (2012) *SA Merc LJ*).

¹⁶¹ Gutuza T (2012) *SA Merc LJ* 429.

These approaches appear to indicate, though under a different test for residence, that the starting point of attributing a characteristic to a company can either be to locate the ‘directing mind’ of that company, or to look at the rules which give it legal personality and regulate its actions. Gutuza submits that although the identification of these approaches would indicate the need for a choice, the approaches can be reconciled.¹⁶²

The effect that the interpretation of the POEM has on the discretionary family trust is that the POEM can be established by taking into account the above steps as set out in the Interpretation Notes. The trustees may then be liable for tax if it is found that the discretionary family trust’s POEM is in SA.

5. SECTION 7 OF THE ITA

Where the income arising in the trust can be linked to a donation made by a donor, the deeming provisions of s 7 of the ITA will apply because the provisions of s 25B are subject to s 7 of the ITA.¹⁶³

The ITA thus seeks to prevent income splitting. The income accruing to the trust is drawn into the hands of the beneficiary with a vested right in terms of s 25B of the ITA. The income will be taxed there unless the income has accrued by reason of a donor’s donation with the main or sole purpose of avoiding tax. Where this is the

¹⁶² Gutuza T (2012) SA Merc LJ 430.

¹⁶³ Section 25B of the ITA.

case, the deeming provisions in s 7 of the ITA will draw the income into the hands of the donor to be taxed there.¹⁶⁴

Section 7 of the ITA was introduced to curb specific tax avoidance schemes. Section 7 is specifically targeting assets which are donated by a donor to another person with the idea of avoiding tax in his own hands on the profits derived from these assets. Whenever one of the subsections of s 7 is applicable, income will not be taxed in the hands of the trustees or the trust beneficiaries, but in those of the donor. Furthermore, for this section to apply the donor must still be alive at the year end.

In order for any of the deeming provisions of s 7 of the ITA to apply, a person must have made a donation, settlement or other gratuitous disposition. For estate planning purposes, it is thus imperative to understand what is meant by the terms ‘donation, settlement or other disposition’, as it is used in s 7 of the ITA. The term ‘donation’ has the normal acceptable meaning of donation. It is a wholly gratuitous disposition and it contains no element of commerciality.¹⁶⁵ In *Estate Welch v Commissioner*¹⁶⁶ the court found that the distinguishing characteristic of a donation was that the disposition was motivated by ‘pure liberality or disinterested benevolence’. This is consistent with the decision reached in *Ovenstone v Secretary for Inland Revenue* (hereafter *SIR*)¹⁶⁷ (hereafter *Ovenstone* case) where the court indicated that as soon as an element of *quid pro quo* is introduced into a transaction there is no donation.¹⁶⁸ With regards to the term ‘settlement’ the court in *Joss v SIR*¹⁶⁹ held that the term

¹⁶⁴ Carroll E ‘SARS’ ability to attribute trust income and capital gains to a donor-parent’ (Unpublished LLM Thesis) North West University (2010) 9 (hereafter Carroll E (2010)).

¹⁶⁵ Olivier PA, Strydom S and Van den Berg GPJ *Trust Law and Practice* 2ed (2006) 7-19.

¹⁶⁶ 2004 (2) SA 586 (SCA) 593.

¹⁶⁷ 1980 (2) SA 721 (A).

¹⁶⁸ *Ovenstone* case 736H.

¹⁶⁹ 1980 (1) SA 674 (T) (hereafter *Joss* case).

‘settlement’ did not include transactions ‘made for full value or money’s worth’.¹⁷⁰ A similar conclusion was reached in the case of *Ovenstone*. The court found that while a settlement could be made for full value, the type of settlement envisaged by s 7(3) of the ITA was the type which was made ‘gratuitously out of liberality or generosity’¹⁷¹ and as such ‘it was part of the same genus as a donation’.¹⁷² The interpretation led the court to decide that settlements made for full consideration would be of a purely commercial nature and therefore, fall outside of the scope of s 7(3) of the ITA. The term ‘other disposition’ should also be limited to dispositions of a gratuitous nature.¹⁷³

An example of a gratuitous disposition would be a donation of property to a discretionary family trust. Any income, such as rental arising from that property, would then be deemed to be income of a person other than the person to whom the income accrues.¹⁷⁴

Sections 7(5) and 7(6) of the ITA are specifically applicable to discretionary family trusts. However, for the sake of completeness, the other sections of s 7 of the ITA will also be discussed.

5.1 Section 7(2) of the ITA : Income is deemed to be that of the spouse

There are many provisions in tax laws that provide that transactions between spouses have no tax consequences. For example, a donation from one spouse to another,¹⁷⁵ transactions between spouses do not have to be taken into account as gains for capital

¹⁷⁰ *Joss* case 680F.

¹⁷¹ *Ovenstone* case 737 A-G.

¹⁷² *Ovenstone* case 737 A-G.

¹⁷³ *Ovenstone* case 737E.

¹⁷⁴ *Geach* (2007) 245.

¹⁷⁵ Section 56(1)(a) of the ITA.

gains purposes,¹⁷⁶ and bequests to a surviving spouse are not subject to estate duty.¹⁷⁷ However, when one spouse's income is higher than the other spouse's income, there can be temptation to ensure that the income or gain of one spouse is treated as the income or gain of the other. In this way income or gains could be taxed in a manner beneficial to the taxpayer. In order to prevent tax avoidance in these circumstances, s 7(2) deems the income of one spouse to be that of the other spouse to the extent that it is not self-earned but arises as a result of a donation, settlement or disposition of the other spouse. In the context of trusts, the application of s 7(2) will ensure that if a spouse has received some income benefit from a trust, and the real cause of this benefit is a donation, settlement or some other gratuitous disposal by the other spouse, the donor will have to take the income into account for tax purposes, and not the spouse who received the income or to whom the income accrued.¹⁷⁸

The impact of this provision can be illustrated by way of an example. If the donor spouse forms a discretionary family *inter vivos* trust and donates income generating assets to the trust for the benefit of the donee spouse, any income which accrues to the donee spouse in consequence of the donation will be deemed to be that of the donor spouse, provided that the main purpose of the donor spouse was to reduce, postpone or avoid paying tax. Section 7(2) of the ITA specifically deems these profits to be taxed in the hands of the donor and not in the hands of the spouse.¹⁷⁹

¹⁷⁶ Paragraph 67 of the Eighth Schedule to the ITA.

¹⁷⁷ Section 4(q) of the EDA.

¹⁷⁸ Paragraph 68 of the Eighth Schedule of the ITA deems gains received by one spouse to be that of the other in similar circumstances to those described here.

¹⁷⁹ 'Does section 7 of the Income Tax Act form part of your annual tax planning?' available at <http://www.tenklobser.co.za> (accessed 6 November 2013) (hereafter 'Tenk Loubser article').

5.2 Section 7(3) of the ITA: Income is deemed to be that of a parent of a minor

Section 7(3) of the ITA provides if a minor child or stepchild receives income as a result of a donation, settlement or gratuitous disposition by the child's parent, the income is deemed to be that of the parent for income tax purposes. Section 7(3) can apply to income distributed or allocated to a minor beneficiary of a trust as is illustrated in the example below.

The founder of a discretionary family trust donates a profit-making investment to the trust and at year-end the trustees of the trust distribute the profits from his investment to his minor child, being in a lower tax bracket than himself. This way he avoids being taxed on these profits in his personal capacity, being at a higher marginal rate. Section 7(3) of the ITA provides that the donor will be taxed in his own hands on these profits and not the minor child.¹⁸⁰

In *Commissioner v Woolidge*,¹⁸¹ (hereafter *Woolidge* case) the court held that for s 7(3) to apply, there had to be a disposition wholly or, to an appreciable extent, gratuitously out of liberality or generosity.¹⁸² In this case shares were sold to a trust at their market value but the selling price was left outstanding on loan account. The court held that where the disposition contained both appreciable elements of gratuitousness (interest-free loan) and proper consideration (the sale of shares at market value), an apportionment could be made between the two elements for the purpose of determining the income deemed to have accrued to a parent under s 7(3) of the ITA.

¹⁸⁰ Tenk Loubser article.

¹⁸¹ 1999 (4) SA 519 (C) 527.

¹⁸² *Woolidge* case 527.

5.3 Section 7(4) of the ITA: Income deemed to be that of parent of minor child

Section 7(4) of the ITA deals with the situation where the reason for the income being received by or accruing to a minor is a donation made by a third person who, or whose family, in turn, is the recipient of a donation or other consideration from the minor's parent. The income received by or accruing to the minor child is deemed to be the parent's. This provision prevents the circumvention of s 7(3) of the ITA.

5.4 Section 7(5): Income is deemed to be that of a donor

Section 7(5) of the ITA provides that if any person has made a donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by that person or by anybody else, to the effect that the beneficiaries or some of them shall not receive the income or some portion of the income until the happening of some event, fixed or contingent, then so much of the income as would, but for the stipulation or condition, be received by or accrued to or in favour of the beneficiary in consequence of the donation, settlement or disposition, is deemed to be the income of the maker of the donation, settlement or disposition until the happening of the event or until his death, whichever takes place first. If someone has made a donation of an asset to a trust and if the trustees decide to retain and accumulate the income from the donation in the trust, then the provisions of s 7(5) of the ITA can deem that income to be that of the donor in certain circumstances. If the income arises as a result of a donation or interest free loan, and if this income will only be distributed to beneficiaries upon the happening of some event or when the trustees in

their discretion decide to distribute it, then the income is deemed to be that of the person who made the loan or who made the interest free loan.

An example of this provision is when the donor donates an investment to his discretionary family trust and decides not to distribute the profits to the beneficiaries but to rather retain the profits within the trust. The impact of this provision is that the donor will be liable for income tax. This provision will particularly have an effect on a discretionary family trust in the sense that if the profits of the investment (as in the above example) are not distributed to the beneficiaries then the donor will be taxed. The result would then be that the trust's income will remain intact and the trust estate will grow. This is particularly good if the intention of the estate owner is to increase the value of the trust estate and to reduce the value of his personal estate.

In the case of *Estate Dempers v SIR*¹⁸³ the court laid down the following guideline to test whether income should be taxed within the ambit of s 7(5) of the ITA:

'The question which the court must ask itself is whether in the absence of the stipulation withholding trust income, this income would have been received by or accrued to the beneficiary. In answering this question regard must be had to the terms of the instrument generally, the donor's benevolent intention as evinced by the terms of the instrument and all the relevant circumstances. In this enquiry the fact that in terms of the instrument as a whole the beneficiary has a vested right to the income, would, as I have

¹⁸³ 1977 (3) SA 410 (A) (hereafter *Estate Dempers* case).

*indicated, be an important factor but it would not be the sole touchstone.*¹⁸⁴

The ‘event’ usually giving rise to an application of s 7(5) of the ITA is the death of some person or the reaching of a certain age. Whether the exercise by a trustee of his discretion, in the case of a discretionary trust, is an ‘event’ within the meaning of s 7(5) has yet to be finally adjudicated upon. An affirmative answer was given in *Hullett v CIR*.¹⁸⁵

What is clear from this section is that where income accrues to a trust in a particular year and the trustee in his discretion distributes that income to a beneficiary in that year, section 7(5) of the ITA has no application to that income. Trustees should therefore ensure that they exercise their discretion before the year end. Once income is deemed to be the donor’s in terms of s 7(5) of the ITA, it is not taxable in the hands of the beneficiaries when subsequently distributed to them.

5.5 Section 7(6) of the ITA: Income is deemed to be that of a person who retains powers

In terms of s 7(6) of the ITA, if a person makes a donation to a trust or makes an interest free loan to a trust, and the donor or lender retains the powers to vary or change the beneficiaries who are entitled to receive any income resulting from that donation or loan, then the income that is received by any beneficiary will be deemed to be that of the donor or lender for as long as the donor or lender retains the powers

¹⁸⁴ *Estate Dempers* case 426.

¹⁸⁵ 13 SATC 58.

to vary or change the beneficiaries.¹⁸⁶ This section accordingly applies to a donor who confers a right of income and retains the power to revoke that gift of income and confer it upon another. The right of a donor to require the income to be lent to the donor may also be a right as envisaged by this section. This is because the substance of such a right is that the trustees are deprived of the power to distribute such income. This section may also apply if a donor retains the power to amend a trust deed.¹⁸⁷ Section 7(6) of the ITA applies when a person seeks to avoid or reduce tax by disposing of an income-producing asset while retaining control over the income generated from that asset.¹⁸⁸

Section 7(6) can be invoked only where the beneficiary has a vested right to receive income subject to a power of revocation being reserved by the donor. Where a donor in his capacity as trustee can exercise the power of revocation without reference to the remaining trustees, s 7(6) of the ITA would apply.

5.6 Section 7(7) of the ITA: Income is deemed to be that of a person who retains an interest in property

If a person donates or otherwise gratuitously disposes of property to a trust but retains the right to regain ownership of that property at some time in the future, then any income from that property is, in terms of s 7(7) of the ITA, deemed to be that of the person who retains the right to regain that property. If an asset is gratuitously transferred to a trust for a certain period of time, but will then revert back to the

¹⁸⁶ Geach (2007) 249.

¹⁸⁷ Geach (2007) 249.

¹⁸⁸ Apart from the application of s 7(6) in the circumstances envisaged by s 7(6), there are also the estate duty implications of s 3(3)(d) of the EDA.

person who disposed of it at some time in the future, any rental, interest, royalties or similar income that is earned by the trust (whether or not the income is distributed to the beneficiaries) will be taxed in the hands of the person who is entitled to regain that property.¹⁸⁹

5.7 Section 7(8) of the ITA: Income is deemed to be that of a resident

Section 7(8) of the ITA is aimed at the avoidance of tax where a South African resident shifts income into the hands of non-residents (particularly offshore trusts) by disposing of income-generating assets to a non-resident.

Section 7(8)(a) of the ITA states that where by reason of or in consequence of any donation made by any resident, any amount is received by or accrued to any person who is not a 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. This section hampers estate owners to donate assets to a person or trust that is not a resident, since he or she will be liable for the tax.

5.8 Certain disposals to a trust can be regarded as donations

An estate owner must also take s 7(9) of the ITA into consideration when he or she intends on making a donation. Estate owners should borne in mind that if it is discovered that assets were disposed to a discretionary family trust for a consideration that is less than the market value in order to try to avoid or limit paying estate duty, the court may regard the disposal as a donation and donations tax may be payable.

¹⁸⁹ Geach (2007) 249.

The donor of the assets to the discretionary family trust may thus be held liable to pay tax. It must however be established that tax avoidance is the sole or main aim of the donation.

5.9 Disclosure in tax return

Section 7(10) further places an obligation on an estate owner who is a resident and who makes a disposition that falls within s 7 to disclose this fact in his or her income tax return and furnish any further information requested by the Commissioner.

One of the reasons why discretionary family trusts are popular is the effect of the anti-avoidance provisions which are contained in s 7 of the ITA. These tax-back or attribution provisions, to the extent that they are applicable to donations and other similar dispositions to a discretionary family trust, have the effect that the estate owner or a donor to a trust, as opposed to a trust itself, will pay any income tax arising from income earned by the trust by reason of or in consequence of any donation to the trust. The result is that the trust's income and assets are preserved and are effectively increased to the extent that the estate owner or donor pays the tax and does not reclaim such tax from the trust. Similar considerations apply with regards to capital gains. Consequently, in circumstances where the estate owner or donor wishes to reduce his estate and increase the estate of the discretionary family trust, he should ensure that the tax-back or attribution provisions of s 7 of the ITA and or the tax- back

or attribution provisions of the Eighth Schedule of the ITA do indeed apply (as opposed to avoid their application).¹⁹⁰

6.CGT

The introduction of CGT, with effect from 1 October 2001,¹⁹¹ has had a profound impact on the field of estate planning. The reason underlying this statement can be attributed to the fact that the death of a person will have both CGT and estate duty consequences.¹⁹² CGT is triggered by an event, being the disposal¹⁹³ or deemed disposal of an asset during a year of assessment. On disposal of an asset a capital gain or capital loss is calculated by subtracting the base cost¹⁹⁴ of the asset from the proceeds.¹⁹⁵

From an estate planning perspective death is regarded as a CGT event.¹⁹⁶ In terms of paragraph 40 of the Eighth Schedule of the ITA a deceased person, subject to certain exceptions, is regarded as having disposed of all his assets to his estate at their market value on the date of his or her death. The financial consequences of an estate being subjected to both CGT and estate duty simultaneously have reinforced the case in favour of acquiring growth assets in a discretionary family trust or transferring existing growth assets to a discretionary family trust. The benefit of doing this from a CGT perspective is that no CGT will arise in the event of the death of the estate owner once the asset is held by the discretionary family trust because there is no

¹⁹⁰ Honiball & Olivier (2009) 199.

¹⁹¹ Taxation Laws Amendment Act 5 of 2001 (TLAA).

¹⁹² Olivier PA, Strydom S & Van den Berg GPJ *Trust Law and Practice* 2 ed (2006) 8-20.

¹⁹³ The term 'disposal' is defined in paragraph 11 of the Eighth Schedule of the ITA.

¹⁹⁴ The term 'base cost' is set out in Part V of the Eighth Schedule of the ITA.

¹⁹⁵ The term 'proceeds' is set out in Part VI of the Eighth Schedule of the ITA.

¹⁹⁶ Stein M *Estate Duty: Principles and Planning* 3ed (2004) 14.2 and 14.4.

disposal or deemed disposal of an asset by the trust at that stage. CGT may however have been payable on the disposal of an existing asset to the trust.¹⁹⁷ The transfer of an asset cannot however be undertaken lightly because the CGT implications of using trusts are extremely complex.

Before considering the attribution rules it is necessary to give a brief overview of the capital gains tax provisions as they apply to trusts.

6.1 Overview of trusts and CGT

The calculation of CGT takes place in terms of what is referred to in the SARS Comprehensive Guide to CGT¹⁹⁸ (hereafter SARS CGT guide) as the core rules. The core rules set out the steps for calculating capital gains and losses and indicate the gain to be included in a taxpayer's taxable income in terms of s 26A of the ITA. Section 26A ensures that any taxable capital gain that is not deemed¹⁹⁹ to be that of a beneficiary or of a donor in relation to a trust must be included in the taxable income of the trust. The capital gains tax rules are contained in the provisions of the Eighth Schedule of the ITA. It is important to determine whether the capital gain will be regarded as having been made by a trust or by a beneficiary of that trust or by a donor in relation to that trust for capital gains tax purposes.²⁰⁰ The connected person rule²⁰¹ applies when there are transactions between a trust and a beneficiary or between a

¹⁹⁷ Paragraph 11(1) of the Eighth Schedule to the ITA.

¹⁹⁸ SARS: Comprehensive Guide to CGT available at <http://www.sars.gov.za> (accessed 6 November 2013).

¹⁹⁹ In terms of paragraph 80 of the Eighth Schedule to the ITA, a capital gain is attributed to a beneficiary in certain circumstances. Part X of the Eighth Schedule provides for the attribution of gains to a donor in certain circumstances.

²⁰⁰ Section 25B together with paragraph 80 of the Eighth Schedule ensures that the conduit principle applies in respect of capital gains.

²⁰¹ Paragraph 38 of the Eighth Schedule of the ITA. In terms of s 1 of the ITA a 'connected person' in relation to a trust includes the following: i) any beneficiary of a trust, ii) any relative of such beneficiary, iii) any other trust of which a beneficiary or relative is a beneficiary.

trust and some other connected person. This rule ensures that transactions between connected persons are always at arm's length and at market values.²⁰² Another anti-tax-avoidance rule that will apply in the case of trusts is the so-called 'clogged- loss' rule,²⁰³ which ensures that any capital loss incurred as a result of a transaction between connected persons, cannot be taken into account in determining a person's aggregate gain or aggregate capital loss for a tax year.

The provisions of paragraphs 80(1) and 80(2) of the Eighth Schedule of the ITA resemble the provisions of s 25B of the ITA. Thus, where a capital gain arises as a result of the vesting of a trust asset in a resident beneficiary, the gain must be ignored when calculating the trust's aggregate gain or loss and must be taken into account in calculating the beneficiary's aggregate gain or loss for that tax year.²⁰⁴ Where the trust disposes of the trust asset (other than to the beneficiary) and the capital gain, or a portion thereof is vested in a resident beneficiary by virtue of the trustees exercising their discretion, the gain is to be ignored when calculating the trust's aggregate gain or loss and must be taken into account in calculating the beneficiaries aggregate gain or loss for that year.²⁰⁵

As in the case of s 25B of the ITA, the provisions of paragraph 80 of the Eighth Schedule of the ITA are also subject to anti-tax-avoidance rules, in this case, the attribution rules which are contained in paragraphs 68 to 72 of the Eighth Schedule of the ITA.

²⁰² Geach (2007) 253.

²⁰³ Paragraph 38 of the Eighth Schedule of the ITA.

²⁰⁴ Paragraph 80(1) of the Eighth Schedule of the ITA.

²⁰⁵ Paragraph 80(2) of the Eighth Schedule of the ITA.

When the core rules and provisions of paragraphs 80(1), 80(2) together with paragraphs 68 to 72 are looked at in totality, the scheme of the ITA creates a clear sequence in which gains are to be taxed. Capital gains will be taxed:

- First, in the hands of a beneficiary where paragraphs 80(1) and 80(2) apply;
- Secondly, where the attribution rules apply, they override paragraphs 80(1) and 80(2), and the gains or a portion thereof, will be taxed in the hands of the donor;
- Lastly, if none of the above applies, the gain will be taxed in the trust.²⁰⁶

6.2 Attribution rules

The Eighth Schedule of the ITA contains anti-avoidance provisions which largely mirror the provisions of s 7 and s 25B(2A) of the ITA. The provisions in the Eighth Schedule of the ITA mirroring those in s 7, all have the effect of deeming a capital gain made by a trust to be that of a person (hereafter donor) who has made a ‘donation, settlement or other disposition’ (hereafter donation) to the trust, if the capital gain is attributable to the donation. Paragraphs 70 and 71 particularly apply to discretionary family trusts. However, for the sake of completeness the other paragraphs will also be referred to.

²⁰⁶ The core rules in Part II of the Eight Schedule.

The anti-tax-avoidance provisions in the Eighth Schedule of the ITA relating to trusts are in summary, as follows:

6.2.1 Attribution of capital gain to a spouse: paragraph 68

If, by reason of a donation made by spouse A or a transaction, operation or scheme entered into by spouse A, a capital gain accrues to spouse B, the capital gain will be deemed to be the capital gain of spouse A, if the purpose of spouse A was to reduce, postpone or avoid any tax administered by the Commissioner. The spouse whose capital gain it is deemed to be, is required to disclose the capital gain in his or her tax return.²⁰⁷ Paragraph 68(1) of the Eighth Schedule of the ITA mirrors s 7(2)(a) of the ITA.

6.2.2 Attribution of capital gain to a parent of a minor child: paragraph 69

Where a donation to a trust is made by a parent of a minor child or by another person in return for a donation by the parent in favour directly or indirectly of that other person or his family, a capital gain which is attributable to the donation is deemed to be that of the parent. The parent whose capital gain it is deemed to be, is required to disclose the capital gain in his or her tax return.²⁰⁸ Paragraph 69 of the Eighth Schedule of the ITA mirrors sections 7(3) and 7(4) of the ITA.

6.2.3 Attribution of capital gain subject to conditional vesting: paragraph 70

²⁰⁷ Section 68(1)(b) of the ITA.

²⁰⁸ Section 68(3) of the ITA.

Where a donation is made to a discretionary family trust which contains a stipulation or condition imposed by the donor or anyone else in terms of which a capital gain attributable to the donation is not to vest in the beneficiaries of the trust or some of them until the happening of some fixed or contingent event, and the gain has not vested during the relevant year of assessment in any resident beneficiary, the gain is deemed to be that of the donor.

A key part of this paragraph is that the capital gain will not vest in any beneficiary until the happening of some event whether 'fixed or contingent'.²⁰⁹ This sort of event may be the death of a person, the attainment of a certain age, the marriage of someone or even, the exercise by trustees of their discretion.

Paragraph 70 will only apply to situations where a capital gain is accumulated in a trust and not paid out or distributed to a beneficiary. Paragraph 70 of the Eighth Schedule mirrors s 7(5) of the ITA.

6.2.4 Attribution of capital gain subject to revocable vesting: paragraph 71

Paragraph 71 of the Eighth Schedule of the ITA contains an anti-avoidance provision similar to s 7(6) of the ITA. It is aimed at the situation where a trust deed confers a right to receive a capital gain on a resident beneficiary but that the person conferring the right has the power to revoke it or confer it upon another person. In such circumstances if such person has made a donation to such trust then if in a particular year a capital gain attributable to such donation vests in the aforesaid beneficiary, the capital gain will be deemed to be that person's gain and not that of the beneficiary.

²⁰⁹ Geach (2007) 270.

For paragraph 71 of the Eighth Schedule of the ITA to operate it is essential that throughout the year in which the relevant capital gain vests in the beneficiary the donor retained the power to revoke or vary and was a resident.

6.2.5 Attribution of capital gain vesting in a non-resident: paragraph 72

Paragraph 72 of the Eighth Schedule of the ITA contains an anti-avoidance provision similar to s 7(8) of the ITA. It covers the situation where a resident has made a donation to a non-resident (including a non-resident trust) and by reason thereof a capital gain²¹⁰ accrues to the non-resident. Paragraph 72 deems the gain to be the donor's gain.

6.2.6 Paragraph 80(3) of the Eighth Schedule of the ITA

Paragraph 80(3) of the Eighth Schedule of the ITA contains an anti-avoidance provision similar to s 25B(2A) of the ITA. It deals with two situations:

- A capital gain arises in a non-resident trust in a particular year but is not subjected to tax in SA in that year. In a subsequent year that capital gain vests in a resident. It is treated as a capital gain in the hands of that resident in that year, if in the year that it arose in the trust the resident had a contingent right to it.²¹¹

²¹⁰ Including any amount that would have constituted a capital gain had that person been a resident (paragraph 72(b)). This inclusion is to counter the argument that it is only South African source gains that can arise in the hands of a non-resident and which can be attributed from that non-resident to a resident in terms of paragraph 72. Such an interpretation would limit the scope of this provision.

²¹¹ Paragraph 80(3)(a)(i) of the Eighth Schedule of the ITA.

- An amount accrues to a non- resident trust in a particular year, which would have constituted a capital gain if the trust had been a resident, and it vests in a resident in that year or any subsequent year and it has not been subject to tax in SA. The capital gain is treated as a capital gain in the hands of the resident in the year that it vests in the resident.²¹²

Since the attribution rules contained in the Eighth Schedule of the ITA mirror the deeming provisions in s 7 of the ITA, the considerations in respect of their application are largely the same. The amount of the gain attributed to the donor is limited by the application of paragraph 73 of the Eighth Schedule of the ITA to the amount which was left to be taxed in the hands of the person who received the donation. The ability to establish the limit to which income and capital gains may be attributed to a donor opens the door to interesting tax and estate planning considerations.²¹³ From an income tax perspective, where the donor is able to satisfy the onus placed on him in terms of s 27 of the TLAA, it can lead to tax savings on his part. The income which is correctly attributable to the donation will be taxable in his hands. The balance will be taxed where it accrued.

Sight must not be lost of the fact that sections 80A to 80L of the ITA (the general anti-avoidance provisions of the ITA) may be applicable where CGT has been avoided, reduced or postponed through the use of trusts.

7. **ESTATE DUTY**

A trust is only regarded as a person for estate duty purposes when statutory provision

²¹² Paragraph 80(3)(a)(ii) of the Eighth Schedule of the ITA.

²¹³ Carroll E (2010) 50.

is made for it.²¹⁴ The fact that a trust is not a separate person, but that the assets also do not form part of the estate of the founder, opens the door for the use of a trust as a vehicle for estate duty avoidance.

The EDA makes provision that estate duty is payable in respect of the estate of every person who dies and who was ordinarily resident in South Africa at the date of his or her death.²¹⁵ Section 4A of the EDA provides that the dutiable amount of the estate of any person shall be determined by deducting from the net value of that estate an amount of R3.5 million. This means that if an estate owner's estate values less than R3.5 million, no estate duty is payable.

The estate of any person consists of all property in terms of s 3(2) of the EDA of that person at the date of his death and of all property which in accordance with s 3(3) of the EDA is deemed to be his property at that date. 'Property' is defined in s 3(2) of the EDA, as any right in or to property, movable or immovable, corporeal or incorporeal, and includes any fiduciary, usufructuary or other like interest in property (including a right to an annuity charged upon property) held by the deceased immediately prior to his death; and any right to an annuity (other than a right to an annuity charged upon any property) enjoyed by the deceased immediately prior to his death which accrued to some other person on the death of the deceased.

Where under a discretionary family trust the trustee has discretion to withhold the trust income and/or trust capital from a trust beneficiary, then the trust beneficiary has no property in terms of s 3(2) of the EDA. This means that the trust beneficiary has

²¹⁴ *CIR v MacNeillie's Estate* 1961 (3) SA 833 (A) 841.

²¹⁵ Section 2 of the EDA provides that estate duty shall be charged, levied and collected in respect of the estate of every person who dies on or after 1 April 1955. Section 3 contains the definition of 'property' and this excludes property outside of SA if that person was a non-resident at the time of death.

not obtained a vested right to such benefit before that discretion is exercised by the trustee. No estate duty will be payable should a trust beneficiary under a discretionary testamentary ownership trust die without ever having received trust income and/or trust capital.²¹⁶

It is clear that a trust can be a useful vehicle in estate planning, because it can be used to ensure that property is not that of the deceased at the time of the deceased's death. To be effective however, it must also be ensured that none of the assets of a trust can be regarded as deemed property of the deceased at the time of death.²¹⁷

Section 3(3)(d) of the EDA is an anti-avoidance provision which deems property of which the deceased was competent to dispose of immediately prior to his death for his own benefit or for the benefit of his estate, to be part of the dutiable property of the deceased for estate duty purposes.²¹⁸ The wording of s 3(3)(d) of the EDA is as follows:

'(3) Property which is deemed to be the property of the deceased includes-

(d) 'property (being property not otherwise chargeable under this Act or the full value of which is not otherwise required to be taken into account in the determination of the dutiable amount of the estate) of which the deceased was immediately prior to his death competent to dispose of for his own benefit or for the benefit of the estate.'

The exact ambit of this section cannot be defined with certainty, but it would seem to apply if the deceased had the power to revoke or vary the provisions of any donation,

²¹⁶ Du Toit F *South African Trust Law* (2007) 171.

²¹⁷ Geach (2007) 281.

²¹⁸ Honiball & Olivier (2009) 195.

settlement or trust, or other disposition made by the deceased, for his own or his estate's benefit.²¹⁹

'Competent to dispose of include':²²⁰

- The power to revoke or vary the provisions of any trust (s 3(5)(b));
- The power that enables the estate owner to cause a trust to dispose of such property as the estate owner sees fit (s 3(4)(b), no matter how such power is conferred (even by way of having power of appointment and replacement of trustees); and
- The power of an estate owner to compel the trustees to agree to variations.

If an estate owner has a power to appoint and replace trustees, such trustees are likely to agree to wishes of the estate owner. However, in law they are not obliged to do so, and therefore the retention of the power by an estate owner is unlikely to bring trust assets in as deemed property. If the deceased retained the powers listed above over assets in a discretionary family trust (which the deceased had formed in order to freeze his or her estate), the whole estate planning exercise could be rendered unsuccessful. To be effective and to avoid this deeming provision, trust deeds should not permit the estate owner to make decisions on property dispositions, whether acting alone or with notice to the trustees. Trust deeds should provide that any disposals of property could only take place by decision of all trustees acting together while exercising their own independent judgement.

²¹⁹ Geach (2007) 281.

²²⁰ Geach (2007) 281.

The effect of s 3(3)(d) of the EDA is that if the trust assets are treated as the personal assets of the estate owner, then the trust property will be regarded as the property of the estate owner. Estate duty may then be payable in the event of the estate owner's estate and that of the trust totals in excess of R3.5 million. In the *Badenhorst* case the court held that in order to succeed in a claim that trust assets be included in the estate of one of the parties to a marriage there needs to be evidence that such party controlled the trust and but for the trust, would have acquired and owned the assets in his own name.²²¹ Generally, estate owners envisage limiting their personal estates to below R3.5 million in order to avoid their estate having to pay estate duty or to limit the amount which is payable.

8.SUMMARY

The discretionary family trust could be held liable for tax if it is found that the trust entered into impermissible avoidance arrangements in terms of the general anti-avoidance provisions of the ITA.

The ITA seeks to prevent income splitting. The income accruing to the trust is drawn into the hands of the beneficiary with a vested right in terms of s 25B of the ITA. The income will be taxed there unless one of the deeming provisions of s7 of the ITA applies. If one of the provisions of s7 applies the ITA will draw the income into the hands of the donor to be taxed there.²²²

The impact that s 25B has on the discretionary family trust is that the beneficiary will only be liable for income tax when the trustees decided to vest the trust income in

²²¹ *Badenhorst* case 367.

²²² Carroll E ' SARS' ability to attribute trust income and capital gains to a donor-parent' (LLM Thesis, North West University (2010) 9 (hereafter Carroll E (2010)).

him. If the income is not vested in the beneficiary then the trust will be taxed. The income will also not form part of the beneficiary's deceased estate because the income has not vested in him.

The interpretation of the term POEM can prevent trustees from manipulating the residence of the discretionary trust in order to avoid tax.

The Eighth Schedule of the ITA contains anti-tax-avoidance provisions which largely mirror the provisions of s 7 and s 25B(2A) of the ITA. The provisions in the Eighth Schedule of the ITA mirroring those in s 7, all have the effect of deeming a capital gain made by a trust to be that of a person who has made a donation to the trust, if the capital gain is attributable to the donation. Paragraph 70 and 71 particularly apply to discretionary family trusts.

Where under a discretionary family trust the trustee has discretion to withhold the trust income and/or trust capital from a trust beneficiary, then the trust beneficiary has no property in terms of s 3(2) of the EDA. This means that the trust beneficiary has not obtained a vested right to such benefit before that discretion is exercised by the trustee.

From an estate planning point of view, it is advisable to create a discretionary *inter vivos* family trust, since estate duty liability will not accrue to the trust beneficiary before vesting has taken place.

CHAPTER 5

CONCLUSION

1.IMPACT OF THE STATUTORY ANTI- AVOIDANCE MEASURES ON THE DISCRETIONARY FAMILY TRUST

Discretionary trusts are those under which the trustees have the discretion to distribute trust income and/or trust capital to the beneficiaries. It is primarily discretionary trusts, whether *inter vivos* or testamentary in nature, which are used in estate planning in SA. A discretionary *inter vivos* family trust is a popular vehicle for estate planning purposes because the trust assets are regarded as separate from those of the founder as well as from those of an individual trust beneficiary.

One reason for this is that a vested right to trust capital and/or trust income clearly falls within the definition of property for estate duty purposes. On the other hand, a contingent right to trust capital and/or trust income or a *spes*, falls outside a dutiable estate. In the *Badenhorst* case which dealt with an *inter vivos* discretionary family trust, the court indicated pertinently that the trust was created to protect the family against creditors and to avoid estate duty.

In practice, the discretionary trust is often the alter ego of the founder and/or trustee-beneficiary of the trust. The assets under the trust may, in law, be regarded as those of the founder and/or trustee-beneficiary and dealt with accordingly. In order to avoid trust assets being regarded as the assets of someone rather than those of the trust, it is advisable to ensure that there is indeed a making over of trust assets to trustees, and that the trustees actually do manage and control assets on behalf of the trust beneficiaries in accordance with the terms and conditions of the trust deed. Due to the abuse of the trust form by founders and /or trustee-beneficiaries, trusts are increasingly coming under scrutiny by the courts.

For estate planning purposes, should estate owners and/or trustees of discretionary family trusts be cognisant of the fact that if the court determines that the reason why a transaction was entered into was for the purpose to avoid liability for tax, the court may regard the transaction as simulated. Tax liability may then possibly follow. The principle of the *NWK* case can, for example, be applied in a situation where an estate owner or donor sells shares to a discretionary family trust at their market value but the selling price is left outstanding on loan account.. The estate owner and/or donor may also be held liable in terms of the general anti-avoidance provisions, which are contained in s 80A to s 80L of the ITA.

There are practical implications when it is discovered that a trust is a sham, on the one hand, and when the trust form has been abused, on the other hand. When a trust is a sham, the 'founder' will remain owner of the 'trust assets'. Consequently, neither the 'trustees' nor the 'beneficiaries' will acquire any rights with regard to these 'trust assets'. Matters are different in the abuse situation since both the trustees and beneficiaries will acquire rights with regard to the trust assets. This opens the door for

the possibility that the court may go behind the trust form and order the application of the trust assets for a particular purpose.

A consequence of treating the trust property as the personal property of the founder and/or trustee-beneficiary is that his estate may be larger than planned. The estate owner's estate and/or trustee-beneficiary may then possibly be liable for estate duty upon his death.

The 'piercing of the veneer of the trust' issue is particularly crucial for discretionary family trusts since generally, the trustees of the family trust are also the beneficiaries of the trust and/ or the founder of the trust is also a trustee of the trust. It is important that the legal separation in the ownership (control) of the trust property and the enjoyment derived from the trust property be maintained. It is also important that the trustees act in terms of the provisions of the trust instrument.

The impact that s 25B of the ITA has on the discretionary family trust is that the beneficiary will only be liable for income tax when the trustees decide to vest the trust income in him. If the income is not vested in the beneficiary then the trust will be taxed. The income will also not form part of the beneficiary's deceased estate because the income has not vested in him. The fact that the income will not form part of the beneficiary's deceased estate is an advantage since the value of his deceased estate will not be increased and the possibility to be liable for estate duty is reduced. The discretionary family trust is however taxed at a high tax rate and this will have the effect of reducing the value of the trust income.

One of the reasons why discretionary family trusts are popular for estate planning purposes is the effect of the statutory anti-tax avoidance provisions, which are contained in s 7 of the ITA. These tax-back or attribution provisions, to the extent that

they are applicable to donations and other similar dispositions to a trust, have the effect that the estate owner or a donor to a trust, as opposed to a trust itself, will pay any income tax arising from income earned by the trust by reason of or in consequence of any donation to the trust. The result is that the trust's income and assets are preserved and are effectively increased to the extent that the estate owner or donor pays the tax and does not reclaim such tax from the trust. Similar considerations apply with regards to capital gains. Consequently, in circumstances where the estate owner or donor wishes to reduce his estate for estate planning purposes and increase the estate of the trust, he should ensure that the tax-back or attribution provisions of s 7 of the ITA and or the tax- back or attribution provisions of the Eighth Schedule of the ITA do indeed apply (as opposed to avoid their application).

In the *Badenhorst* case the court took into consideration the fact that the founder and trustee had the discretion whether to distribute the trust income or trust capital to the beneficiaries in order to determine whether the founder and trustee was in *de facto* control of the trust estate. This discretion of the founder is also entrenched in s 7(6) of the ITA. When it is discovered that the founder was in *de facto* control of the trust, liability for tax may arise.

The impact of s 3(3)(d) of the EDA on the discretionary family trust is that if the trust assets are treated as the personal assets of the estate owner, then the trust property may be regarded as the property of the estate owner. Estate duty may then be payable in the event of the estate owner's estate and that of the trust totals in excess of R3.5 million. The purpose of creating a discretionary family trust as an estate planning vehicle would thus be defeated because the trust property would under these

circumstances be regarded as the personal property of the estate owner and not as those of the trust. It is thus important for estate planning purposes that the trust assets should be treated separately from the personal property of the estate owner as well as from those of the trustees. It is particularly important in discretionary family trusts where the trustees and beneficiaries are the same persons.

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