

**SARS' ABILITY TO ATTRIBUTE TRUST INCOME AND
CAPITAL GAINS TO A DONOR-PARENT**

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Summary

The scheme of the *Income Tax Act* 58 of 1962 (the Act) aims to prevent the diversion of income from the donor-parent to his minor-child. This is achieved through the deeming provisions in the Act and the attribution rules in the Capital Gains Tax (CGT) provisions. These provisions allow the South African Revenue Services (SARS) to ignore the fact that income has accrued to the minor child and to draw the income or capital gain through to a donor-parent's income. The immediate practical issue which arises from these provisions is that the Act itself does not establish any limit to the amounts that may be attributed to the donor-parent.

This research examines the limits to the amount of income and capital gains that may be attributed to a donor-parent in terms of the deeming provisions in section 7(3) of the *Income Tax Act* (the Act) and the attribution rules set out in paragraph 69 of the Eighth Schedule to the Act. The research is conducted against the background of a case study, based on a typical estate planning strategy, in terms of which an asset is sold to a trust on an interest-free loan account basis.

Three key cases being, *Joss v Secretary for Inland Revenue* 1980 1 SA 674 (T), *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A), and *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C) are examined in order to establish a practical basis for apportioning income and capital gains between the donor-parent and his minor child.

The conclusion reached is that there certainly are limits to the amount of income as well as capital gains that may be attributed to a donor-parent. Importantly, in the context of estate planning, the deeming provisions, contrary to perception, can be seen as a help rather than a hindrance. They provide an opportunity for diverting income and capital gains from the donor-parent to his minor child. In addition they can be utilised to deplete donor-parent's estate in favour of the minor child or trust's estate.

Chapter 1

Introduction

1.1 Background

The purpose of this research is to determine whether there are limits to the amount of income and capital gains that may be attributed to a donor-parent in terms of the deeming provisions in section 7(3) of the *Income Tax Act*¹ (the Act) and the attribution rules set out in paragraph 69 of the Eighth Schedule to the Act.²

In the context of estate planning the deeming provisions will typically arise in situations³ where a planner (referred to as the "donor-parent") has, as part of an estate pegging⁴ exercise, transferred income-generating, growth assets to an *inter vivos* trust of which his minor child is an income beneficiary. From the planner's perspective the purpose of transferring growth assets to a trust would be to limit the rapid increase in the nominal value of the assets in his estate thereby limiting his estate's exposure to estate duty⁵ and capital gains tax - with the added opportunity to divert part of his income to his minor child.

There is a significant incentive for a donor-parent to divert part of his income or capital gains to his child, because in so doing he would be able to reduce his own taxable income. In addition he would be able to reduce the overall tax burden by benefitting from the lower marginal tax rate that may apply to the minor. The minor-child will usually have little or no other taxable income. In addition the minor will also qualify for the

1 58 of 1962.

2 Also referred to as deeming provisions or tax back provisions; see Honiball and Olivier *The Taxation of Trusts* 84.

3 Honiball and Olivier *The Taxation of Trusts* 189; Davis, Beneke and Jooste *Estate Planning* 11-3; Jordaan *et al Silke: SA Income Tax 2008* 807.

4 Hands 2009 *Insurance and Tax* 19.

5 Estate duty is levied in terms of the *Estate Duty Act* 45 of 1955.

annual exclusions,⁶ interest exemptions⁷ and rebates⁸ applicable to the minor-child as a taxpayer in his own right.

In order to prevent the diversion of income from the donor-parent to his minor-child, the deeming provisions *Income Tax Act* and the attribution rules in the Capital Gains Tax (CGT) provisions, allow the South African Revenue Services (SARS) to ignore the fact that income has accrued to the minor child⁹ and to draw the income or capital gain through to a donor-parent's income. The outcome sought by the Act is to limit the opportunity for income splitting¹⁰ by levying tax in the hands of the donor-parent at his usually higher tax rates.¹¹

The Act, however, does not state how much income should be deemed to be the income of the donor-parent. Statements such as the following extract from the *Financial Adviser's Handbook*¹² reflect the generally held view that all the income will be taxed in the hands of the donor-parent. In dealing with section 7(3), the authors state:

If the property is sold on interest-free loan account, this is a gratuitous disposition and if any income is earned on the property, the father will be taxed on it.¹³

6 Natural persons and special trusts are entitled to an annual capital gains tax exclusion of R17 500 for the 2010 to 2011 tax year. Par 5 of the Eight Schedule to the *Income Tax Act* 58 of 1962; *Sanlam Tax Guide 2010 -2011* 24; *Jordaan et al Silke: SA Income Tax 2010* 686.

7 Interest income which accrues to a natural person under the age of 65 years will qualify for an annual exemption of R22 300 for the 2010 to 2011 tax year in terms of s 10(1)(i) of the *Income Tax Act* 58 of 1962; *Jordaan et al Silke: SA Income Tax 2010* 70; *Sanlam Tax Guide 2010 -2011* 11.

8 A taxpayer who is a natural person qualifies for an annual rebate in terms of s 6 of the *Income Tax Act* 58 of 1962; *Jordaan et al Silke: SA Income Tax 2008* 247. For persons under the age of 65 years the annual rebate for the 2010 to 2011 tax year is R10 260. *Sanlam Tax Guide 2010 -2011* 7.

9 The Act does not define the term minor, however, it is contended that a minor will be a person who is unmarried and under eighteen years of age. S 17 of the *Children's Act* 38 of 2005, changed the age of majority from 21 to age 18 with effect from 1 July 2007. For the purposes of the Act, child includes an adopted child, and s 7(3) specifically refers to a step-child.

10 Income splitting can be described as the practice of spreading a single amount of income across a number of taxpayers in order to lower the overall tax burden in respect of that amount. Taxpayers are entitled to arrange their affairs so that they legitimately avoid or reduce their tax liability. *Jordaan et al Silke: SA Income Tax 2008* 633; *Duke of Westminster v IRC* 1953 520.

11 Mitchell 2009 *Tax Planning* 101.

12 Engels, Chambers and Chait *Financial Adviser's Handbook 2010*.

13 Engels, Chambers and Chait *Financial Adviser's Handbook 2010* 19.

This statement fails to indicate that there is a limit to the income which may be taxed in the hands of the donor-parent and that once the limit is reached the remaining income will be taxed where it accrues – in the context of this research – in the hands of the minor child at his usually more beneficial tax rates.

1.2 The practical challenges

The practical challenges which arise from the failure on the part of the Act to establish clear limits to the amount of income and/or capital gains that may be attributed to the donor-parent creates a threefold problem for the donor-parent. Firstly, seen from the perspective of the donor-parent's tax planning, failure to appreciate the amount of the income and capital gains attributable to him will usually lead to an over payment of these taxes. Secondly, the onus¹⁴ is on the donor-parent as the taxpayer to prove how much income is taxable in his hands, and consequently how much should remain to be taxed in the hands of the minor child. Where he fails to prove that a portion of the income remains to be taxed in the hands of the minor child all the income will be deemed to be his.¹⁵ Finally, it is difficult for the donor-parent to comply with section 68(3)(b)¹⁶ of the Act in terms of which he is required to include any income and capital gains which are deemed to be his in his income tax return.

It is against the background set out above that this research will examine the relevant provisions of the Act, as well as the applicable case law, in order to establish where the limits to the income and capital gains that may be attributed to the donor-parent lie. Once these limits have been established it will be possible to address a secondary issue, being the

14 See the discussion of onus in point 3.5.3 section.

15 In *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A), it was held that "[i]f apportionment is not possible or if insufficient evidence is adduced to enable the court to effect it (the burden being on the taxpayer under s 82) the composite disposal will usually because of the appreciable element of bounty be then simply treated as a gratuitous settlement or disposition, as the case may be, that falls within the scope of the critical phrase."

16 S 68(3)(b) reads: "Every parent shall be required to include in that parent's return any income deemed to be that parent's income in terms of sub-sections (3) or (4) of s 7 or any capital gain deemed to be that parent's capital gain in terms of par 69 of the Eighth Schedule."

commonly held perception that because the Act enables SARS to attribute income and capital gains to a donor-parent, the application of the deeming provisions will always be disadvantageous to the taxpayer.

The research will demonstrate that there are indeed limits¹⁷ to the income and capital gains that may be attributed to a donor-parent. Also that, instead of being a disadvantage to donor-parent's tax-planning, the deeming provisions in the Act, the attribution rules in the Eighth Schedule, and the judicious application of section 90¹⁸ of the Act can be applied to his benefit in the context of estate planning.

1.3 Case study

The limits of SARS' ability to attribute income and capital gains to a donor-parent, in terms of the Act, will be addressed against the background of the following case study.¹⁹

As part of an estate planning exercise Mr Planner transfers a block of flats valued at R1 000 000 to an *inter vivos* trust. The fair market value of the block of flats was established on the basis of two independent valuations received from qualified valuers. The purchase price of the block of flats is left outstanding on loan account due to Mr Planner.²⁰ The terms and conditions of the loan are set out in a comprehensive loan agreement, the gist being that the loan is interest-free and repayable on

17 It is contended that the term 'limit' as it applies to income which may be attributed to the donor-parent, has two distinct dimensions. On the one hand the concept of a limit applies to the amount of income accruing an annual basis. While, on the other, the term relates to the period of time, ie for how long may income continue to accrue.

18 The proviso to s 90 reads "Provided that any person may recover so much of the taxation paid by him under this Act as is due to the inclusion in – his income any income deemed to have been received or to be his income, as the case may be, in terms of ss 7(3), (4), (5), (6) or (8), from the person entitled whether on his own behalf or in a representative capacity, to the receipt of the income so included; or his taxable income of any capital gain in terms of paras 68, 69, 70, 71 or 72 of the Eighth Schedule from the person whether personally or in a representative capacity, to the proceeds on the disposal of the asset, as contemplated in the Eighth Schedule, which gave rise to the capital gain."

19 The facts of the case study are entirely fictitious and are presented by way of illustration only.

20 Davis, Beneke and Jooste *Estate Planning* 11-3.

demand.²¹ For the sake of avoiding unnecessary apportionment calculations it is assumed that the asset was transferred to the trust at the beginning of the tax-year.

The block of flats is fully let and produces an annual rental income of R150 000, translating into an annual yield of 15%.

The market related interest rate at which the trust can borrow money is 10%.

Mr Planner's son Patrick, a minor, is the income beneficiary of the trust with a vested right to the trust income.²²

1.4 Outline

In addressing the limit to which income and capital gains may be attributed to the donor-parent in the circumstances described above the forthcoming chapters will address the extent to which income may be attributed to a donor-parent on an annual basis first.²³ Thereafter the specific events which bring an end to the application of section 7(3) will be addressed in order to highlight a second dimension to the term limit, being the period for which income may be attributed to the donor-parent on an annual basis.²⁴

The CGT provisions will be addressed after dealing with the income tax provisions because the capital gain, to be taxed as part of the donor-parent's income in terms of Paragraph 69, can only be determined once the income attributable to the donor-parent in terms of section 7(3) has been established.²⁵

21 Davis, Beneke and Jooste *Estate Planning* 11-12; Stark points out that demand loans are difficult to value from a donations tax and income tax perspective and are thus preferable to fixed term loans. See Stark *Is the granting of an interest-free loan for tax planning purposes from the lender's perspective under threat?*

22 The tax treatment on vested and discretionary beneficiaries is dealt with under point 2.2 below.

23 See chaps 2, 3, and 4 below.

24 See chap 5 below.

25 Capital gains tax is addressed in Chap 6 below.

The conclusion reached is that, there are certainly limits to the amounts of income as well as capital gains that may be attributed to a donor-parent. In the context of estate planning – there are considerable benefits to be gained from understanding the limits to which income and gains may be attributed to a donor-parent.

Chapter 2

The hierarchy created by the interaction between section 25B and section 7(3) of the Act

2.1 Introduction

In order to limit the opportunity for income splitting, the Act establishes a hierarchical structure. In terms of this structure trust income is drawn, firstly into the hands of the beneficiary, and then through the operation of the deeming provisions into the hands of the donor-parent. In this regard it is necessary to examine the interaction between section 25B and section 7(3) of the Act.

2.2 The application of section 25B of the Act to trust income

Where income arises in a trust the special provisions dealing with the taxation of trusts set out in Section 25B of the Act apply.²⁶ In the context of this research, section 25B determines that income arising in a trust will be taxed either:

- in the hands of a beneficiary with a vested²⁷ right to the income;²⁸
- in the hands of a beneficiary who acquires a vested right to the income during the tax year;²⁹ or
- where neither of the above provisions apply the income will be taxed in the trust.³⁰

26 S 25B Act 58 of 1962; Honiball and Olivier *The Taxation of Trusts* 73; Huxham and Haupt *Notes on SA Income Tax 2010* 738; Victor and King *Law and Estate Planning Easiguide* 6.17.1.

27 In *ITC 76 1927 3*, SATC 68 70 it was held that "[v]esting implied the transfer of dominium, and the children had clearly not in the year under review acquired dominium of the trust income or any portion thereof. A vested right was something substantial; something which could be measured in money; something which had a present value and could be attached. A contingent interest was merely a spes – an expectation which might never be realised. From its very nature it could not have a definite present value. In the income tax sense, therefore, a vested right was an accrued right." Also *Jewish Colonial Trust Ltd v Estate Nathan* 1940 AD 163 175-176.

28 S 25B(1) of the Act.

29 S 25B(2) of the Act.

30 S 25B(1) of the Act.

Where the income arising in the trust can be linked to a gratuitous disposition made by the donor-parent the deeming provisions will apply because the provisions of section 25B are subject to section 7.³¹

2.3 The interaction between section 25B and section 7(3) of the Act

Despite the income having accrued to Patrick³² through the operation of section 25B(1), this does not necessarily mean that the income will be taxed in his hands because section 25B is subject to the deeming provisions of section 7(3)³³ which, where applicable, will draw the income through to the donor-parent.

The purpose underlying the deeming provision in section 7(3) was explained in *Ovenstone v Secretary for Inland Revenue*³⁴ (hereinafter *Ovenstone*) as follows:

These sections are aimed at transactions in which the taxpayer seeks to achieve tax avoidance by donating, or disposing of income producing property to or in favour of another under the therein specified conditions or circumstances, thereby diverting its income from himself without his replacing or being able to replace it.³⁵

Du Toit³⁶ puts it more succinctly:

The object of section 7(3) is to prevent income splitting between parent and minor child in order to take advantage of the child's lower tax rate.

Section 7(3) is applicable where income accrues to a minor child by reason of a donation, settlement or other disposition made by a parent of the child. When applicable the section deems the portion of the income

31 S 25B of the Act is subject to s 7. Honiball and Olivier *The Taxation of Trusts* 84; Huxham and Haupt *Notes on SA Income Tax 2010* 740.

32 See the case study at 1.3.

33 In this regard s 25B(1) states that "Any amount received by or accrued to any person during the year of assessment in his capacity as the trustee of a trust, shall, *subject to the provisions of section 7 ...*" (emphasis added). See also Meyerowitz *Meyerowitz on Income Tax* 2008 16-46 par 16.133; Cameron *et al Honoré's SA Law of Trusts* 445; Pace and Van der Westhuizen *Wills and Trusts* 74.

34 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A).

35 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 736A-H.

36 Du Toit *SA Trust Law* 135.

received³⁷ by³⁸ or accrued to the minor child to be that of the donor-parent, but as will be indicated below, only to the extent that the income can be causally linked to the donor-parent's gratuitous disposition.

When taken together the provisions of section 25B and section 7 establish a clear hierarchical structure for the taxation of income arising in a trust.

2.4 Summary

The Act seeks to prevent income splitting by establishing the following hierarchical structure. The income accruing to the trust is drawn into the hands of the minor beneficiary in terms of section 25B(1). The income will be taxed there unless the income has accrued by reason of the donor-parent's gratuitous disposition. Where this is the case the deeming provision in section 7(3), will draw the income into the hands of the donor-parent to be taxed there.

As yet no limit to the income attributable to the donor-parent in terms of section 7(3) has been established. It is only through the detailed examination of section 7(3) and the relevant case law, which follows, that the limit to the annual amount to be included in the donor-parent's income can be ascertained.

37 The term 'receives' is used loosely here and it must be borne in mind that s 7(3) includes income which has been received, by or accrued to the minor as well as income which has been spent on his maintenance, or education, or for his benefit, or has been accumulated for his benefit. See also *Estate Munro* 1925 TPD 693, 1SATC 163 where it was held that "even if income from a trust is not paid directly to the beneficiary but is expended by the trustee for his benefit, the income will be taxed in the hands of the beneficiary". Also *CIR v Polonsky* 1942 TPD 12 SATC 11.

38 The term received by in the context of "gross income" has been held to mean "received by the taxpayer on his own behalf for his own benefit". *Geldenhuys v Commissioner for Inland Revenue* 1947 3 SA 256 (C) 266; 14 SATC 419; *Commissioner of Taxes v G* 1981 4 SA 167 (ZA) 162; 43 SATC 159.

Chapter 3

Analysis and application of the critical phrase in section 7(3) of the Act

3.1 Introduction

Up to this point, this research has demonstrated that, in order to prevent tax avoidance by means of income splitting, the scheme of the Act operates to draw income which has accrued to a minor child, into the hands of his donor-parent where the income has accrued as a result of the donor-parent's gratuitous disposition. However, as alluded to earlier,³⁹ provided that the donor-parent is able to discharge the burden of proof placed on him, in terms of section 82 of the Act,⁴⁰ it will not be all of the income that accrues to the minor child which will be deemed to be the income of the donor-parent. The reason for this is that the deeming provisions only apply to the extent that the income can be linked to⁴¹ the gratuitous element of a disposition, in the form of a "donation, settlement or other disposition". In this regard, what has been referred to as the critical phrase⁴² in section 7(3) plays the crucial role in determining the amount of income that may be attributed to the donor-parent.⁴³ The

39 See point 1.2 above.

40 S 82 reads: "The burden of proof that any amount is -
(a) exempt from or not liable to any tax chargeable under this Act or;
(b) subject to any deduction, abatement or set off in terms of this Act or;
(c) to be disregarded or excluded in terms of the Eighth Schedule,
shall be upon the person claiming such exemption, non-liability, deduction
abatement or set-off, or that such amount must be disregarded or excluded,
and upon the hearing of any appeal from any decision of the Commissioner,
the decision shall not be reversed or altered unless it is shown by the
appellant that the decision is wrong." With regard to the onus on the donor-
parent see: *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A)
740; *Mitchell 2009 Tax Planning* 101; *Commissioner of Inland Revenue v
Butcher Brothers (Pty) Ltd* 1945 AD 301 (13 SATC 21); *Commissioner for
South African Revenue Services v Wouldge* 1999 4 SA 519 (C) 527.

41 S 7(3) reads "by reason of".

42 In *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 722H the
court referred to "the critical phrase".

43 Pace and Van der Westhuizen *Wills and Trusts* 76; Huxham and Haupt
Notes on SA Income Tax 2010 740-744.

critical phrase being: "by reason of, any donation, settlement, or other disposition".⁴⁴

In the discussion of the critical phrase that follows it will be broken down into two components, and the phrase "donation, settlement, or other disposition" will be dealt with before examining the phrase "by reason of".

3.2 The significance of the phrase donation, settlement, or other disposition

The phrase "donation, settlement or other disposition" is significant for two reasons:

- Firstly, without a "donation, settlement or other disposition" section 7(3) will not apply.⁴⁵
- Secondly, it is significant because, as has been indicated, it is only the income which is causally related to the gratuitous element of a donation, settlement or other disposition that can be attributed to the donor-parent.⁴⁶

Where income is received by way of a disposition which is only partly a donation, settlement or other disposition and partly commercial (composite transactions),⁴⁷ Olivier⁴⁸ states that there is no reason why the income cannot be apportioned between the gratuitous and the non-gratuitous elements of the disposition. It is in the context of composite transactions that the limit to which income may be attributed to the donor-parent will be examined.

44 Pace and Van der Westhuizen *Wills and Trusts* 76; Huxham and Haupt *Notes on SA Income Tax 2010* 740-744.

45 Mitchell 2009 *Tax Planning* 101; Olivier, Strydom and Van den Berg, *Trust Law and Practice* 7-22.

46 Olivier, Strydom and Van den Berg *Trust Law and Practice* 7-20 to 7-22; Cameron *et al Honoré's SA Law of Trusts* 455.

47 In *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 740B, it was held that, "I wish to add this observation about the last kind of composite disposal – one that is partly gratuitous and partly for consideration".

48 Olivier, Strydom and Van den Berg *Trust Law and Practice* 7-20 state that "[w]here income is received partially as a donation, settlement, or other disposition and partially for some other reason, an apportionment of the tax payable should be made".

Consequently, each of the components of this phrase will be examined in the context of being able to distinguish between their gratuitous and the non-gratuitous elements in order to effect an apportionment of the income linked thereto.

3.2.1 Donation

According to Olivier, Strydom and Van den Berg,⁴⁹ the term "donation" as used in section 7 has the normal acceptable meaning of donation. It is a wholly gratuitous disposition – it contains no element of commerciality. Also in *Estate Welch v Commissioner for SARS*⁵⁰ the court found that the distinguishing characteristic of a donation was that the disposition had to have been motivated by, "pure liberality or disinterested benevolence". This is consistent with an earlier decision reached in *Ovenstone v Secretary for Inland Revenue*⁵¹ where the court indicated that as soon as an element of *quid quo pro* is introduced into a transaction there is no donation.⁵²

In keeping with the above, section 7(9) of the Act defines a donation,⁵³ for the purposes of section 7(3) as:

Where any asset has been disposed of for consideration which is less than the market value of such asset, the amount by which such market value exceeds such consideration shall for the purposes of this section deemed to be a donation.

As such the definition excludes the element of commerciality and it is only the gratuitous element of the transaction which is regarded as a donation.

49 Olivier, Strydom and Van den Berg *Trust Law and Practice* 7-19.

50 *Estate Welch v Commissioner for SARS* 2004 2 SA 586 (SCA) 593.

51 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A).

52 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 736H, "In a donation the donor disposes of property gratuitously out of liberality or generosity, the donee being thereby enriched and the donor correspondingly impoverished, so much so that if the donee gives any consideration at all therefore, it is not a donation."

53 Olivier, Strydom and Van den Berg *Trust Law and Practice* 7-19 point out that the definition of donation in s 58 of the Act only applies to Part V of the Act and does not apply to s 7.

In the case of a donation, therefore, there is no non-gratuitous (commercial) element. There is as a result no opportunity for apportionment. This means that all the income related to the donation will be taxed as part of the donor-parent's income. There is no limit to this amount, other than the total amount of the related income.

This, however, does not mean that transactions which are not purely gratuitous will escape the provisions of section 7(3) and it is, therefore, necessary to look at the terms, settlement and other disposition in the critical phrase more carefully.

3.2.2 Settlement

Quoting from Classen *Dictionary of Legal Words and Phrases*, Olivier⁵⁴ describes the term settlement as:

The transference of property to a beneficiary or to trustees for the benefit of a beneficiary, usually upon specific conditions set out in a deed of settlement.

This definition makes no reference to gratuitous dispositions. However, the court in *Joss v Secretary for Inland Revenue*⁵⁵ with reference to section 7(3) held that given the purpose of the section the term settlement did not include transactions, "made for full value or money's worth."⁵⁶

A similar conclusion was reached in *Ovenstone*.⁵⁷ Here, the court found that while a settlement could be made for full value, the type of settlement envisaged by section 7(3) was of the type which, from the beneficiary's perspective, was made "gratuitously out of liberality or generosity"⁵⁸ as such "it was part of the same genus as a donation."⁵⁹ This interpretation lead the court to conclude that settlements made for

54 Olivier, Strydom and Van den Berg *Trust Law and Practice* 7-19.

55 *Joss v Secretary for Inland Revenue* 1980 1 SA 674 (T); Clegg and Stretch *Income Tax in South Africa* 17.3.5.

56 *Joss v Secretary for Inland Revenue* 1980 1 SA 674 (T) 680F.

57 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 737; Clegg and Stretch *Income Tax In South Africa* 17.3.5.

58 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 737A-G.

59 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 737A-G.

full consideration would be of a purely commercial nature and, therefore, fall outside of the scope of section 7(3).

The interpretation reached in *Joss* and *Ovenstone* above that the term settlement as envisaged in the critical phrase was of the same genus as a donation had a significant influence on the interpretation of the phrase "other disposition".

3.2.3 Other disposition

The conclusion reached by the courts in *Joss* and *Ovenstone*, paved the way for the court in *Ovenstone*, when addressing the phrase "other disposition", to confirm⁶⁰ that the phrase, was not intended to be given as wide an interpretation as was reached in *Barnett v Commissioner of Taxes*,⁶¹ but that it should be limited *ejusdem generis* to dispositions of a gratuitous nature.⁶²

In *Ovenstone* the appellant-taxpayer was offered shares in a company by way of a special private placing. He took up 130 000 of these shares himself and placed 100 000 (25 000 each) of the remaining shares with his four children two of whom were minors. In order to enable his children to take up the shares he lent each of them R12 500. Interest on the loans was charged at the same rate of interest that the bank would have charged him for borrowing the money.

60 Two earlier decisions, *ITC 551* 1943 13 SATC 204, and *ITC 642* 1947 15 SATC 238, had found that the term other disposition should be interpreted *ejusdem generis* with the term donation.

61 In *Barnett v Commissioner of Taxes* 1959 2 SA 713 (FC) the court concluded that the term settlement was not necessarily gratuitous as a result the term "other disposition" could not be interpreted *ejusdem generis* with donation and settlement.

62 The court held "Hence the words donation settlement or other disposition all have this feature in common: they each connote the disposal of property to another otherwise than for due consideration ie otherwise than commercially or in the course of business. Since 'disposition' the general word that rounds off the critical phrase, was not intended to have its wide, unrestricted meaning, I think that this is an appropriate situation in which to circumscribe its scope by extending that common element of gratuitousness to it too by the *ejusdem generis* or *noctitur a sociis* rule. The critical phrase should in other words, be read as "any donation, settlement or other *similar* disposition" (emphasis added).

The court concluded that the common thread running through the phrase, "donation, settlement or other disposition" was that the words each indicated a disposal of property to another, other than for due consideration ie "other than commercially or in the course of business".⁶³ Consequently, it was held that the critical phrase should be read as "any donation, settlement, or other *similar* disposition".⁶⁴ The court then added that the phrase also covers any disposal of property made under a settlement or other disposition for some consideration but in which there is "an appreciable element of gratuitousness and liberality or generosity".⁶⁵ In relation to the loans made to the children this meant that, because the loans were made to them at an interest rate at which their father, based on his financial and business standing, could have borrowed money, the rate was more favourable than the rate at which the children would have been able to borrow money. Accordingly, the court found that the loans were not purely commercial, and that they contained an element of gratuitousness, sufficiently appreciable to prompt the application of section 7(3). Where a disposition consisted of elements which were gratuitous and non-gratuitous, the court found that there was no reason "why in those circumstances the income should not be apportioned between the two elements".⁶⁶ However, the onus⁶⁷ was on the taxpayer to prove that apportionment was possible, and if he failed to do so all the income would be attributed to him.

3.3 Summary

In summary it can be said that it is dispositions which are either purely gratuitous such as donations, or dispositions and settlements which contain an appreciable element of gratuitousness, liberality or generosity, that fall within the ambit of section 7(3). In the case of settlements or other dispositions which are neither purely gratuitous nor purely commercial (composite dispositions) it is necessary to be able to draw

63 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 737E.

64 Emphasis added.

65 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 740A.

66 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 740B.

67 In terms of s 82 of the Act.

distinction between the gratuitous and non-gratuitous elements of the settlement or other disposition, in order to facilitate an apportionment of the income linked to the disposition.

In context of estate planning the most widely used form of "other disposition" is an interest-free loan. It is, therefore, necessary to examine how interest free loans fit into the critical phrase before looking at how the courts have dealt with issue of apportionment.

3.4 Interest-free loans in the context of 'donation, settlement, or other disposition'

The deterrent posed by donations tax⁶⁸ has necessitated the utilisation of other less costly methods of disposing of assets to a trust. In order to avoid paying donations tax on the value of assets transferred to the trust, the assets are usually sold to the trust, at their fair market value, and the purchase price is left outstanding, in the form of an interest-free loan account, due by the trust to the planner.⁶⁹

In the context of the critical phrase the first question which arises is whether a loan is a disposition, within the context of section 7(3). This question was addressed in *Ovenstone* where the court concluded that in its ordinary wide sense, the term disposition would include a loan of money because the lender parts with, gives or makes over the rights to or dominium of the money to the borrower when it is advanced to him.⁷⁰

A second question in this regard is whether any value can be attached to the failure to charge interest on the loan account. This was answered in

68 For the purposes of s 54 of the *Income Tax Act* 58 of 1962 a donation is defined in s 55(1) as: "means any gratuitous disposal of property including any gratuitous waiver or renunciation of a right".

69 Davis, Beneke and Jooste *Estate Planning* 11-3; Goodall and King *Tax and Investments Easiguide* 1.4.1 state that "[i]nterest-free loans have been part of the South African financial arena for a number of years".

70 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 735. Quoting from Voet 12.1.14 (Gane's trans vol 2 at 768) the Court held that "The effect of a loan on the side of the lender is that both ownership in and the risk of consumable things lent pass to the receiver. It is settled that in loan an alienation of the articles lent take place, and that not the articles themselves which were measured, weighed or counted out but only others like them ought to go back to the lender."

the affirmative in the recent decision of *Commissioner for the South African Revenue Service v Brummeria Renaissance (Pty) Ltd*.⁷¹ It was held that the right to use "loan capital" interest-free is a "valuable right."

Also in *Commissioner for South African Revenue Services v Woulidge*⁷² the court found that the failure to charge interest was not conduct of a purely commercial or business nature and as a result constituted a disposition which fell within the ambit of section 7(3).

In *Commissioner for Inland Revenue v Berold*⁷³ (hereinafter referred to as *Berold*) the court found that the granting of an interest-free loan was a "continuing donation" of the interest. The implication of this decision is that the income that can be linked to the benefit enjoyed due to the non-charging of interest will be attributable to the donor-parent for as long as the loan is outstanding.

From the donor-parent's perspective, the granting of an interest-free loan, or the failure to demand payment of a market related rate of interest where interest is chargeable is a disposition of a valuable right containing an element of gratuitousness sufficiently appreciable to prompt the operation of section 7(3).

3.5 The phrase "by reason of"

Having identified the gratuitous elements of the dispositions within the phrase "donation settlement or other disposition", it remains to examine the link that must exist between the income and the gratuitous disposition. This is indicated by the term "by reason of". It is contended that within the context of section 7(3) of the Act, the phrase, "by reason of", plays two, yet, interrelated roles, being, that it:

- establishes the measure of the link that must exist between the income and the gratuitous disposition; and

71 *Commissioner for the South African Revenue Service v Brummeria Renaissance (Pty) Ltd* 2007 4 SA 1338 (SCA).

72 *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C) 527.

73 *Commissioner for Inland Revenue v Berold* 1962 3 SA 748 (A) 753F-G.

- enables an apportionment⁷⁴ of the linked income between the donor-parent and the minor child. Importantly, it is the issue of apportionment that establishes the annual limit to the income that may be attributed to the donor-parent.

These roles will be examined in the sections that follow.

3.5.1 *The link between the income and the gratuitous disposition*

In its first role the phrase, "by reason of", indicates that there must be a causal link between the income received by the minor, and the gratuitous disposition made by the donor-parent. At the same time it addresses the proximity of the accrual of the income to the disposition.

The need for the existence of a causal link was addressed in *Commissioner for Inland Revenue v Widan*⁷⁵ (hereinafter referred to as *Widan*). In dealing with section 9(3) of the *Income Tax Act* of 1941⁷⁶ the court found that "[t]here must be some causal link between the donation, and the income generated".⁷⁷

Honoré⁷⁸ points out that:

For s 7(3) to apply the income must be received, accrue, or be accumulated by reason of the donation or disposition. This has been interpreted to mean that the disposition must be the proximate cause of the receipt etc. The test of the proximate causes is difficult to apply but at least it is clear that, if the founder has successfully planned a series of transactions, however complex, at the end of which his child will receive income, that income is received by reason of the donor's disposition which is its proximate cause.

74 *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C); *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 740A.

75 *Commissioner for Inland Revenue v Widan* 1955 1 SA 226 (A).

76 Act 31 of 1941 was replaced by the current *Income Tax Act* when it came into effect in 1962. The provisions of s 9(3) and the current s 7(3) are materially the same.

77 *Commissioner for Inland Revenue v Widan* 1955 1 SA 226 (A) 234A-B. When income has been received by a minor child the enquiry is whether such income has been so received 'by reason of any donation settlement or other disposition' made by the parent of the child. There must be some causal relation between the donation and the income generated.

78 Cameron *Honoré's SA Law of Trusts* 455.

The proximity of the link between the income and the gratuitous disposition raised by Honoré was also answered in *Widan*.⁷⁹ The taxpayer (the donor-parent) in *Widan* deliberately entered into a series of complex transactions, designed to capitalise on the outcome of an earlier case of *Kohler v Commissioner for Inland Revenue*⁸⁰ (hereinafter referred to as *Kholer*). In *Kholer* the court had held that the term required a direct and immediate causal connection, and that rather than merely being the *causa sine qua non* – it had to be the *causa* by reason of which the income accrued to the minors.⁸¹ However, in *Widan* the Appeal Court found that the decision in *Kohler* was distinguishable. Centlivres CJ did not agree with the narrow application of the term 'proximate' reached in *Kohler*. The Chief Justice concluded that it was "out of the question" to treat the proximate cause as the cause which is proximate in time only, and that the proximate cause need not be the immediate cause.⁸² The court found that it was necessary to establish the "real and efficient cause" of the income accruing to the minor child, and if that "real and efficient cause" was the donation made by the parent, then section 9(3) applied.⁸³

More recently, Davis J in *Commissioner for South African Revenue Services v Woulidge*⁸⁴ found that it was necessary to establish "the real substantive cause" of the income accruing. In this regard the court found that the requirement of a causal connection between the disposition and the income was satisfied by the fact that the income accruing to the donor-parent's two minor children had been enhanced by the fact that the

79 *Commissioner for Inland Revenue v Widan* 1955 1 SA 226 (A).

80 *Kohler v Commissioner for Inland Revenue* 1949 4 SA 1022 (T).

81 *Kohler v Commissioner for Inland Revenue* 1949 4 SA 1022 (T) 1028-1029.

82 *Commissioner for Inland Revenue v Widan* 1955 1 SA 226 (A) 233C.

83 *Commissioner for Inland Revenue v Widan* 1955 1 SA 226 (A) 234F. Followed in *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C). See also *Thoroughbred Breeders Association of South Africa v Price Waterhouse* 2001 4 SA 161 (A) 190; *Commissioner for Inland Revenue v Shell Southern Africa Pension Fund* 1984 1 SA 672 (A); 46 SATC 1.

84 *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C).

trusts, of which they were the beneficiaries, had enjoyed the benefit of an interest-free credit facility.⁸⁵

Once it has been established that the income which has accrued to the minor child, has accrued "by reason of" the donor-parent's gratuitous disposition, the disposition must be examined in order to determine whether an apportionment between its gratuitous and non-gratuitous elements is possible.

3.5.2 *Apportionment*

It is contended that the issue of apportionment lies at the heart of the limit to which income may be attributed to a donor-parent on an annual basis. This is because it is only that part of the income which accrues to a minor child that can be causally linked to the gratuitous element of the disposition that may be attributed to the donor-parent.

In this regard the court in *Ovenstone*⁸⁶ found that, where income accrues by reason of elements of both consideration and gratuitousness, there was no reason why apportionment could not be effected between the two elements. Significantly, the court stated that the words "by reason" of indicated that apportionment was necessary to "give proper effect to the real cause of the accrual or receipt of the income".

By apportioning the income between the gratuitous and non-gratuitous elements of a disposition it is possible to establish the limit to which income may be attributed to the donor-parent on an annual basis. The Act, however, makes no specific reference to apportionment and it is, therefore, necessary to turn to case law to establish how apportionment has been applied by the courts.

In *Joss v The Secretary for Inland Revenue*⁸⁷ the taxpayer sold shares and made an interest free loan to a company in which his minor daughter

85 *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C) 527.

86 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A).

87 *Joss v Secretary for Inland Revenue* 1980 1 SA 674 (T).

was a shareholder. The court accepted that the shares had been sold at their fair value. The Secretary for Inland Revenue included all of the dividends accruing to the minor daughter in the donor-parent's income.

The judgement indicates that the court *a quo* (Transvaal Income Tax Special Court) held that once a gratuitous disposition brings section 7(3) into play - it is brought "fully into play" and as a result, all the income linked to the disposition was taxable in the hands of the donor-parent.⁸⁸

On appeal, the Transvaal Provincial Division had to address two issues, namely:

- whether any portion of the income had accrued to the taxpayer's minor daughter despite the donation settlement or other disposition; and
- if so, how much?

In addressing these questions the court held⁸⁹ that on the strength of the words by "reason of" it was "logically imperative" to distinguish between the disposition of the shares, at their market value on the one hand, and the interest-free loan to the company, on the other. Accordingly there were what the court regarded as two dispositions, and it was only the interest-free loan which fell within the provisions of section 7(3).

The court then ordered the Secretary for Inland Revenue to amend the taxpayer's assessment to reflect the position that it was only the interest-free loan that was a disposition within the meaning of section 7(3).

It is only once the order, made by the court, is related back to the facts of the case, that the significance of the decision becomes apparent. The order indicates that the permissible maximum rate of interest at that stage was 12%, and for the tax year in question, if interest had been charged at 12%, the income accruing to the taxpayer's daughter would

88 This is similar to the extract from the financial advisers handbook quoted earlier. Engels, Chambers and Chait *Financial Adviser's Handbook 2010* 19.

89 *Joss v Secretary for Inland Revenue* 1980 1 SA 674 (T) 683.

have been R1 111 instead of the actual R1 464. The interest that should have been charged was thus R354. In terms of the order it was the R354 which had to be attributed to the donor-parent.

Importantly it was not all the income linked to the loan that was deemed to be the income of the donor-parent but only the portion linked to the non-charging of interest. Put differently, it was the amount by which the daughter was "better off" because of the benefit of the interest-free loan which had to be included in the donor-parent's income.

This point was reiterated in the seminal judgement of *Woulidge*.⁹⁰ In dealing with the issue of apportionment the court concluded that, provided the taxpayer was able to discharge the onus imposed by section 82⁹¹ of the Act, the income that accrues to a minor child can be apportioned between the gratuitous and non-gratuitous elements of the disposition.⁹² The court concluded that it is the enhanced income, which it referred to as "notional interest", which satisfies the link between the gratuitous element of the disposition, and it was the 'notional interest' that had to be attributed to the donor-parent.⁹³

3.5.3 *The question of onus*

Once the Commissioner for SARS can show that an amount having an ascertainable monetary value has been received by or accrued (including deemed to have accrued) to the taxpayer the onus, in terms of section 82

90 *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C).

91 S 82 reads "Burden of proof as to exemptions, deductions, abatements, disregarding or exclusions. The burden of proof that any amount is -
(a) exempt from or not liable to any tax chargeable under this Act; or
(b) subject to any deduction, abatement or set-off in terms of this Act; or
(c) to be disregarded or excluded in terms of the Eighth Schedule, shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off, or that such amount must be disregarded or excluded, and upon the hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong".

92 West and Surtees 2002 *Meditari Accountancy Research* 259-294.

93 Similarly, *Joss v Secretary for Inland Revenue* 1980 1 SA 674 (T) 683.

of the Act, rests on the taxpayer to show that the amount is not gross income.⁹⁴

It was pointed out in *Ovenstone*, while dealing with the issue of apportionment (between gratuitous and non-gratuitous elements) that the onus was on the taxpayer to prove that apportionment was possible, and if he failed to do so all the income would be attributed to him.

If apportionment is not possible or if insufficient evidence is adduced to enable the court to effect it (the burden being on the taxpayer under section 82) the composite disposal will usually because of the appreciable element of bounty be then simply treated as a gratuitous settlement or disposition, as the case may be, that falls within the scope of the critical phrase.⁹⁵

It is also necessary to note from the *Ovenstone* decision that the interest rate which must be applied to determine the notional income will be the rate applicable to a minor child or trust and not the rate at which the donor-parent could have borrowed or invested money.⁹⁶

In *Ovenstone* the 8,5% interest rate which the taxpayer charged on the loan made to his children was, in the view taken by the court, probably, or at least possibly unduly favourable. The court based its view on the assumption that, given the taxpayer's status as a businessman, his personal wealth and his relationship with the bank, he would have been entitled to a special low rate of interest.⁹⁷

Three points can be emphasised from the above.

Firstly, one has to look at what the donor-parent actually did with the money and also what the donee invested in. It would be unnecessarily speculative to look at what the donor-parent could possibly have done with it or which investment the trust could have made. If this were not the case SARS could argue that the donor-parent would have invested in the highest interest bearing instrument available, and the taxpayer, on the

94 *Commissioner of Inland Revenue v Butcher Brothers (Pty) Ltd* 1945 AD 301, 13 SATC 21. See also Goldswain 2009 *Tax Planning* 76.

95 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 740; Mitchell 2009 *Tax Planning* 102.

96 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 741.

97 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 741.

other hand, would argue that the money could have been kept under the proverbial mattress at home, earning neither income nor capital gains.

Secondly, the rate of interest to be used when calculating the notional interest in order to determine the amount to be attributed to the donor-parent will be the rate at which the borrower could have accessed the funds in an arms-length transaction.

Lastly, it is contended that the test for determining an appropriate interest rate is purely subjective. The onus will be on the donor-parent (as the taxpayer) to prove an appropriate rate.

Based on the foregoing analysis of the income tax provisions and their application by the courts it is possible to address an alternative to the notional interest test by way of a step by step approach in order to determine the amount of income which may be attributed to the donor-parent.

3.6 Summary

Before an amount of income can be attributed to a donor-parent the following fundamentals need to be present.

- There must be a donation settlement or other disposition.
- The income, and the donation, settlement, or other disposition must be causally linked i.e. the donation needs to be the "real efficient cause" of the income accruing to the minor beneficiary.
- Once this link has been established it becomes necessary to examine the disposition in order to determine the extent of the gratuitousness involved.
- Where the disposition is wholly gratuitous or is appreciably gratuitous not only is the link established but an apportionment can be effected.

- An apportionment between the gratuitous and non-gratuitous elements of the disposition can only be effected where the donor-parent can prove the extent to which apportionment is applicable.
- The income linked to the gratuitous element of the disposition is drawn into the hands of the donor-parent while the balance remains where it accrued – in the hands of the minor child.

Where all of these elements are present the amount which may be attributed to the donor-parent on an annual basis will be the amount of income by which the minor child is better off by because of the donor-parent's gratuitous disposition, or as referred to in *Woulidge*, the notional income.

The application of this "notional income" limit, as well as its potential shortcomings will be addressed in the next chapter.

Chapter 4

Establishing the limit to which income will be attributed to the donor-parent on an annual basis

4.1 Introduction

The conclusion reached in both *Joss* and *Woulidge* was that the income attributable to the donor-parent was the amount by which the person to whom the income accrued was advantaged because of the donor-parent's failure to charge interest on the loan amount. In *Woulidge*⁹⁸ the court referred to this amount as the "notional income".

This chapter will examine the application of the notional income test, highlight a potential shortcoming, and suggest a possible alternative test.

The application of the notional income test can be illustrated by way of the following example.

Practical illustration 1

Based on the facts of the case study,⁹⁹ an amount of R150 000 in the form of rental income accrues to Patrick from the trust on an annual basis. If the trust had been required to pay a market related rate of interest on its borrowings, 10% in the example, then R100 000 would have been spent on interest leaving only R50 000 to accrue to Patrick. Patrick is thus R100 000 better off because of Mr Planner's failure to charge interest on the loan account.

The "notional income" which will be deemed to be the income of Mr Planner (the donor-parent) is thus R100 000. The remaining R50 000 will be taxed where it accrued – in Patrick's hands.

98 *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C).

99 See 1.3 above.

4.2 A potential shortcoming

The conclusion to be drawn from the *Joss* and *Woulidge* decisions is that the limit to which income may be attributed to a donor-parent on an annual basis must be established by determining the notional income.

However, in an editorial note to a discussion of the *Woulidge* decision in *The Taxpayer*,¹⁰⁰ Meyerowitz highlights a potential shortcoming in this test. Meyerowitz makes the point that the notional income basis cannot be the only way of determining the value of the disposition by the donor-parent. If it were the only way, then a donor-parent would, from a tax perspective, be in a better position where assets are sold to a trust below market value because in this situation, interest would only be chargeable on the lower purchase price. The trust/minor child would, however, be in a far better position because of the benefit of a lower purchase price and a lesser interest obligation.

Unfortunately Meyerowitz does not supply any solution to his conundrum. Yet, it is precisely the solution to this conundrum that provides the limit to which income will be deemed to accrue to the donor-parent, and it is, therefore, necessary to seek a possible alternative.

4.3 A possible alternative test

It is contended that a possible alternative to the notional income test, and one from which a solution to the conundrum posed by Meyerowitz can be distilled, lies in an examination of the purpose of section 7(3).¹⁰¹

In *Ovenstone*¹⁰² the court held section 7(3) was aimed at transactions, in which the taxpayer sought to avoid income tax by disposing of income-

100 Meyerowitz (January 2000) *The Taxpayer* 10-11.

101 *Glen Anil Development Corporation v Secretary for Inland Revenue* 1975 4 SA 715 (A), held that tax avoidance provisions should be interpreted so that they serve the purpose for which they were introduced, namely, to prevent tax avoidance.

102 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 736A-H. The transactions the Legislature seems to have had in mind in enacting ss (3)-(6) are those in which the taxpayer seeks to achieve tax avoidance by donating, or disposing of income producing property to or in favour of another under

generating assets to another, and in so doing "diverting income from himself without his replacing or being able to replace it". If, "due consideration" had been received then the income could have been replaced, and section 7(3) would not apply.

In *Woulidge* the same point was made as follows:

Section 7(3) was not intended to encompass dispositions of property for due consideration, that is bona fide commercial, business, or arms-length transactions for full and fair consideration in money or money's worth, but only a gratuitous disposal of property whereby the taxpayer seeks to achieve tax avoidance by diverting from himself/herself income by donating or disposing of income producing property without replacing it or being able to replace it, fully or at all.¹⁰³

It can be concluded from the above that what section 7(3) purports to do is - "to fill a hole"¹⁰⁴ in the taxpayer's income. One left "by reason" of his "donation, settlement, or other disposition".

It is contended that in the light of the extracts from *Woulidge* and *Ovenstone* above, it is only the income which is necessary to "fill the hole" in the donor-parent's income, created by each component of a transaction (in the case of composite transactions) that may be attributed to him in terms of section 7(3).

The conundrum posed by Meyerowitz can now be addressed by way of the following step-by-step example.

Practical illustration 2

Based on the facts of the case study Meyerowitz's concern can be explained as follows:

Market value of the asset:	R1 000 000
Annual net rental:	R150 000 (Yield 15%)
Market interest rate:	10% (applicable to the trust)

the therein specified conditions or circumstances, thereby diverting its income from himself without his replacing or being able to replace it.

103 *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C) 526-527.

104 *Burmah Steamship Co Ltd v IRC* 1931 SC 156.

Selling price:	R600 000
Donation: ¹⁰⁵	R400 000

The balance of the purchase price being R600 000 is left outstanding on an interest-free loan account.

The concern is, therefore, that if the only test is the notional interest test, the beneficiaries will in effect be R90 000 better off. This is because if the notional income test were the only test, then it is only R60 000 that can be included in the donor-parent's income (R600 000 x 10%), while the trust/minor beneficiary has benefited by virtue of both the failure to charge interest, and the sale at below market value.

A different picture emerges where "the hole" in the taxpayer's income is calculated on a transactional basis. The entire transaction is made up of a number of dispositions. Each disposition has to be examined in the light of the steps set out below.

The first disposition

The first disposition in the transaction being the sale of the property below where fair market value can be analysed as follows.

Step 1: Is there a donation settlement or other disposition?

Response: Yes. There is a gratuitous disposition of the difference between the fair market value and the actual selling price, being R400 000.

Step 2: Has income been received "by reason of" the "donation settlement or other distribution"?

Response: Yes. The annual rental amount of R150 000.

Step 3: What is the extent of the 'hole' left in the donor-parent's income "by reason of" this disposition?

¹⁰⁵ See the earlier discussion of s 7(9) of the *Income Tax Act* 58 of 1962 under 3.2.1 above.

It is contended that the hole in the donor-parent's income exists to the extent that was created by the donation of the income-producing asset to the trust thereby diverting income from himself without his replacing, or being able to replace in accordance with *Ovenstone* and *Wouldge*.

As contended earlier,¹⁰⁶ in the case of donations there is no opportunity for apportionment and all the income attributable to the donation must be included in the donor-parent's income i.e.

$$R150\ 000 \times \frac{R\ 400\ 000}{R1\ 000\ 000}$$

$$= R60\ 000$$

The second disposition¹⁰⁷

The second disposition in the transaction being the sale of the property below fair market value can be analysed as follows.

Step 1: Is there a donation settlement or other disposition?

Response: Yes. The failure to charge interest on the loan is a gratuitous disposition falling within the meaning of term other disposition for the purposes of section 7(3).

Step 2: Has income been received "by reason of" the "donation settlement or other distribution"?

Response: Yes. The annual rental amount of R150 000.

Step 3: What is the extent of the hole left in the donor-parent's income as a result of the failure to charge interest on the loan amount of R600 000?

106 See 3.2.1 above.

107 In *Joss v Secretary for Inland Revenue* 1980 1 SA 674 (T) 682 it was held that, "In a case such the present one must be careful to distinguish between the disposition of the shares at a proper value and thereafter the loan to the company which is interest free. Thus there are two dispositions and it is only the latter which is a disposition within the meaning of s 7(3) of the Act."

Response: There is a 'hole' in the taxpayer's income to the extent of the interest he failed to charge the trust being R60 000 (R600 000 x 10%).

The total amount of income attributable to the donor-parent will be the aggregate of the two amounts calculated above being R120 000 i.e. the R60 000 (attributable to the disposal at below market value) plus the R60 000 attributable to the interest-free loan. The excess income of R30 000, (R150 000 - R120 000) will be taxed in the hands of the minor child.

4.4 The limit on the income attributable to a donor-parent annually

The conclusion that can be drawn from the practical illustrations set out above is that the limit to which income may be attributed to a donor-parent on an annual basis, after looking at each disposition, can be formulated as:

The lesser of:

- the actual income earned on the asset disposed of; and
- the 'hole' left in the donor-parent's income as a result of each gratuitous disposition.

4.5 An estate planning consideration

The calculations above indicate that in the case of a donation more income will be attributed to the donor-parent than where an interest-free loan is used. Taken together with the cost of donations tax this mitigates in favour of using interest-free loans in estate-pegging.

Chapter 5

The events which will stop income from being attributed to a donor-parent

5.1 Introduction

Up to this point this research has focused on the quantum of the income that may be attributed to a donor-parent on an annual basis. The annual amounts as established above will continue to accrue to the donor-parent until the occurrence of an intervening event which is of such a nature that it will bring an end to the application of section 7(3).

This chapter will deal with the second dimension of the term limit, being the period for which income may continue to be attributed to the donor-parent. The specific events that will stop income from being attributable to the donor-parent will be examined on an event by event basis along with some of their attendant estate planning considerations.

5.2 When the minor child becomes a major

Section 7(3) refers specifically to "minor" child". Once the child ceases to be a minor (at age eighteen) or by marriage,¹⁰⁸ the provisions of section 7(3) can no longer apply and the minor will be taxed on the income accruing to him/her.¹⁰⁹

According to Meyerowitz,¹¹⁰ section 7(3) will cease to apply "from the date" that a child ceases to be a minor. This means that where a child attains majority during the tax year it will be necessary to do an apportionment of the deemed income so that the donor-parent is only taxed on the income accruing to the child during the portion of the tax year during which he was a minor.

108 Cronje and Heaton *SA Family Law* 49.

109 Mitchell 2009 *Tax Planning* 101.

110 Meyerowitz *Meyerowitz on Income Tax* 2008 par 16.52.

The reduction in the age of majority from twenty-one to eighteen¹¹¹ brings with it a tax planning opportunity. A parent's expenses in respect of a child will usually peak when the child reaches university-going age around the age of eighteen at the same time section 7(3) ceases to apply to the child's income. The current income tax thresholds and basic interest exemption for persons under the age of sixty-five are R54 200¹¹² and R21 000¹¹³ respectively. Therefore, assuming an investment return of 8% - it is possible for a parent to dispose of - by way of an interest-free loan to a child, or to an *inter vivos* trust established for the benefit of the child - an interest producing investment of R940 000¹¹⁴ without any taxable income being attributable to him. In addition, no tax will be payable by the child because income accruing to, the now adult child, will be below the annual tax threshold. It is, in a sense, therefore, possible for parents to fund university fees out of pre-tax income.

5.3 When the donor-parent dies

According to Olivier,¹¹⁵ it is obvious that section 7(3) will not apply after the death of the donor-parent.

It is contended that what may seem obvious is, with respect, not necessarily true in all instances.

Firstly, it is contended that where the donor-parent is married in community of property, the income accruing to a minor child will be attributed to each of the parents by virtue of the gratuitous disposition from their joint estate.¹¹⁶ Where one parent dies, section 7(3) will continue to apply to attribute a proportionate amount, being half, of the attributable-income to the surviving parent.

111 S 5 of the *Children's Act* 38 of 2005.

112 Applicable to persons under the age of 65 for the 2009/2010 tax-year.

113 Applicable to persons under the age of 65 for the 2009/2010 tax-year.

114 (R54 200+ R21 000) / 8%.

115 Olivier, Strydom and Van den Berg *Trust Law and Practice* Point 7-22.

116 S 57A of the Act; S 14 of the *Matrimonial Property Act* 88 of 1984; Robinson *et al Introduction to Family Law* 153.

A second scenario raises an interesting estate planning issue. Up until the introduction of CGT¹¹⁷ it was common practice for the donor-parent to bequeath the balance due on a loan account by a trust back to that trust.¹¹⁸ However, with the advent of CGT and in particular Paragraph 12(5)¹¹⁹ and the interpretation thereof of reached in ITC 1793,¹²⁰ the bequest of a loan account due by a trust back to the trust has created a potential CGT trap.

The effect of Paragraph 12(5) is to treat the bequest of a loan account back to the debtor- trust as a deemed disposal by the debtor (the trust) at a base cost of nil.¹²¹ Therefore, assuming that a loan account of R1 000 000 bequeathed back to a trust – the trust having been relieved of a debt - will be liable for CGT on the full R1 000 000. At the trust's effective rate of 20% this will equal R200 000 in CGT.¹²²

In order to avoid CGT in the scenario sketched above it is sometimes recommended that the loan account be bequeathed to a surviving spouse, instead of to the trust. This advice is also premised on the fact that the loan account is a non-growth asset and that the surviving spouse

117 Capital gains tax came into effect on 1 October 2001.

118 Jooste 2010 *Premiums and Problems* Article Edition B1. See also Seligson 2010 *Business Tax & Company Law Quarterly* 1 and Stein 2008 *Tax Planning* 21; Meyerowitz 2009 *The Taxpayer* 163.

119 Par 12 (5) of the Eighth Schedule to the Act. The relevant parts of this par read as follows:

- "(a) Subject to p 67, this subparagraph applies where a debt owed by a person to a creditor has been reduced or discharged by that creditor -
 - (i) for no consideration; or
 - (ii) for a consideration which is less than the amount by which the face value of the debt has been so reduced or discharged, but does not apply where,
 - (aa) ...

- (b) Where this subparagraph applies the person contemplated in item (a) shall be treated as having -
 - (i) acquired a claim to so much of that debt as was reduced or discharged for no consideration, or if a consideration was paid, to so much of the reduction or discharge of the debt as exceeds the consideration, which claim shall have a base cost of nil; and
 - (ii) disposed of that claim for proceeds equal to that reduction or discharge."

120 *ITC 1793* 67 SATC 256 at 261.

121 Cilliers 2009 *The Taxpayer* 203; Stein 2008 *Tax Planning* 21.

122 The so-called inclusion rate for trusts is 50%. Par 10(c) of the Eighth Schedule to the Act. The taxable income of trusts other than special trusts is taxed at 40%. Together these provisions create an effective Capital Gains Tax rate of 20% applicable to trusts.

will continue to reduce the dutiable value of her estate by reducing the outstanding loan account during her life time.

The concern with this bequest is that if the surviving spouse also refrains from charging interest on the loan account, she (assuming that the surviving spouse is the wife) will in the light of the dictum of Hoexter JA¹²³ in *Commissioner of Inland Revenue v Berold*¹²⁴ be making a "continuing donation". As a result of which her children will continue to benefit from the non-payment of interest.¹²⁵

It is argued that where the loan account is bequeathed to a surviving parent, and where the income continues to accrue to a minor child, that income may still continue to be attributed to the surviving parent in terms of section 7(3).

In the light of the above it can be concluded that the application of section 7(3) to the income of the minor child will not cease in all cases.

5.4 Income on income

The question as to whether the link between the income and the donor-parent's gratuitous disposition has been broken arises in the so-called 'income on income' situations i.e. where the income which accrues as a result of the original gratuitous disposition is reinvested and generates further income. Does the further income accrue:

- As a result of the original gratuitous disposition? In which event at least a portion thereof, will still be attributed to the donor-parent.
- Or, as a result of the investment of the income?

123 *Commissioner of Inland Revenue v Berold* 1962 3 SA 748 (A) 753. Held "... and for so long as he refrained from compelling Luzen to repay the sum, there was a continuing donation by him to Luzen of the interest on that loan".

124 *Commissioner of Inland Revenue v Berold* 1962 3 SA 748 (A) 753.

125 In this regard Clegg and Stretch *Income Tax in South Africa* 5A 7.3.2 states that "[i]f the gratuitous funding of the trust was by way of loan account and the loan has been inherited on the death of the original creditor by another person, then if that loan remains low interest and repayable on demand, the new creditor is generally treated as a funder".

As discussed when dealing with the term "by reason of" the Appeal Court in *Widan*¹²⁶ it was concluded that the proximate cause of income accruing was not necessarily "the cause which is proximate in time only", and that the proximate cause need not be the "immediate cause". The court found that it was necessary to look at "real and efficient cause" of the income accruing to the minor child, and if that "real and efficient cause" was the donation made by the parent, then section 9(3) of the old Act (which was the same as the current section 7(3)) applied.¹²⁷

The judgement in *Widan* indicates that something more than the mere capitalisation of income is required in order to constitute an intervening event of sufficient proportion to break the causal link.

As pointed out in *Widan* each case will have to be judged on its merits but it is contended that the following examples may serve to illustrate that point.

Practical illustration 3

The rental income in the case study¹²⁸ being R150 000 per annum is reinvested in a money market account earning interest at 8% per annum.

It is contended that the additional R12 000 i.e. R150 000 x 8%, being the income on income will still be causally linked to the original gratuitous disposal. So too will all future reinvestments' annual income and the interest earned thereon in a passive income investment.

If, on the other hand, the R150 000 is used by Patrick, the minor beneficiary, to buy a biltong dryer and he earns an active income from the manufacture and sale of biltong, the causal link between the original gratuitous disposition and the income earned will have been broken. The

126 *Commissioner for Inland Revenue v Widan* 1955 1 SA 226 (A) 233C.

127 *Commissioner for Inland Revenue v Widan* 1955 1 SA 226 (A) 234F. Followed in *Commissioner for South African Revenue Services v Woulidge* 1999 4 SA 519 (C). See also *Thoroughbred Breeders Association of South Africa v Price Waterhouse* 2001 4 SA 161 (A) 190 and *Commissioner for Inland Revenue v Shell Southern Africa Pension Fund* 1984 1 SA 672 (A); 46 SATC 1.

128 See 1.3 above.

income from biltong making will have accrued as a result of the productive employment of Patrick's "labour, wits and skills".¹²⁹ As a result the link with section 7(3) will have been broken and all income attributable to the sale of biltong will accrue to, and be taxed in Patrick's hands.

5.5 Settling the loan account

It has already been indicated that an interest-free loan will be regarded as an "other disposition" thereby prompting the application of section 7(3).

It seems trite to state that where the trust repays the loan, the gratuitous disposition falls away, and there is no cause for attributing income to the donor-parent. However, this contention will also not hold true in all situations.

It is a common practice for estate-planners to use their annual donations' tax concession, currently R100 000 per person¹³⁰ to reduce the outstanding loan account due to them by the trust.¹³¹

Where the loan account is reduced by way of an annual donation it is contended that the income attributable to the donor-parent will increase rather than decrease on an annual basis. This is as a result of the apportionment of the income between the various elements of the transaction. Part of the income will be attributable to the interest forgone on the loan account while part will be attributable to the donation used to reduce the loan account.

5.6 Summary

The events discussed above establish the time limit for which income continues to be attributed to the donor-parent. By their nature they are

129 *Millin v CIR* 1928 AD 3 SATC 170 251.

130 S 56 (2)(b) of the *Income Tax Act* 58 of 1962.

131 This is subject to the caveat that loan account must be reduced in such a way the par 12(5) of the Eighth Schedule of the Act is not brought into operation.

casuistic, and other than for the income on income scenario, cannot be deliberately put into operation. However, being aware of these events will provide the planner with either a tax planning opportunity or enable him to avoid some nasty pitfalls.

The limits to which income may be attributed to a donor-parent do not end the computation of his annual taxable income. In addition to the income tax consequences the limits calculated thus far also play a significant role when determining the capital gain to be taxed in the hands of a donor-parent in terms of the CGT provisions.

Chapter 6

Capital Gains Tax

6.1 Introduction

Having established the limits to which income may be attributed to a donor-parent it is now possible to determine the limit to which capital gains may be attributed to a donor-parent. This chapter examines how the capital gains provisions set out in the Eighth Schedule to the Act operate to prevent tax avoidance occasioned by a donor-parent's gratuitous disposition. The capital gains tax provisions will be examined against the background of the case study¹³² i.e. a scenario in which a donor-parent disposes of an income generating growth asset (the block of flats) to a trust. Where on disposal of the asset by the trust a gain accrues to the minor child of the donor-parent the attribution rules,¹³³ more specifically paragraph 69¹³⁴ will operate to draw the gain back into the hands of the donor-parent.¹³⁵ As in the case of section 7, it is only a portion of the gain that may be attributed to the parent. In this regard the limitation imposed in paragraph 73 will be examined to establish its role the limiting the capital gains that may be attributed to a donor-parent.

132 See 1.3 above.

133 Also referred to as deeming provisions or tax back provisions; see Honiball and Olivier *The Taxation of Trusts* 84.

134 Par 69 reads as follows:

69 Where a minor child's capital gain or a capital gain that has vested in or is treated as having vested in or that has been used for the benefit of that child during the year of assessment in which it arose can be attributed wholly or partly to any donation, settlement or other disposition -
made by the parent of that child; or
made by another person in return for any donation, settlement or other disposition or some other consideration made or given by a parent of that child in favour directly or indirectly of that person or his or her family,
so much of that gain as can be so attributed must be disregarded when determining that child's aggregate capital gain or aggregate capital loss and must be taken into account in determining the aggregate capital gain or aggregate capital loss of that parent.

135 The provisions of the Eighth Schedule are referred to as paras as opposed to the term sections used in the Act itself. All references to paras therefore refer to paras of the Eighth Schedule to the Act.

6.2 Background

The introduction of CGT¹³⁶ with effect from 1 October 2001,¹³⁷ has had a profound and lasting impact on the field of estate planning. The rationale underlying this statement can be attributed to the fact that the death of a person will have both CGT and estate duty consequences.¹³⁸

CGT is triggered by an event, being the disposal or deemed disposal¹³⁹ of an asset during a year of assessment.¹⁴⁰ On disposal of an asset a capital gain or capital loss is calculated by subtracting the base cost¹⁴¹ of the asset from the proceeds.¹⁴² From an estate planning perspective, death is regarded as a CGT event,¹⁴³ and in terms of paragraph 40(1) of the Eighth Schedule to the Act a deceased person is, subject to certain exceptions, regarded as having disposed of all his assets to his estate at their market value on the date of his death.¹⁴⁴ 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 trust, or transferring existing growth assets to a trust as part of an estate pegging exercise.¹⁴⁵ The benefit of an estate pegging exercise from a CGT perspective is that, no CGT will arise in the event of the death of the planner once the asset is held by the trust, because there is no 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

136 Capital Gains and Capital Losses are calculated in terms of the provisions of the Eighth Schedule to the *Income Tax Act* 58 of 1962. Capital Gains arising in a year of assessment are included in the taxable income of a person in terms of s 26 A of the Act.

137 CGT was introduced into South African law by the *Taxation Laws Amendment Act* 5 of 2001, which was promulgated on 20 June 2001. Davis, Beneke and Jooste *Estate Planning* 2A-3; Huxham and Haupt *Notes on SA Income Tax 2010* 693.

138 Olivier, Strydom and Van den Berg *Trust Law and Practice* 8-20; Stein *Estate Duty Principles and Planning* 1.1.

139 The term "disposal" is defined in par 11 of the Eighth Schedule.

140 Davis, Beneke and Jooste *Estate Planning* 2A-4.

141 The term "base cost" is set out in Part V of the Eighth Schedule to the Act.

142 The term "proceeds" is set out in Part VI of the Eighth Schedule to the Act.

143 Stein *Estate Duty Principles and Planning* 14.2 and 14.4. Goodall and King *Tax and Investments Easiguide* 1.4.1 state that "[a]t death, CGT is activated through a deemed disposal".

144 Davis, Beneke and Jooste *Estate Planning* 2A-8.1.

145 See 1.1 above where the concept of estate pegging is discussed.

asset to the trust.¹⁴⁶ While the estate pegging considerations of transferring assets to a trust are fairly settled, the transfer of an asset to a trust from a CGT perspective, cannot be undertaken lightly because there can be no doubting the words of Davis¹⁴⁷ where the authors state that:

[t]he CGT implications of using trusts are extremely complex, adding to the complications that already exist surrounding the taxation of trust income.

This research examines the extent to which a capital gain may be attributed¹⁴⁸ to a donor-parent who has transferred an income generating growth asset to a trust as part of an estate planning exercise. More specifically by way of sale on an interest-free loan account, and where the trust disposes of the asset during his lifetime.

Before delving into the attribution rules it is necessary to sketch a brief overview of the capital gains tax provisions as they apply to trusts, and trust beneficiaries.

6.3 Overview of trusts and CGT

The calculation of CGT takes place in terms of what is referred to, in the SARS Comprehensive Guide to Capital Gains Tax¹⁴⁹ (referred to as "the 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 section 26A of the Act.¹⁵⁰ As in the case of section 25B of the Act, however, trusts and trust

146 Par 11(1) of the Eighth Schedule to the Act.

147 Davis, Beneke and Jooste *Estate Planning* 4-8(2).

148 According to Davis, Beneke and Jooste *Estate Planning* 2A-8.1 the attribution rules are essentially anti-avoidance provisions similar to those governing the taxation of trust income contained in the Act. See Part X of the Eighth Schedule "Attribution of Capital Gains". Part X consists of paras 68 to 73.

149 South African Revenue Service: *Comprehensive Guide to Capital Gains Tax*.

150 26A reads "[i]nclusion of taxable capital gain in taxable income.—There shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule." Stein *Estate Duty Principles and Planning* 14.2.

beneficiaries are singled out for special treatment when it comes to calculating capital gains tax.

In the case of trusts, unless the anti-avoidance provisions, referred to as the attribution rules set out in paragraphs 68 to 72, applying the disposal of an asset by a trust will be subject to CGT in accordance with paragraphs 80(1) and 80(2). The stipulations of paragraphs 80(1) and 80(2) resemble the provisions of section 25B of the Act.¹⁵¹ Thus where a capital gain arises as a result of the vesting of a trust asset in 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.¹⁵² Likewise, where the trust disposes of the asset (other than to the beneficiary) and the capital gain,¹⁵³ or a portion thereof is vested in a resident beneficiary by virtue of the trustees exercising their discretion. Here too the gain is to 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.¹⁵⁴

As in the case of section 25B of the Act, the provisions of paragraph 80 are also subject to anti-avoidance rules, in this case, the attribution rules contained in paragraphs 68 to 72 of the Eighth Schedule to the Act.¹⁵⁵

6.4 The attribution rules

This research examines only one of these attribution rules, being paragraph 69. This paragraph mirrors the provisions of sections 7(3) and 7(4) in the Act.¹⁵⁶ As in the case of Section 7(3), Paragraph 69 also rests on the critical phrase being "by reason of any donation, settlement or

151 Mitchell 2009 *Tax Planning* 103.

152 Par 80 (1) of the Eighth Schedule to the Act.

153 Losses are trapped in the trust and can be used to calculate the aggregate gain or loss of the trust, as taxpayer, and cannot be distributed to a beneficiary.

154 Par 80(2) of the Eighth Schedule to the *Income Tax Act* 58 of 1962.

155 Mitchell 2009 *Tax Planning* 101 makes the point that the only difference between sub-sections 25B(1) and (2) and par 80(2) is that sub-sections 25B(1) and (2) are subject to the deeming provisions in s 7(5) where as par 80(2) is not subject to par 70.

156 Clegg and Stretch *Income Tax in South Africa* 5A 7.3.2.

other disposition". The SARS CGT guide¹⁵⁷ indicates that the interpretation to be placed on the critical phrases is exactly the same as that which was discussed earlier, when dealing with the income tax provisions and section 7(3) of the Act.

When the core rules and provisions of paragraphs 80(1), 80(2) together with paragraph 69 are looked at in totality the scheme of the Act creates a clear sequence in which gains are to be taxed. Capital gains (not capital losses) will be taxed:

- Firstly, in the hands of a beneficiary where, paragraphs 80(1) and 80(2) apply.
- Secondly, where the attribution rules do apply they over-ride paragraphs 80(1) and 80(2) and the gains, or a portion thereof, as indicated below, will be taxed in the hands of the donor-parent.¹⁵⁸
- Lastly, if none of the above applies, the gain will be taxed in the trust.¹⁵⁹

It is contended that in this sequence the trust is treated as the taxpayer of last resort which in itself is not all bad,¹⁶⁰ considering that the capital gains which are taxed in a trust other than a special trust,¹⁶¹ are subject to a 50% inclusion rate and a flat marginal tax rate of 40%, without the benefit of any annual exclusion.¹⁶² This means that where the capital

157 Honiball and Olivier *The Taxation of Trusts* 143 state that: "[t]hese tax-back rules are the equivalent of the tax-back (or deemed accrual) provisions contained in s 7 of the *Income Tax Act*"; SARS <http://www.sars.gov.za> Chap 15 at 15.2 and 15.4; Huxham and Haupt *Notes on SA Income Tax 2010* 855; Mitchell 2009 *Tax Planning* 103.

158 Par 69.

159 The core rules in Part II of the Eighth Schedule.

160 Geach and Yeats *Trusts: Law and Practice* 268.

161 For the purposes of CGT a special trust only includes a trust as contemplated in par (a) of the definition of 'special trust' in s 1 of the Act. The term is thus limited to trusts established solely for the benefit of persons suffering from severe mental and physical disability and who as a result of their disability are unable to earn sufficient income for their maintenance needs or manage their own financial affairs.

162 Par 10 of the Eighth Schedule to the Act. Davis, Beneke and Jooste *Estate Planning 2A-3*; Huxham and Haupt *Notes on SA Income Tax 2010* 693; Jordaan *et al Silke: SA Income Tax 2008* 686; Mitchell 2009 *Tax Planning* 101.

gains are taxed in a trust the gains will be subject to an effective tax rate of 20% which is double the maximum effective rate applicable to individual taxpayers.¹⁶³ As a result there is an obvious tax benefit where the gain is taxed as part of the beneficiary's or the donor-parent's income, confirming the view that the application of the attribution rules is not as dire as often perceived.¹⁶⁴

In addition to the above, where income-producing growth asset has been transferred to a trust by way of a sale on an interest-free loan account, the provisions of paragraph 73 play a significant role in establishing the gain to be attributed to the donor-parent. It is in this regard that paragraph 73 places a limit on the gain to be attributed to the donor-parent.¹⁶⁵

6.5 The limit on the gain attributable to a donor-parent imposed by paragraph 73

Where paragraph 73¹⁶⁶ applies it will operate, ostensibly, in favour of the donor-parent, to limit the total quantum of the income and capital gains to be taxed as part of his income. This section examines how the scheme of the CGT provisions operate so that together the attribution rules and paragraph 73 limit the capital gain to be taxed in the hands of the donor-parent.

163 Stein *Estate Duty Principles and Planning* 14.2.

164 See 1.2 in this regard.

165 In this regard par 15.1 in the SARS <http://www.sars.gov.za> : "There is no limit on the extent of the attribution of a capital gain in the case of an asset funded by a donation."

166 (1) Where both an amount of income and a capital gain are derived by reason of or are attributable to a donation settlement or other disposition the total amount of that income and gain - that is deemed in terms of s 7 to be that of a person other than the one to whom it accrues or by whom it is received or for whose benefit it is expended or accumulated; and that is attributed in terms of this Part to a person other than the one in whom it vests, shall not exceed the amount of the benefit derived from that donation settlement or other disposition.

(2) For the purposes of this par, the benefit derived from a donation, settlement or other disposition means the amount by which the person to whom that donation, settlement, or other disposition was made, has benefited from the fact that it was made for no or an inadequate consideration, including consideration in the form of interest."

Where a trust disposes of an asset during the tax year, either by vesting the asset in a minor child of the donor-parent, or disposes of the asset to a third-party and thereafter, in the same tax year, vests the gain in the minor, the capital gain will accrue to the minor in terms of either of paragraphs 80(1) or 80(2). Because the gain is linked to a gratuitous disposition made by the minor's parent the gain will be attributed back to a donor-parent and taxed as part of his taxable income, as a result of the operation of the attribution rule in paragraph 69. In this regard it is the entire gain which can be linked to the gratuitous element of the donor-parent's disposition which will be attributed back to the donor-parent. The donor-parent, as the taxpayer, will bear the onus¹⁶⁷ of proving that an apportionment is possible.

Where the asset, disposed of by the trust, was an income producing asset, which was acquired by the trust by way of a donor-parent's gratuitous disposition the gain may be limited in terms of paragraph 73.¹⁶⁸ Paragraph 73 applies where both income¹⁶⁹ and capital gains accrue by reason of the donor-parent's gratuitous disposition. Where this happens the amount of the capital gain and income that can be attributed to the donor-parent is limited to the total amount of that income and capital gain. This is subject to the further limitation that attributed amount shall not exceed the benefit derived from that donation.

Meyerowitz¹⁷⁰ explains that:

167 In terms of s 82 of the Act. See footnote 27 above; *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A).

168 Honiball and Olivier *The Taxation of Trusts* 148. Also see Meyerowitz *Meyerowitz on Income Tax* 2008 par 39.16.8; SARS <http://www.sars.gov.za> 15.8 on page 464.

169 It must be noted that in this regard the term "income" has been used deliberately, because according to the SARS <http://www.sars.gov.za>, as well as Honiball and Olivier *The Taxation of Trusts*, the word income is to be ascribed its ordinary meaning as described in *Commissioner for Inland Revenue v Simpson* 1949 4 SA 678 (A); 16 SATC 268, as meaning of profits or gains. Thus even exempt income e.g. exempt dividends must be taken into consideration when limiting capital gains by amounts which have already been included in the taxpayer's income, even though they may not have been subjected to tax as taxable income.

170 Meyerowitz *Meyerowitz on Income Tax* 2008 par 39.16.8.

[w]here both income and capital gains are derived by reason of or are attributed to a donation, income in terms of section 7 and capital gains attributed as set out, the total must not exceed the amount of the benefit derived from the donation.

Unfortunately this explanation does little more than embellish upon the existing wording of paragraph 73 and one is left to the interpretation adopted by SARS in their Comprehensive Guide to Capital Gains Tax.¹⁷¹

The practical application of paragraph 73 is explained by way of an example in the SARS CGT guide¹⁷² which, if transposed onto the facts of the case study produces the following result.

Practical illustration 4

The block of flats, in the case study, was sold to the trust for R1 000 000¹⁷³ on 1 March 2006, and on 28 February 2010 the trust sold the block of flats for R1 700 000.¹⁷⁴ The gain is thus R700 000.

Assuming that the annual yield (15%) and the interest rate at which the trust could have borrowed money (10%), remain unchanged throughout the period. The income flows and their tax consequences can be summarised by way of the following table.

Year	Income	Interest at 10%	Deemed income¹⁷⁵	Portion taxable as the minor's income
2006	R150 000	R100 000	R100 000	R50 000
2007	R150 000	R100 000	R100 000	R50 000
2008	R150 000	R100 000	R100 000	R50 000
2009	R150 000	R100 000	R100 000	R50 000
Total	R600 000	R400 000	R400 000	R200 000

If this is the case then according to SARS, the portion of the R700 000 capital gain attributable to the donor- parent will be calculated as follows:

171 SARS <http://www.sars.gov.za> 15.8 at 464. See also Stein *Stein on Capital Gains Tax* 17.3.5.

172 SARS <http://www.sars.gov.za> 15.8 at 466.

173 Total "base cost expenditure" as anticipated in par 20 of the Eighth Schedule.

174 Total "proceeds" as anticipated in par 35 of the Eighth Schedule.

175 Deemed to be the income of the donor-parent in terms of s 7(3) of the Act.

Total Gain: R700 000
Less: R400 000 (being the amount taxed as part of the donor-parent's income in terms of section 7(3))
Attributable gain: R300 000

Therefore R300 000 of the R700 000 will be attributed to the donor-parent. The remaining R400 000 of the gain will be subject to CGT where it accrues, in this example, in the hands of the minor child.¹⁷⁶

6.6 The limit of the capital gain attributable to the donor-parent

In the light of the above, where a gain is attributed to a donor-parent in terms of paragraph 69, the attributable gain will be limited by the application of paragraph 73. Thus, where paragraph 73 applies the limit can be stated as:

- the aggregate of the amounts of income which were taxable in the hands of the minor child i.e. the amounts which were not deemed to be the donor-parent's income in terms of section 7(3) of the Act.

It is contended that this limit has to be limited even further. Capital gains tax only came into effect on 1 October 2010. It would make sense, therefore, that it is only the deemed income after that date which may be taken into account for the purposes of section 73.¹⁷⁷

6.7 Summary

In a typical estate pegging scenario, an income producing growth asset will have been disposed of to a trust on interest-free loan account. Where on disposal of the asset by the trust, a gain arises which vests in a minor beneficiary paragraph 69 will apply to attribute the gain to the donor-parent. The attributable gain is, however, limited by the application of paragraph 73.¹⁷⁸

176 Honiball and Olivier *The Taxation of Trusts* 148.

177 SARS <http://www.sars.gov.za> 15.8 on page 464.

178 The decisions of *Joss* and *Woulidge*, distinguish between two transactions being the sale at an arms-length price and the failure to charge interest on the loan amount. It is contended that in the light of these cases there is no

Chapter 7

Conclusion

At the outset¹⁷⁹ it was indicated that section 68(3) of the Act requires a donor-parent to include in his income any amounts which were deemed to be his.¹⁸⁰ The Act does, however, not specify any limit to the amount of his minor child's income to be included in his income. From the parent's perspective this is seen as problematic because, in terms of section 82 of the Act, the parent bears the onus of showing which amount is correctly taxable in his hands and which amount remains to be taxed where it accrued i.e. in the hands of his minor child.¹⁸¹

An examination of the relevant income tax provisions in the light of three key cases, being *Joss*, *Ovenstone* and *Woulidge*, indicate that while the deeming provisions in the Act do operate to attribute income to a donor-parent, there is a clear limit to which income can be attributed to a donor-parent.

The operation of the deeming provisions is prompted by the donor-parent's gratuitous disposition in the form of "any donation, settlement or other disposition". In order to establish the amount of income that may be correctly attributed to a donor-parent on an annual basis it is necessary to examine each disposition made by the donor-parent separately. It is only a disposition which contains "an appreciable element of gratuitousness"¹⁸² that will prompt the application of the deeming provisions. Dispositions for full value will not lead to income being attributed to the donor-parent and, therefore, these amounts will not be included in the parent's income.

link between the capital gain and the failure to charge interest. The failure to charge interest is a benefit which accrues on income account while the gain accrues on capital account. No portion of the capital gain should be attributable to the donor-parent and s 73 should have no application. As it applies now s 73 is an attribution rule rather than a limiting provision.

179 See 1.2 Practical challenges, above.

180 Either as a result of the operation of s 7(3) of the Act, or par 69 of the Eighth Schedule.

181 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 740.

182 *Ovenstone v Secretary for Inland Revenue* 1980 2 SA 721 (A) 740.

Where an element of gratuitousness is present in a disposition it is only the income which is causally linked to that gratuitous element of the disposition that must be included in the donor-parent's income. The test for determining a sufficiently close causal link was described in *Woulidge* as the "notional interest income" test. This test, as indicated by Meyerowitz does, however, have its limitations. The research suggests that a possible alternative test can be distilled from the *Ovenstone* case. This test is described as "the hole left in the donor-parent's income". The application of this test indicates that the income to be attributed to a donor-parent on an annual basis, after looking at each disposition, can be formulated as "the lesser of":

- the actual income earned; and
- the 'hole' left in the donor-parent's income as a result of the disposition.

A second dimension to the term limit relates to the period for which income may continue to be attributed to the donor-parent. This dimension indicates that there are certain events that will stop the application of the deeming provisions of section 7(3). These specific events include:

- when the minor child becomes a major;
- when the donor-parent dies;
- income on income situations; and
- where the loan account is settled.

Except for where the minor child reaches majority, the events mentioned above do not apply unequivocally and have to be examined in the light of the circumstances of each case.

From a Capital Gains Tax perspective, because the attribution rules contained in the Eighth Schedule mirror the deeming provisions in Section 7 of the Act, the considerations in respect of their application are largely the same. The amount of the gain attributed to a donor-parent is

limited by the application of paragraph 73 of the Eighth Schedule to the amount which was left to be taxed in the hands of the minor child.

The ability to establish the limit to which income and capital gains may be attributed to a donor-parent opens the door to interesting tax and estate planning considerations.

From an income tax perspective where the donor-parent is able to satisfy the onus placed on him in terms of section 82 of the Act can lead to tax savings on his part. The income which is correctly attributable to the gratuitous element of his disposition will be taxable in his hands. The balance will be taxed where it accrues i.e. in the hands of his minor child. The application of the attribution rules in this instance can, therefore, be applied to facilitate a measure of income splitting and are not as dire as perceived. The income taxable in the minor's hands will usually be taxable at a lower marginal rate than that which would have applied to the donor-parent. In addition, the minor child will qualify for the annual interest exemptions where applicable, as well as the annual rebates thereby providing the donor-parent with considerable tax relief.

In the same way the capital gains taxable in the minor child's hands could be taxed at a lower effective rate because of his usually lower marginal rate. The gain will also be reduced by the minor child's annual exclusion amount provided for in paragraph 5(1) of the Eighth Schedule, currently R17 500.

Finally, in terms of the proviso to section 90 of the Act, the donor-parent is entitled to recover any tax paid on income attributed to him from the person to whom the income accrued. From an estate planning perspective it is contended that there will be an advantage in not recovering the tax from the person to whom the income accrued. In this way the planner/donor-parent's estate is depleted and the minor child or trust's estate is retained.

In can, therefore, be concluded that in the context of estate planning there are considerable benefits to be gained from understanding the limits to which income and gains may be attributed to a donor-parent.

There are a myriad of different reasons for using trusts in the context of estate planning. Tax is but one of the considerations in the decision making process. In order to provide their clients with valuable advice estate planners should, however, be aware of the principles applicable to SARS' ability to attribute trust income and capital gains to donor-parent.

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