Tax benefits of discretionary trusts: abolishment of the conduit pipe principle

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ABSTRACT

Keywords: Inter vivos trusts; conduit pipe principle, estate planning, section 25B
Trusts have long been effective and beneficial estate planning instruments for various reasons, amongst which their favourable flow-through nature (with special reference to applicable tax benefits). For purposes of estate planning this popular planning instrument is utilised to protect assets, contribute to succession planning and minimising tax liability for the estate owner, the trust itself and the involved beneficiaries. One of the most effective measures of obtaining tax benefits by means of a trust is through the application of the conduit pipe principle. This principle allows for income and capital to 'flow' through the trust to the beneficiaries while retaining its original nature. Application of this principle results in tax reliability to be shifted from the trust to the beneficiaries, who often, as natural persons, qualify for a variety of tax exemptions, exclusions and rebates.

However, in recent national budgets the conduit pipe principle has increasingly been scrutinised due to the South African Revenue Service's belief that it is being used to acquire tax benefits. After investigation of the taxation of discretionary trusts, the appointed Davis Tax Committee proposed the abolishment of the conduit pipe principle.

This dissertation evaluates the effect that the abolishment of the conduit pipe principle will have on the taxation of trusts and their beneficiaries, as well as the ultimate effect thereof on the popularity of discretionary *inter vivos* trusts for the purposes of estate and tax planning. The research goal is attained at the hand of a literature study on the objectives of estate planning, specifically tax minimisation by means of trusts and the conduit pipe principle. Various case laws are examined together with the applicable and relevant legislation in order to determine the current tax benefits of trusts. In conclusion a case study is conducted to evaluate the tax benefits of a trust with the application of the conduit pipe principle and an evaluation of the future taxation of trusts, should the conduit pipe be abolished as proposed by the Davis Tax Committee, is given.

OPSOMMING

Sleutelterme: inter vivos trust, geleibuisbeginsel, boedelbeplanning, artikel 25B

Trusts dien vir 'n geruime tyd reeds as doeltreffende en voordelige boedelbeplanningsinstrumente om verskeie redes, waaronder hul gunstige geleibuis-aard (met spesifieke verwysing na die toepaslike belastingvoordele). Vir boedelbeplanningsdoeleindes word hierdie gewilde beplanningsinstrument aangewend vir die beskerming van bates, doeltreffende erflatingbeplanning en dra dit by tot die vermindering van belastingaanspreeklikheid vir die boedeleienaar, die trust self, asook die betrokke begunstigdes. Een van die mees doeltreffende metodes vir die verkryging van belastingvoordele deur middel van 'n trust is die geleibuis-beginsel. Hierdie beginsel laat die 'vloei' van inkomste en kapitaal deur die trust na die begunstigdes toe, met die behoud van hul oorspronklike aard. Die toepassing van hierdie beginsel lei tot die verskuiwing van belastingaanspreeklikheid vanaf die trust na die begunstigdes, wat dikwels as natuurlike persone kwalifiseer vir 'n verskeidenheid van belastingvrystellings, uitsluitings en kortings.

In die afgelope nasionale begrotings is die geleibuis-beginsel egter toenemend onder die loep geneem as gevolg van die Suid-Afrikaanse Inkomstediens se oortuiging dat dit aangewend word om belastingvoordele te bekom. Na 'n ondersoek geloods is rakende die belasting van diskresionêre trusts, het die Davis Tax Committee, soos aangestel deur die Minister van Finansies, die afskaffing van die geleibuis-beginsel aanbeveel.

Hierdie proefskrif evalueer die effek wat die geleibuis-beginsel sal hê op die belasting van trusts en hul begunstigdes, asook die uiteindelike uitwerking daarvan op die gewildheid van diskresionêre *inter vivos* trusts vir die doeleindes van boedel- en belastingbeplanning. Die navorsingsdoel sal bereik word deur middel van 'n literatuurstudie rakende die doelwitte van boedelbeplanning, met spesifieke verwysing na die vermindering van belastingaanspreeklikheid deur middel van trusts en die aanwending van die geleibuis-beginsel. Verskeie regsprekende gesag sal tesame met relevante wetgewing ondersoek word om te bepaal watter belastingvoordele trusts tans inhou. Ten slotte sal 'n gevallestudie onderneem word om die huidige belastingvoordele van trusts, met die toepassing van die geleibuis-

beginsel, te bepaal en daarna te evalueer hoe trusts in die toekoms belas gaan word, sou die geleibuis-beginsel afgeskaf word soos aanbeveel deur die Davis Tax Committee.

LIST OF CONTENTS

CHAPTER 1

Introduction

1 Introduction

1.1 Problem statement

Trusts have long been effective and beneficial estate planning instruments for various reasons, including the favourable application of its flow-through nature (with special reference to tax benefits).[1] The flexibility and adaptability of the South African trust have contributed greatly to this popularity.[2] Two of the most important aspects that should be taken into account when planning an estate are the planning instruments and its accompanying tax rates.[3] Individuals and estate planners constantly explore and refine methods[4] to obtain tax benefits in order to ensure that the taxpayer's (either beneficiaries or the trust) tax liability is kept to the minimum.[5] This is not surprising when taken into account that South Africa has one of the highest tax rates, especially with reference to income tax.[6]

In recent years one of the most effective measures to gain tax benefits has been the use of the conduit pipe principle (hereafter the principle),[7] as embodied in section 25b of the *Income Tax Act* 58 of 1962 (hereafter the *ITA*) and paragraph 80 of the Eighth Schedule to the *ITA* with reference to capital gains tax. This principle allows for amounts accrued to the trust to flow through the trust to the beneficiaries, while retaining its identity or nature[8] (for example: a dividend stays a dividend and a capital gain retains its nature as capital gain).[9] The application of this principle results in a shift of the trust's tax liability to the beneficiaries[10] who are entitled to a

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1 Brink and Willemse 2014 *JEF* 796.
2 Hyland and Smith 2006 *JEPL* 1.
3 Burger *The future of trusts as an estate planning tool* 1.
4 Permissible tax planning entails the structuring of an individual's affairs in an effective and efficient manner, while still maintaining legal and regulatory compliance. Stephens *When to cry, "sham!"* 4.
5 Grobbelaar 2014 *Tax Talk* 20.
6 Carter 2014 http://www.bbc.com/news/magazine-26327114.
7 Brink and Willemse 2014 *JEF* 798.
8 Dachs 2014 *The Taxpayer* 106.
9 *Armstrong v Commissioner for Inland Revenue* 1938 (AD) para 343.
10 Honiball and Olivier *The Taxation of Trusts in South Africa* 74.

variety of tax exemptions[11] – dividends are, for instance, excluded by way of section 10(1)(k)(i) of the *ITA*. This principle that allows for a beneficiary's income from a trust to retain its nature was laid down in *Armstrong v CIR* 1938 AD 343 10 SATC 1 (hereafter the *Armstrong* case).

The conduit pipe principle is a legitimate and legal method to obtain tax benefits,[12] but since the South African Revenue Service (hereafter SARS) is actively closing existing tax gaps[13] this method may not prove as an effective estate planning measure for tax benefit purposes in the future.[14] From a reading of the *Income Tax Practice Manual* it appears as though SARS supports the principle. Some authors however argued that in practise the contrary might be true.[15]

According to SARS the current tax gap,[16] originating from their Commissioner's failure to effectively collect all income tax,[17] is estimated to be between fifteen to thirty percent of tax revenues.[18] The Minister of Finance indicated in his explanatory notes to the 2013/2014 National Budget Speech that the government is proposing several legislative measures concerning trust control abuse in relation to the acquisition of tax benefits through the conduit pipe principle in discretionary trusts.[19]

On 17 July 2013 a tax review committee, known as the Davis Tax Committee (hereafter the DTC), was announced.[20] The DTC released a draft report that made recommendations to assist SARS on closing mentioned tax gaps considered to be exploited by trusts[21] and which SARS regards as tax avoidance schemes. Although the proposals are yet to be enforced, it is clear that the conduit pipe principle is

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11 Croome *Tax Law: An Introduction* 121.
12 Section 25b *Income Tax Act* 58 of 1962 is subject to tax avoidance provisions as set out in s 7 of the act, which is discussed in chapter 4.
13 Steyn *Mail & Guardian* 4.
14 Brink and Willemse 2014 *JEF* 807.
15 Honiball and Olivier *The Taxation of Trusts in South Africa* 73.
16 Keanly 2011 *Basic Building Blocks of SARS Domestic Resource Mobilization* http://slideplayer.com/slide/4390404/#.
17 Pretorius 2014 *Tax Talk* 17.
18 Keanly 2011 *Basic Building Blocks of SARS Domestic Resource Mobilization* http://slideplayer.com/slide/4390404/#.
19 Brink and Willemse 2014 *JEF* 795; Croome 2014 http://www.thesait.org.za/news.asp?id=130112&hhSearchTerms=%22beric+and+croome%22.
20 Pretorius 2014 *Tax Talk* 18.
21 Steyn *Mail & Guardian* 4.

increasingly being scrutinised. The flow-through nature of discretionary trusts is disputed by SARS and this could endanger the future use of discretionary trusts for income tax benefit purposes.[22] This in turn poses new challenges to the art of estate planning.

This study therefore explores the proposed legislative measures envisaged by the government and evaluates the possible impact thereof on the conduit pipe principle as currently utilised by discretionary trusts. The probable effect on beneficiaries' and trusts' tax responsibilities is also discussed. Conclusively this dissertation evaluates whether discretionary trusts will, given the proposed amendments, prove to be effective estate planning instruments for tax purposes.

1.2 Research questions and aims

The general research question of this study is:

Given the proposed abolishment of the conduit pipe principle, how effective is a discretionary trust as an estate planning instrument with reference to tax benefits?

In order to answer this question the following specific research questions are formulated:

- What are the current benefits of trusts as estate planning instruments? What are their tax benefits in the *status quo*?
- What does section 25b, as well as paragraph 80 of the Eighth Schedule to the *ITA* stipulate and what is the effect thereof on taxes?
- What are the proposed amendments to taxation of trusts and how will this affect the use of trusts for tax benefits?

The aims of this study are thus:

22 Pretorius 2014 *Tax Talk* 18.

- to determine the extent of current benefits of trusts as estate planning instruments as well as any tax benefits thereto. As a result analyses must be done on what the tax benefits in the *status quo* are*;*
- to give a critical discussion of section 25b and paragraph 80 (contained in the Eighth Schedule of the *ITA*), together with its effects on trusts as methods of obtaining tax benefits; and
- to investigate the proposed amendments and indicate the probable impact on beneficiaries' and trusts' tax liability, the future of the conduit pipe principle and the effectiveness of trusts as estate planning instruments with reference to tax benefits.

1.3 Case study

The proposed taxation amendments concerning trusts are not yet promulgated or in force.[23] In order to assess the potential impact(s) of these proposals, a qualitative literature review is undertaken. A case study is also utilised to represent the findings of the application of the proposed amendments and is discussed in chapter 4.

1.4 Research outline

Chapter 2 of this dissertation serves as a background for the study where the definitions of estate planning and a trust are provided. The various benefits of trusts as estate planning instruments are listed in chapter 3, but tax benefits are discussed in more detail as these are the main focus of the study. An overview is given with reference to the boundaries of the research, since the study only focuses on discretionary trusts and the presented tax benefits thereof.

In chapter 4 case law, statutory provisions and current legislation set out the origin, function and implementation of the conduit pipe principle. Both the tax benefits of the principle, as well as the limitation thereof are laid out and analysed. In essence this chapter should ultimately prove to be a critical analysis of section 25b and paragraph 80 in the Eighth Schedule of the *ITA*.

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23 Brink and Willemse 2014 *JEF* 795.

Chapter 5 firstly consists of an indication of what the proposed amendments to the taxation of trusts will entail, as envisaged in the 2013/2014 National Budget speech and the interim report of the DTC. Secondly a case study depicts the possible and probable impact(s) of the proposed amendments on the principle, the taxation of discretionary trusts and ultimately the tax liability of beneficiaries and trusts.

In the sixth and concluding chapter, the research findings are summarised. The summary answers the general research question posed in the introduction, namely whether discretionary trusts will still prove to be efficient estate planning instruments in the light of the effect the proposed amendments will have on the tax benefits previously obtained by means of the principle. Lastly recommendations are given to estate planners and beneficiaries with regard to the future use of discretionary trusts for tax benefit purposes.

CHAPTER 2

Estate Planning

2 Estate planning

2.1 Introduction

This chapter aims to clearly define the concepts 'estate' and 'estate planning' in order to create the correct legal context within which the use and function of a trust are discussed. Before the benefits of a trust, especially the tax benefits of a trust can be explored, the utilisation of the trust figure as an estate planning instrument must be expounded in order to determine whether the trust will still prove an effective instrument in light of the proposed abolishment of the conduit pipe principle.

An introductory explanation of an estate and estate planning, including its process, reasons for use, benefits and the accompanying estate duty levied, is therefore provided. Although various estate planning instruments are used to execute the estate planning process, trusts are the primary focus of this study and therefore the nature and taxation of only trusts and specifically *inter vivos* discretionary trusts are presented.

In order to answer the first specific research question the following topics are addressed in this chapter: the scope and limitations of the chapter, the definition of estate and estate planning and the objectives of estate planning and its accompanying duty.

2.2 Scope and limitations

'Estate planning' and 'trusts' are extremely broad and comprehensive concepts with different aspects and facets. For the sake of answering the particular research question posed in this dissertation, only certain key concepts are considered.

The term 'trust', as referred to throughout the study, is limited to the notion of a discretionary *inter vivos* trust (hereafter trust). The reason for this limitation is the fact that the proposals concerning the possible abolishment of the conduit pipe principle are only applicable to discretionary trusts.[24] Due to length restrictions and requirements it is practical to focus on *inter vivos* trusts, instead of both *inter vivos* and testamentary trusts. The character, nature and functions of this specific type of trust are discussed in the next chapter. This dissertation furthermore focuses only on South African founded trusts and not off-shore trusts.

2.3 Definition of estate and estate planning

According to the *Farlex Legal Dictionary* an estate, in the legal context, can be described as:[25]

> the degree, quantity, nature and extent of interest that a person has in real and personal property. Such terms as estate in land, tenement, and hereditaments may also be used to describe an individual's interest in property.
>
> It means, ordinarily, the whole of the property owned by anyone, the realty as well as the personality.

The term 'estate', for purposes of this study, denotes the collection of all property that a person owns[26] and includes assets such as bank and investment accounts, retirement policies, monetary value of life insurance, personal property items (cars, jewellery, furniture and collectibles), business interests, money payable to the person and fixed property, as well as liabilities that may consist of credit card debt, personal loans and mortgages.[27]

'Estate planning' is the term often used by financial advisors, lawyers and life insurance agents to signify the process of fostering an estate.[28] Weinstock[29] adopts the following approach towards estate planning as art of designing an estate:

> An estate plan is an arrangement for the use, conservation and transfer of one's wealth. The process by which an estate plan is created is called estate planning. This process involves much more than merely preparing the estate

24 As will be discussed in chapter 4 of this dissertation.
25 Farlex 2011 http://legal-dictionary.thefreedictionary.com/estate.
26 See s 3 of the *Estate Duty Act* 45 of 1955 with reference to what constitutes an estate, which includes both 'property' and 'deemed property' as per s 3(2) and 3(3) of a resident person – situated anywhere in the world.
27 Howard 2011 *Tax Talk* 16.
28 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.1.
29 Weinstock's definition of estate planning, Davis *et al Estate Planning* Lexis Nexis at par 1.1.

> owner's will. A well thought out estate plan concerns itself with the creation of an estate where none would otherwise exist, the increase of an existing estate to meet the needs of the owner and its family, and the preservation and protection of the estate from unnecessary taxes and costs.

Estate planning is not only a process of acquiring property and ensuring that the owner derives the maximum benefit from his/her ownership thereof during his/her lifetime, but it also safeguards the estate against erosion and minimising because of, amongst others, taxes and duties levied upon the estate and its contents.[30]

2.4 Objectives of estate planning

Estate planning has numerous objectives and goals, but one of the most fundamental prerequisites for a successful and effective estate plan is flexibility. Flexibility in this context necessitates not only suiting the needs of the specific estate owner, but also adaptation to the ever-changing forms that taxes embrace throughout time.[31] This essential element of flexibility should not be limited to the structure of the estate plan, but should also dictate the nature of the planning tools or instruments to be used.[32] The emphasis will once again fall upon the use of the discretionary trust as an estate planning tool.

For practical purposes the objectives of estate planning that are significant to trusts and taxes are summarised.[33] Despite the fact that income tax savings are possible,[34] minimising income tax is rarely seen as a major objective of estate planning.[35] An estate planner should possess extensive knowledge of income tax in order to plan properly and ensure that no tax prejudice is suffered. One example of an income tax minimising method is the splitting of income by a trust through distribution to its various beneficiaries:[36]

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30 The inclusion of the objective of minimisation of income tax and estate duty should not be taken as indicating that these objectives are of overriding importance; Davis *et al Estate Planning* Lexis Nexis at par 1.1; Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.2.1.

31 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.2.

32 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.2.

33 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.2.

34 Duncan 2004 *Moneyweb's Tax Breaks* 7.

35 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.2; Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.5.2.2.1.

36 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.2.

> As endless in its facets as mankind in its characteristics and peculiarities, and exactly as interesting, the estate plan is far too worthwhile as an intellectual exercise to be made dependent upon tax quirks and loopholes; and it deserves to be co-joined with a motive far nobler than mere tax economics.

Although tax avoidance should not form the core of an estate plan, the various objectives of estate planning as a science include minimising other taxes as well.[37] This also includes, amongst other, the minimising of capital gains tax, donations tax, transfer duty and ultimately estate duty.[38] Skilful planning can ensure that taxes (either income, capital gains or estate) are limited to a minimum as far as legally possible.[39] The relevance of this statement lies in the fact that no person should be legally or morally compelled or forced to pay more taxes than necessary.[40]

Also listed amongst the objectives of estate planning, as dealt with by Davis, is the provision of capital and income for dependants; capital appreciation and the generation of income; as well as protection against insolvency and inflation.[41] These objectives can be attained by using a trust. Trusts have various benefits and advantages for the purposes of both estate and tax planning and are further discussed in chapter 3.

Due to the nature of this dissertation, it is important to conclude from this paragraph that although tax planning and minimisation may not be the main objective of estate planning, it clearly serves as an important consideration. Knowledge of the current tax objectives of estate planning is thus of great importance in order to assess the impact proposed taxation amendments will have on tax objectives as one of the considerations of a proper estate plan.

2.5 Estate duty

Although the focus of this study is the levying of income taxes on accruals received through a trust, a discussion of estate duty is of great relevance to determine the reason why one would use a trust to minimise the value of an estate.

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37 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.2.3.
38 Jacobs 2012 *Moneyweb's Tax Breaks* 4.
39 Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.2.1.
40 Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.2.1.
41 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.2.

Estate duty has not yet been abolished,[42] even though some optimists believe that it could happen in the near future.[43] Currently estate duty is levied[44] at a rate of 20%[45] of the dutiable amount[46] of an estate.[47] Although this percentage is lower than the 40% income tax levied upon income received by a trust, it can still amount to a sizeable sum, should the estate's dutiable amount reach into millions of rands.[48]

Consequently, estate and estate duty planning encompass the structuring of an individual's affairs in such manner as to curtail his/her estate duty liability[49] *inter alia* by composing an appropriate will and creating trusts as part of the estate planning process.[50] Honiball and Olivier justify this assertion:[51]

> A trust, especially a discretionary *inter vivos* trust, is a popular instrument for estate-planning purposes because the trust assets are regarded as separate from those of the founder/settlor as well as from those of an individual beneficiary.

The conclusion can be drawn from this statement that creating the *inter vivos* discretionary trust will effectively reduce the value of the estate by selling[52] the assets in the estate to the trust (thereby pegging the value of the assets). This minimises the dutiable amount of the estate because the assets form part of the trust and do not belong to the estate of the estate owner, which will in turn lessen the estate duty liability at death.

It should be noted that in practice it is mostly the assets of one of the trustees that are 'sold' to the trust, or assets acquired/bought by the trust itself. Rarely does the founder place his/her assets in the trust. It is thus very important from an estate

42 Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.5.2.2.2.
43 Jacobs 2012 *Moneyweb's Tax Breaks* 4.
44 Section 2 of the *Estate Duty Act* 45 of 1955.
45 First schedule of the *Estate Duty Act* 45 of 1955 Rate of Estate Duty.
46 Section 4a of the *Estate Duty Act* 45 of 1955.
47 Croome *Tax Law: An introduction* 7; Honiball and Olivier *The Taxation of Trusts in South Africa* 188.
48 Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.5.2.2.2.
49 Davis 2015 *et al Estate Planning* Lexis Nexis at par 1.2.3.
50 Honiball and Olivier *The Taxation of Trusts in South Africa* 188.
51 Honiball and Olivier *The Taxation of Trusts in South Africa* 198.
52 Mostly one of the trustees, not the founder, will sell their assets to the trust on an interest-free loan account and then bequeath the loan account to the trust in their will. If a trustee donates his/her assets to the trust, SARS will hold him/her liable for the payment of donations tax. That is why the interest-free loan account is the most popular and tax beneficial option.

planning point of view to start the estate planning process from an early stage in order for estate owners with large estates to purchase the assets by means of the trust *ab initio*.

It is therefore clear why the trust is such a popular mechanism to remove the estate owner's assets from his/her personal estate with the intent of decreasing his/her estate in order to reduce adverse or unfavourable estate duty implications.[53]

In this chapter the concepts 'estate' and 'estate planning' were defined to create the legal context for the reasons to use a trust as an estate planning tool. A trust not only assists in the minimisation of various taxes and estate duty, but also protects the assets of the estate owner and provides the dependants with income and capital.[54]

53 Hyland and Smith 2006 *JEPL* 1.

54 All of these objectives, which can be attained by means of a trust, are listed as estate planning objectives. The trust is therefore a means by which the estate planner can achieve his/her estate planning goals.

CHAPTER 3

Trusts

3 Trusts

3.1 Introduction

From the previous chapter it is ineluctable to see that trusts are widely considered as excellent estate planning instruments due to various reasons. To evaluate the future popularity of trusts as estate planning instruments for tax-related benefits, it is crucial to comprehensively discuss the function, nature and characteristics thereof.

> Trusts have now pervaded all fields of social institutions in Common Law countries. They are like those extraordinary drugs curing at the same time toothache, sprained ankles and baldness, sold by peddlers on the Paris boulevards; they solve equally well family troubles, business difficulties, religious and charitable problems. What amazes the sceptical civilian is that they really do solve them.[55]

Despite the trust being an estate planning tool taking on different forms, the specific type of trust relevant for this dissertation is the discretionary *inter vivos* trust and therefore all subsequent analyses will concentrate on this trust category. The relevance of specifically focussing on the discretionary *inter vivos* trust can be ascribed to fact that a discretionary trust is currently the preferred and most popular estate planning instrument,[56] the reasons of which are discussed as the chapter continues.

The proposals[57] within the 2013/2014 National Budget Speech[58] and SARS' renewed scrutinising attitude[59] towards trusts, call for, or rather demand, the assessment of trusts for the sake of effective and successful estate planning. The proposed amendments will apply to and affect the taxation of discretionary trusts and their

55 Davis 2015 *et al Estate Planning* Lexis Nexis at par 14.1.
56 Brink and Willemse 2014 *JEF* 796.
57 The specified proposals are discussed in chapter 5.
58 Gordhan 2014 *National Budget Speech* National Treasury.
59 Petersen *Taxation of a trust* 10.

beneficiaries. In order to answer the general research question an in-depth analysis needs to be done on this specific trust type.[60]

3.2 Origin of trusts

The law of trusts evolved during the Middle Ages in England within the body recognised in English law as 'equity', which was established and formed by the Court of Chancery.[61] This concept, together with countless other rules, laws and legislative measures, was assimilated by the South African legal system after the second occupation of the Cape.[62] The merging of the 'trust concept' was however not done by means of legislative intervention, but by English-trained practitioners who drew up wills and trusts.[63] This resulted in South African courts attempting to interpret English institutions which also led to the incorporation of the English trust as an institution,[64] but never incorporating the English law of trusts into South African law.[65]

Early lawyers and judges were British and, because of their unfamiliarity with the Dutch law, they improperly introduced English legal terms and principles/concepts into South African law by using the judicial technique.[66] Despite the initial derogation of the Roman-Dutch law by the English law, the South African common law is still firmly grounded in the rules and principles of the Roman-Dutch legal system.[67]

According to the initial English perception of a trust, it could be defined as:[68]

> the relationship which arises wherever a person called the trustee is compelled in Equity to hold property, whether real or personal, and whether by legal or equitable title for the benefit of some persons (of whom he may be one and who are termed *cestuis que* trust) or for some object permitted by law, in such a way that the real benefit of the property accrues, not to the trustee but to the beneficiaries or other objects of the trust.

60 Brink and Willemse 2014 *JEF* 796.
61 Honiball and Olivier *The Taxation of Trusts in South Africa* 2.
62 Olivier *et al Trust Law and Practice* Lexis Nexis at par 2.
63 Honiball and Olivier *The Taxation of Trusts in South Africa* 2.
64 Honiball and Olivier *The Taxation of Trusts in South Africa* 2.
65 *Estate Kemp v McDonald Trustees* 1915 (AD) 499.
66 Honiball and Olivier *The Taxation of Trusts in South Africa* 2.
67 Honiball and Olivier *The Taxation of Trusts in South Africa* 2.
68 Honiball and Olivier *The Taxation of Trusts in South Africa* 2.

Most other concepts of English jurisprudence have equivalents in other legal systems, but the trust is unique.[69] South African courts have however always been of the opinion that although the trust concept forms part of South African law, it is not a precise reflection of its English counterpart.[70] The South African law, with reference to trusts, had developed and evolved without any legislative intervention for many years.

Under the influence of the Roman-Dutch law, South African courts have developed and shaped a unique South African trust law through trial and practice, which does not resemble its current English counterpart.[71]

Despite the Law Commission's decision against the codification of trust law, their recommendations lead to the enactment of the *Trust Property Control Act* 57 of 1988 (hereafter the *TPCA*) for the purpose of the registration and administration of South African trusts.[72]

3.3 Statutory definition

Section 1 of the *TPCA*[73] defines a trust as follows:

> The arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed –
>
> (a) to another person, the trustee, in whole or in part, to be administered or disposed of according the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
>
> (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument, but does not include the case where the property of another is to

69 Honiball and Olivier *The Taxation of Trusts in South Africa* 2.
70 Honiball and Olivier *The Taxation of Trusts in South Africa* 10; *Estate Kemp v McDonald Trustees* 1915 (AD) 499.
71 Honiball and Olivier *The Taxation of Trusts in South Africa* 2.
72 Honiball and Olivier *The Taxation of Trusts in South Africa* 10.
73 57 of 1988.

be administered by any person as executer, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965 (Act 66 of 1965).

From this definition it can be derived that section 1(a) depicts the nature of a discretionary trust, because it stipulates that the 'ownership' in property of one person, the founder, is ceded or bequeathed to the trustee to be administered for either the benefit of the persons designated, the beneficiaries, or the achievement of the object stated in the trust instrument.

This section also encompasses the vesting trust which entails ownership still falling to the trustee, but the trustees have no discretion whether or not to distribute income or capital to the beneficiaries, since the beneficiaries have vested rights in the income or capital.[74] Subsequently a vested capital beneficiary enjoys the certainty that, upon the trust's dissolution, the assets will be distributed to them, even though the ownership thereof belonged to the trustees during the existence of the trust.[75]

Section 1(b) is the alternate case where the ownership of the property vests in the beneficiaries *ab initio* and the trustees never obtain ownership of the assets in the trust[76] – they merely retain control over the assets and administer or dispose thereof to the benefit of the beneficiaries or for the achievement of the object stipulated in the trust document. Such a trust is referred to as a 'bewind' trust and should not be confused with discretionary or vested trusts.[77] The focus of this study is on discretionary trusts, not vested or 'bewind' trusts.

It is of utmost importance not to confuse the nature of the trust with the nature of a beneficiary's right to income or capital. Beneficiaries of a discretionary trust can have either vested or discretionary rights to income and/or capital, or both, but the ownership of the trust assets never vests in those beneficiaries. In a 'bewind' trust, however, ownership of the trust assets belongs to the beneficiaries.

From a tax perspective it proves vital to determine the nature of a beneficiary's right to income accrued to a trust because it will ultimately govern whether the amounts

74 Honiball and Olivier *The Taxation of Trusts in South Africa* 5.
75 Honiball and Olivier *The Taxation of Trusts in South Africa* 5.
76 See s 1(b) of the *Trust Property Control Act* 57 of 1988 quoted in the above paragraph.
77 Honiball and Olivier *The Taxation of Trusts in South Africa* 5.

received are taxed in the hands of the beneficiary or the trust. The nature of a beneficiary's right in a discretionary trust, either vested or contingent (discretionary), is discussed in chapter 4.

Despite the fact that the *TPCA*[78] provides for the definition and stipulation of various rights and duties with regard to a trust, it does not regulate the actual creation or formation of a trust, nor does it conclusively address the legal nature of a trust.[79]

3.4 Legal nature

The Supreme Court of Appeal has placed it beyond all doubt that a trust is not a separate legal person or entity.[80] The court stated that:[81]

> Like a deceased estate, a trust, if clothed with juristic personality, would be like a persona or a legal entity consisting of an aggregate of assets and liabilities. Neither our authorities nor our Courts have recognised it as such a persona or entity. It is trite law that the assets and liabilities in a trust vest in the trustee.

The judgement given in *Braun v Blann and Botha* 1984 2 850 (A) was the defining step to emphasise the uniqueness of the trust as a distinct legal institution – it is *sui generis* and differs from any other entity in the law of South Africa.[82] A trust is not a legal person, but despite this particular characteristic, it can be a debtor in terms of the *Insolvency Act* 24 of 1963[83] and can also qualify as a beneficiary under the terms of a will.[84] To comprehend the function of a trust as a unique legal entity, yet not a juristic person,[85] the following definition serves as the basis for the consequent discussion of a trust and its benefits within the context of estate planning.

A trust is a legal relationship created by the founder (also known as either the donor or settlor) who then places assets under the control of another person(s) known as

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78 57 of 1988.
79 Marais *The taxation of income and expenditure of trusts in South Africa* 8.
80 Honiball and Olivier *The Taxation of Trusts in South Africa* 9.
81 *CIR v MacNeillie's Estate* 1961 3 SA 833 (A) 840F-G.
82 In *CIR v MacNeillie's Estate* 1961 3 SA 833 (A) 859E-H it was said: "In its strictly technical sense the trust is a legal institution *sui generis*".
83 *Magnum Financial Holdings (Pty) Ltd v Summerly* 1984 1 SA 160 (W).
84 Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.1, *Burnett v Kohlberg* 1984 2 SA 137 (E).
85 Honiball and Olivier *The Taxation of Trusts in South Africa* 9.

the trustee(s).[86] With reference to an *inter vivos* trust, this process occurs during the founder's lifetime.[87] The rationale behind this legal relationship is that the assets of the founder within the trust will be administered by the trustees to the benefit of third persons called the beneficiaries.[88]

In section 1 of the *ITA*[89] a 'trust' is defined as:

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

In *CIR v Friedman* 1993 1 SA 353 (A) the court determined that a trust did not qualify as a person under the provisions and rules of common law. As a result of the decision in this case the definition of a 'person' for income tax purposes was extended through legislative measures to also encompass a trust. The rationale behind this expansion of the scope of the definition of a 'person' was for SARS to extend or broaden their tax base.[90] Thus the trust is currently considered a 'person' for income tax purposes.[91]

The effect of the fact that a trust is now considered a person for tax purposes is that any income or accruals that remain in the trust. In other words: amounts not distributed to the beneficiaries, will effectively be taxed in the hands of the trust at the applicable rate.

A trust can either be created by a contract, which will be an *inter vivos* trust, or by the will of a testator, called a testamentary trust or a *mortis causa* trust.[92] In the case of *Crookes v Watson* 1956 1 SA 277 (A) the court accepted the notion that an

86 Goodall *et al The South African Financial Planning Handbook* par 33.2, Honiball and Olivier *The Taxation of Trusts in South Africa* 3.

87 Goodall *et al The South African Financial Planning Handbook* par 33.4.1, Honiball and Olivier *The Taxation of Trusts in South Africa* 4.

88 Goodall *et al The South African Financial Planning Handbook* par 33.2.

89 58 of 1962.

90 Croome *Tax Law: An introduction* 8.

91 Section 1 of the *ITA*: 'person' includes- (a) an insolvent estate; (b) the estate of a deceased person; (c) **any trust**; and (d) any portfolio of a collective investment scheme.

92 Marais *The taxation of income and expenditure of trusts in South Africa* 8.

inter vivos trust is a contract for the benefit of a third person, also known as the *stipulatio alteri* as mentioned earlier.[93]

Even though the trust in theory is not a separate legal or juristic person, the *ITA*[94] does in fact define it as a 'person' for income tax purposes and in addition to that the *Companies Act* 71 of 2008 furthermore defines a trust as a 'juristic person'.

3.5 Types of trusts

Trusts as estate planning instruments take on various forms and can be categorised based on the different criteria of their creation and function.[95] Apart from the categories of *inter vivos* and *mortis causa* (trusts created during the founder's lifetime and the trusts created after the testator's death) a further distinction can be made between a vested and a discretionary trust.[96] From a tax point of view it is crucial to establish the nature of both the trust and the beneficiary's rights to determine whether the income or amounts accrued to the trust will be taxed in the hands of the beneficiary or the trust.[97]

3.5.1 Inter vivos trusts

When a founder makes over his/her assets to the trustees by means of a contract during his/her lifetime, an *inter vivos* trust is created.[98] A trust deed is drawn up and contains all the terms, provisions and conditions.[99] Within this deed the trustees contractually agree to not only take ownership of the said assets, but also to administer it to the benefit of the nominated beneficiaries.[100]

This type of trust can be utilised for, among other advantages, receiving property from the estate owner (also the founder) in order to 'peg the value' of the estate in the owner's hands.[101] In laymen's terms this benefit means the *inter vivos* trust is

93 Marais *The taxation of income and expenditure of trusts in South Africa* 8.
94 58 of 1962.
95 Marais *The taxation of income and expenditure of trusts in South Africa* 11.
96 Honiball and Olivier *The Taxation of Trusts in South Africa* 4.
97 Honiball and Olivier *The Taxation of Trusts in South Africa* 4.
98 Marais *The taxation of income and expenditure of trusts in South Africa* 12.
99 Marais *The taxation of income and expenditure of trusts in South Africa* 12.
100 Marais *The taxation of income and expenditure of trusts in South Africa* 12.
101 Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.2.3.

used to 'minimise' the value of the founder's estate in order to diminish his/her personal tax liability.

This living trust created between living people is used on a large scale in practice and is very popular within the estate planning milieu for various reasons, including the previously mentioned tax benefits.[102] The *inter vivos* trust can furthermore be divided into the categories of either vested or discretionary trusts.[103]

3.5.2 Discretionary trusts

A discretionary trust refers to a trust where the founder confers discretion upon the trustees to decide which beneficiaries will be entitled to the income and/or capital accrued to a trust, as well as the amount to be distributed to these beneficiaries.[104] The trust deed determines the degree to which trustees have discretion.[105] Trustees are not under obligation to distribute the income and/or capital to the nominated discretionary beneficiaries[106] and therefore beneficiaries have a right, but the right is a mere *spes* or hope.[107]

This means that the beneficiaries are merely beneficiaries in name and they only retain a contingent right.[108] In the case of *Durban City Council v Association of Building Societies* 1942 27 (AD) 33 Watermeyer described the contingent right to be "the conditional nature of someone's title to the right".[109] Due to the contingent nature of a discretionary beneficiary's right, the right cannot be transferred to their successors at death or insolvency.[110]

In South Africa it is primarily these types of discretionary trusts that are used for estate planning purposes.[111]

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102 Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.2.3.
103 A discussion of vesting trusts is not within the ambit of this dissertation.
104 Croome *Tax Law: An introduction* 381.
105 Marais *The taxation of income and expenditure of trusts in South Africa* 13.
106 Goodall *et al The South African Financial Planning Handbook* par 33.4.1.
107 Honiball and Olivier *The Taxation of Trusts in South Africa* 6.
108 Croome *Tax Law: An introduction* 381.
109 Croome *Tax Law: An introduction* 381.
110 Marais *The taxation of income and expenditure of trusts in South Africa* 13.
111 Petersen *Taxation of a trust* 13.

3.6 Tax advantages of a discretionary inter vivos trust

Notwithstanding the numerous benefits and advantages of trusts, especially with regard to taxes, it is important to note that South African law places no time limits on the duration of a trust.[112] A founder has the discretion to determine the trust period in the trust deed.[113] This leniency, within the regulatory framework of trust law, makes the trust an exceedingly popular estate planning instrument. The fact that there is no time limit on a trust makes it the ideal instrument for the continuance of a business entity, because a business can continue by means of a trust without the activities being interrupted by either members' death or their insolvency.[114] With reference to family trusts it is therefore also a great 'generation-skipping' instrument for estate-duty planning purposes, in that the children draw only income and capital gains from the trust during their lifetime, while ownership in the assets will only pass to the grandchildren in due course.[115]

A proper and extensive discussion on all the benefits and advantages of a discretionary *inter vivos* trust is not feasible within the ambit of this dissertation and consequently only the appropriate and applicable tax-related advantages are discussed. Certain core principles have however been absorbed and with the aid of the most recent literature on trust-taxation it should prove possible to concentrate on the tax advantages necessary for the aim of this study.[116]

Despite the fact that trust income and/or capital gains are subject to higher tax rates than other entities or individuals in certain circumstances,[117] trusts still offer significant tax-related benefits.[118] One of the most common mechanisms that can be

112 Honiball and Olivier *The Taxation of Trusts in South Africa* 11.
113 Honiball and Olivier *The Taxation of Trusts in South Africa* 11.
114 Honiball and Olivier *The Taxation of Trusts in South Africa* 11.
115 The Katz Commission recommended that trusts should be taxed at periodic intervals on their net assets, but this recommendation was not followed; Davis 2015 *et al Estate Planning* Lexis Nexis at par 14.3; Honiball and Olivier *The Taxation of Trusts in South Africa* 11.
116 Davis 2015 *et al Estate Planning* Lexis Nexis at par 7.
117 A trust pays tax at a flat rate of 40% of taxable income, representing the highest tax rate. Furthermore, a trust is also taxed at the highest rate with regard to capital gains tax at an inclusion rate of 66.6% of the net capital gain of the trust. A trust does not qualify as a natural person and will therefore not be able to use the primary, secondary or tertiary rebates, or the annual capital gains tax exclusion of R30 000.
118 Honiball and Olivier *The Taxation of Trusts in South Africa* 12.

used to obtain tax benefits through a trust is the splitting of income. This entails that not only the tax liability of the trust is diminished, but the overall tax liability of the beneficiaries as well, due to the possible tax exclusions that individuals may qualify for.[119]

To illustrate this beneficial trust-mechanism an example can be utilised:

Chris (the founder) created the Swart Family Trust with his children (adults) Rona and Adriaan as the income beneficiaries. Chris holds shares in a private company and the dividends are declared to the trust. The trustees exercise their discretion within the year of accrual and distribute half the dividends to Rona and the other half to Adriaan.

This means that the trust itself does not pay income tax on the dividends received[120] and the dividends received by Rona and Adriaan are exempt from income tax in accordance with section 10(1)(k)(i) of the *ITA*[121].

This example also illustrates the function and advantage of the conduit pipe principle since the dividends declared to the trust retain their nature when distributed to the beneficiaries – which allows the beneficiaries to make use of income tax exemptions when the accruals are taxed in their hands.[122]

Pretorius[123] confirms and highlights the advantage of splitting income through the use of a discretionary trust:

> In addition we can go further and split the income or gain to various beneficiaries as opposed to just a single beneficiary. By so doing, we can apply the thresholds, deductions, exemptions and rebates applicable to individuals, in respect of income and the annual exclusion applicable to individuals, in respect of capital gains, to each beneficiary to whom the income or gain is distributed or awarded by the application of the conduit principle.

119 Honiball and Olivier *The Taxation of Trusts in South Africa* 13 give a list of a few tax exclusions.
120 Section 25b *ITA*.
121 58 of 1962 and the description of section.
122 The effect of the abolishment of the conduit pipe on the nature of accruals such as dividends and interest are discussed in chapter 4 and 5.
123 Pretorius 2014 *Tax Talk* 17.

She depicts this income-splitting "instrument" by means of her own example:[124]

> By way of a simple example, if a trust makes R300 000 capital gain, we could split the gain to three of the beneficiaries at say a R100 000 each. Each beneficiary would then be able to subtract the R30 000 annual exclusion from the capital gain of R100 000, thus making the taxable gain in each of their hands R70 000. Assuming each beneficiary is on the highest capital gains tax rate of 13.3% the net effect of this would be 13.3% of R210 000 as opposed to distributing or awarding the gain to only one beneficiary, where the net effect would be 13.3% of R270 000.

The tax effect would have been far worse should the R300 000 have remained in the trust (due to the high tax rate applicable to trusts).[125]

Trusts are furthermore used in estate planning to minimise estate duty and capital gains tax that may arise on death of the founder.[126] This key advantage works as a perfect tool for so-called 'estate freezing' – a person can sell growth assets to a trust and any increase in the value of these assets will be excluded from the individual's capital gains tax that may arise on death and will also be excluded from his/her dutiable estate for the purposes of estate duty.[127] This outcome is attainable due to the fact that the growth of said assets takes place within the trust itself.[128] Apart from the income tax,[129] capital gains tax and estate duty benefits, trusts also offer donations tax benefits considering that the distribution of trust property to beneficiaries is not regarded as a donation.[130]

The relevance of discussing the tax benefits of discretionary *inter vivos* trusts is founded upon the fact that the South African Minister of Finance, together with the DTC, is proposing a number of amendments ostensibly aimed at turning this type of trust into an unattractive tool for tax-advantage purposes.[131]

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124 Pretorius 2014 *Tax Talk* 17.

125 The net tax effect thereof would have amounted to R80 100.

126 Goodall *et al The South African Financial Planning Handbook* par 33.1.

127 Goodall *et al The South African Financial Planning Handbook* par 33.1.

128 Goodall *et al The South African Financial Planning Handbook* par 33.1.

129 Discussed in depth in chapter 4 together with section 25b.

130 Olivier *et al Trust Law and Practice* Lexis Nexis at par 8.1.

131 Petersen *Taxation of a trust* 13; Davies Tax Report; Gordhan 2014 *National Budget Speech* National Treasury.

CHAPTER 4

Conduit Pipe Principle

4 Conduit pipe principle

4.1 History and introduction

A trust, especially a discretionary *inter vivos* trust, is by nature a *stipulatio alteri*.[132] It is created and structured in such a way that the trustees manage, control and administer the trust assets to the benefit of the beneficiaries.[133] It is clear that trusts are conduits by nature in which the trustees hold and administer the assets on behalf of the beneficiaries until such time as the assets (income or capital) are distributed to them.[134]

To establish the origin of this conduit pipe principle[135] and the flow-through nature of the trust, a brief overview of the history of its development throughout the South African case law up to its current form in legislature is provided.

The previous chapters serve as background for the following discussion. Now that it has been established that trusts play an important role in the estate planning process as extremely beneficial planning instruments,[136] and that trusts offer various benefits including great tax benefits,[137] it is necessary to discuss how tax benefits are currently obtained by means of trusts. This chapter ultimately gives a critical discussion on the function and use of section 25b of the *ITA* (the conduit pipe principle) together with its effect on trusts as a method of obtaining tax benefits.

Even before this conduit principle or flow-through nature of trusts was codified in South African legislation, it was clear from case law that it proved one of the main features and attractions of a trust. The very first mention of the conduit pipe

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132 Rabenowitz *et al South African Financial Planning Handbook* 821.
133 Stiglingh *et al SILKE: Suid-Afrikaanse Inkomstebelasting* 874.
134 Van Gijsen 2015 *The Taxpayer* 116.
135 Note that the 'conduit pipe principle' not only implies the flow-through of income in a trust, but also refers to capital gains as per paragraph 80 of the Eighth Schedule to the *Income Tax Act,* which is discussed later in this chapter.
136 See chapter 2.
137 See chapter 3.

principle in South African case law appeared in *Commissioner for Inland Revenue v Polonsky* 1942 TPD 249 where the court found that the trustees of a trust are no more than a mere 'conduit pipe' because they have no material interest in the income of the beneficiaries.[138] The judge remarked:[139]

> In short, therefore, I rise from a perusal of the will and the facts of the stated case with a conviction that the balance of the income retained by the trustees belongs to the respondent's wife and to no one else; that the trustees are no more than a conduit pipe and have no material interest in her income.

Later this transpired in *Armstrong*-case where the court held that income received by a beneficiary from a trust retains its nature.[140] In this case the appellant disclosed an income of £2 469, within the relevant year of assessment, as received by a trust.[141] In her tax return she divided said income as follows: £1 495 as derived from dividends and another £974 as received from rent and interest.[142]

Although dividends were not subject to tax at that time, the commissioner levied standard income tax on the entire amount received.[143] The court clearly stated that a trust (by means of its trustees) is nothing more than a conduit pipe and that the beneficiary was therefore entitled to the applicable dividend exemption.[144] The result of this judgement is that, if the trust income includes both taxable and exempt receipts/accruals, the beneficiaries are entitled to the exemptions available in terms of the *ITA* on a pro-rata basis.[145]

The principle was confirmed yet again in *Estate Dempers v SIR* 36 SATC where the court highlighted that income capitalised by a trustee will retain its identity despite a contradictory provision in the relevant trust deed.[146] In a subsequent decision, relying upon *Estate Dempers*, the court held that income received by a trust "does

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138 Honiball and Olivier *The Taxation of Trusts in South Africa* 72.
139 On page 245 of the judgement.
140 Honiball and Olivier *The Taxation of Trusts in South Africa* 72; Stiglingh *et al SILKE: Suid-Afrikaanse Inkomstebelasting* 877.
141 Honiball and Olivier *The Taxation of Trusts in South Africa* 72.
142 Honiball and Olivier *The Taxation of Trusts in South Africa* 72.
143 Honiball and Olivier *The Taxation of Trusts in South Africa* 72.
144 *Armstrong v CIR* 1938 AD 343; Honiball and Olivier *The Taxation of Trusts in South Africa* 72.
145 Stiglingh *et al SILKE: Suid-Afrikaanse Inkomstebelasting* 877; Honiball and Olivier *The Taxation of Trusts in South Africa* 72; *SIR v Rosen* 1971 A.
146 Honiball and Olivier *The Taxation of Trusts in South Africa* 72.

not lose its essential character of being income” when it is distributed to the beneficiaries.[147]

Another example that depicts the effect of the conduit pipe follows:[148] Should interest be received by the trust and the trustees distribute the interest to a beneficiary, the income will retain its nature as 'interest' and be treated as such in the hands of the beneficiary for tax purposes[149] – in other words the interest will be exempt from income tax in accordance with section 10(1)(i) of the *ITA*.[150]

Due to the regular reference made to the conduit pipe principle in case law, the legislator decided to amend the taxation laws applicable to trusts in order to create clarity with regard to the taxation of income accrued to a trust and distributed to beneficiaries.

4.2 Conduit pipe in current legislation

It is clear from the previous discussion and previous case law that the conduit pipe has a long history and is settled quite firmly in the concept and structure of trusts as a common law principle. However, all the cases under discussion were decided upon before a trust was considered a 'person' for income tax purposes and therefore it was only logical that the beneficiaries were liable for the taxes levied upon any accruals distributed to them by means of a trust.

The definition of 'person' for income tax purposes was extended by legislature as a result of the decision in *Commissioner for Inland Revenue v Friedman* 1993 1 SA 353 (A) in which the court held that a trust does not constitute a 'person' under the common law rules.[151] Now that trusts are included in the definition of a 'person' for both income and capital gains tax purposes, the possibility exists for the income/capital received by a trust, to be taxed in either the hands of the trust, or those of the beneficiaries entitled to said amounts of income or capital.

147 Honiball and Olivier *The Taxation of Trusts in South Africa* 72.
148 Rabenowitz *et al South African Financial Planning Handbook* 837.
149 Rabenowitz *et al South African Financial Planning Handbook* 837.
150 58 of 1962.
151 Honiball and Olivier *The Taxation of Trusts in South Africa* 65.

With the inclusion of trusts in the definition of 'person' for income tax purposes, section 25b[152] was simultaneously enacted in order to govern the taxation of trust income.[153] This creation by the legislature can therefore be seen as the statutory codification of the common law conduit pipe principle. Together with section 25b similar flow-through provisions with accompanying tax rules were enacted by means of paragraph 80 of the Eighth Schedule to the *ITA*[154] to govern the taxation of capital gains received by a trust.[155] These two provisions are examined in the following paragraphs.

4.2.1 Section 25b(1)

Section 25b currently stipulates the following with regard to the taxation of trust income:[156]

> 25b Income of trusts and beneficiaries of trusts
>
> (1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to the trust.

This first subsection means that an amount that accrues to a trust will either be taxed in the hands of the trust at the applicable trust tax rate (currently 40%) or will be subject to tax in the hands of the beneficiary.[157] It will therefore never be subject to double tax. Section 25b(1) also serves as the general tax principle regarding the taxation of trust income and states that the application of the section is subject to the provisions set out in section 7, which constitutes the tax back or attribution provisions.[158] The effect of this provision is that wherever section 7 might find

152 58 of 1962.
153 Van Gijsen 2015 *The Taxpayer* 109.
154 *ITA* 58 of 1962.
155 Van Gijsen 2015 *The Taxpayer* 109.
156 *ITA* 58 of 1962.
157 Honiball and Olivier *The Taxation of Trusts in South Africa* 74.
158 Honiball and Olivier *The Taxation of Trusts in South Africa* 74.

application, section 25b will not apply. Trust income can therefore never be subject to tax in accordance with both sections 25b and 7.[159]

4.2.2 Section 25b(2)

When a trust has beneficiaries with both discretionary and vested rights, the taxation of the income will be determined by section 25b(1) in the case of a beneficiary with a vested right to income and section 25b(2) will apply in the case of beneficiaries with discretionary (contingent) rights.[160]

Section 25b(2) determines the following with reference to the taxation of trust income in the case of beneficiaries with contingent rights:[161]

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

The effect of this section is that if an amount is distributed to a beneficiary by means of the trustee exercising his/her discretionary powers, the beneficiary acquires a 'vested' right to receive that amount,[162] because this section deems it an amount derived for the benefit of that beneficiary and therefore it not be taken into account when the trust's tax liability is determined (in other words: the amount will be taxed in the hands of the beneficiary).[163]

Under scrutiny, the wording of this subsection only applies to discretionary trusts, as opposed to vesting or bewind trusts.[164] Therefore it is the most important section for the purposes of this dissertation, since the ambit of this study focuses on the flow-

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159 Honiball and Olivier *The Taxation of Trusts in South Africa* 74.
160 Honiball and Olivier *The Taxation of Trusts in South Africa* 75.
161 *ITA* 58 of 1962.
162 This is one of SARS's greatest concerns regarding trusts – s b(2) does not require the amount to be received, but only stipulates that the beneficiary "has acquired a vested right to an amount". Trusts can therefore award an amount of income, but never actually pay out the amount. It is kept on a loan account within the trust. In reality the income belongs to the beneficiary, but the trust keeps it and invests it further.
163 Honiball and Olivier *The Taxation of Trusts in South Africa* 75.
164 Section 25b(2) of the *ITA*; Honiball and Olivier *The Taxation of Trusts in South Africa* 75.

through nature (conduit pipe principle) of discretionary trusts and the possible abolishment thereof. When this conduit pipe principle is applied, it effectively avoids economic double tax due to the fact that an amount must either be taxed in the hands of the trust or the beneficiary to whom the income is distributed.[165]

Another extremely important and beneficial result of the application of the conduit pipe principle is that the income distributed by the trustees to the beneficiaries retains its original nature.[166] This section, with its dual function of regulating the taxation of trust income together with allowance for income to retain its identity, is applicable regardless of the way in which the trust was created (whether *inter vivos* or by means of a will).[167] It is therefore submitted that the conduit pipe principle has been and remains to be an essential component of the taxation of trusts in South Africa due to the fact that it favours neither the fiscus, nor the taxpayer.[168]

4.2.3 Section 25b(3)

Subsection (3) of section 25b provides for the deductions and allowances that may be made for income tax purposes:[169]

> (3) Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any amount referred to in subsection (1), must, to the extent to which that amount is under that subsection deemed to be an amount which has accrued to –
>
> (a) a beneficiary, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary;
>
> (b) the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that trust.

The result of the application of this subsection is that the expenses are deducted in the same proportion to which the income has been allocated by the trustees to each of the involved beneficiaries and between the beneficiaries and relevant trust.[170]

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165 Honiball and Olivier *The Taxation of Trusts in South Africa* 75.
166 Honiball and Olivier *The Taxation of Trusts in South Africa* 76.
167 Honiball and Olivier *The Taxation of Trusts in South Africa* 76.
168 Honiball and Olivier *The Taxation of Trusts in South Africa* 76.
169 *ITA* 58 of 1962.

It appears from the wording of this subsection that it is only applicable to beneficiaries referred to in subsection (1).[171] If that is indeed the case, it means that beneficiaries with contingent rights, who receive income by means of the trustees exercising their discretionary powers, are not entitled to claim a deduction of expenditure incurred by the trust, even though those beneficiaries will be liable for the tax levied upon the income they receive.[172] On the other hand it is very clear that undistributed income will be taxed in the hands of the trust, who, by way of section 25b(3) will be entitled to claim the deductions and allowances.

This subsection may at first glance seem to benefit or favour beneficiaries with vested rights over a discretionary beneficiary with a mere contingent right, but in practice this loophole proves no real challenge since the trustee could merely distribute the net income (allowing it to vest in the discretionary beneficiary) after deducting any 'related expenditure'.[173] In essence this places the discretionary beneficiary in the same position as the vested beneficiary claiming the deduction of related expenditure himself/herself.[174]

4.2.4 Section 25b(2a)

This section stipulates that income received by a resident beneficiary acquires a vested right to any amount representing capital of any offshore trust (non-resident trust. That amount must be included in the income of the resident beneficiary during the year of assessment in specified circumstances.[175] These provisions will apply if the capital that arose from any receipts and accruals of such trust and it would constitute income if such trust had been a resident in any previous tax assessment year during which the resident beneficiary had a contingent right to the relevant

170 Honiball and Olivier *The Taxation of Trusts in South Africa* 80.

171 Should a trust, for instance, acquire operating income and award it to a beneficiary, the beneficiary will not be able to deduct operation expenses in terms of section 11 of the *ITA*. The trustees will have to carefully consider where they prefer the income to be taxed.

172 Honiball and Olivier *The Taxation of Trusts in South Africa* 81.

173 Section 25b(3) stipulates that the deductions be made 'to the extent' that an amount is deemed to have accrued to a beneficiary. This gives the impression that unrelated expenditure cannot be deducted. Once again the trustee can simply deduct the expenditure related to the income and distribute the net income.

174 Honiball and Olivier *The Taxation of Trusts in South Africa* 82.

175 Honiball and Olivier *The Taxation of Trusts in South Africa* 77.

amount, and if that amount had not been subjected to tax in South Africa in accordance with the *Income Tax Act.*[176]

It is clear from the words 'offshore' and 'non-resident' that this subsection does not fall within the ambit of this discussion, as the dissertation topic is limited to resident trusts only. Therefore the effect of this section will not be analysed or discussed further in any detail.[177]

4.2.5 Sections 25b(4) to (7)

Subsections 24b(4) to (7) contain all restrictions and limitations on the deductions and allowances that may be made in the determination of the taxable income derived by the beneficiary of a trust.[178] These provisions are otherwise referred to as 'ring-fencing' provisions.[179]

These subsections provide as follows:[180]

> (4) The deduction or allowance contemplated in subsection (3) which is deemed to be made in the determination of the taxable income of a beneficiary of a trust during any year of assessment, shall be limited to so much of the amount deemed to have been received by or accrued to that beneficiary in terms of subsection (1), as included in the income of that beneficiary during that year of assessment.
>
> (5) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the amount included in the income of the beneficiary during a year of assessment as contemplated in that subsection:
>
> (a) is deemed to be a deduction or allowance which may be made in the determination of the taxable income of the trust during that year: Provided that the sum of those deductions and allowances shall be limited to the taxable income of that trust during that year of assessment as calculated before allowing any deduction or allowance under this subsection; or

176 58 of 1962; Honiball and Olivier *The Taxation of Trusts in South Africa* 77.
177 The existence and importance of the other subsections of s 25b with regard to the taxation of trusts is however acknowledged, but it falls outside the ambit of this dissertation to critically analyse these subsections in order to answer the posed research question.
178 As per s 25b(3) discussed in 4.2.3.
179 Honiball and Olivier *The Taxation of Trusts in South Africa* 82.
180 Sections 25b(4) to (7) of the *ITA* 58 of 1962.

(b) where the trust is not subject to tax in the Republic, must be carried forward and be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary by way of amounts referred to in subsection (1) during the immediately succeeding year of assessment.

(6) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the sum of the amount included in the income of the beneficiary as contemplated in subsection (4) and the taxable income of the trust as contemplated in subsection (5)(a), must be deemed to be a deduction or allowance for purposes of subsection (3), which may be made in the determination of the taxable income derived by that beneficiary by way of any amount referred to in subsection (1) during the immediately succeeding year of assessment.

(7) Subsections (4), (5) and (6) do not apply in respect of any amount which is deemed to have accrued to any beneficiary in terms of subsection (1), where that beneficiary is not subject to tax in the Republic on that amount.

Although all of the above subsections only refer to amounts as derived per subsection (1), the net effect in practice remains the same for discretionary beneficiaries.

4.3 Subordinate sections applicable to section 25b

In the first subsection of section 25b, subsection (1), it is provided that the effect and application of the section is subject to section 7.[181] When this section[182] is read together with section 25b, four possibilities of whom to tax with regard to trust income are set out:[183]

(a) Income retained in a trust, will be taxed in the hands of the trust.[184]

[181] 25b Income of trusts and beneficiaries of trusts
(1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, **subject to the provisions of section 7**, to the extent to which the amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which accrued to the trust.

[182] Note that s 7 is not limited to trusts or trust income, but subsections 7(3) to (8) all apply to trusts to some extent and subsections 7(5) and (8) are of particular importance to trusts.

[183] Adapted and elaborated on from Croome *et al Tax Law: An introduction* 385.

[184] Section 25b(1) of the *ITA* 58 of 1962.

(b) Income that accrues to ascertained beneficiaries who retain a vested right to the income will be taxed in the hands of those beneficiaries.[185]

(c) Income that accrues to ascertained beneficiaries by means of the trustees exercising their discretionary rights within the year of assessment[186] will be taxed in the hands of the discretionary beneficiaries.[187]

(d) Income can be taxed in the hands of the donor (founder of the trust) if any of the circumstances provided for in section 7 come into play.[188]

Section 7 ('tax-back' provision) contains the various anti-avoidance provisions which determine certain situations when income is deemed to have accrued or have been received by persons who legally did not accrue nor actually receive the income (in most instances the donor or founder of the trust).[189]

The general aim of this section is to counter or prevent tax avoidance,[190] because it provides that income will be deemed to have accrued to a person notwithstanding that such income has been invested or capitalised by him/her or has not actually been paid to him/her.[191] In other words: the donor makes a donation or deemed donation/disposition towards the trust, but does not permit the beneficiary to enjoy the income derived from the trust by means of deeming the income to be that of the donor.[192] The core requirement for the application of any of the provisions in section 7 and its subordinate subsections is that the disposition, disposal or donation had to be made with the aim of avoiding the tax liability of the relevant donor.[193]

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185 Section 25b(1) of the *ITA* 58 of 1962.

186 Note that the year of receipt of the amount of income needs to be the same year of assessment in order for the conduit pipe to find application.

187 Section 25b(2) of the *ITA* 58 of 1962.

188 Croome *et al Tax Law: An introduction* 385; s 7 of the *ITA* 58 of 1962.

189 Croome *et al Tax Law: An introduction* 386; Honiball and Olivier *The Taxation of Trusts in South Africa* 84.

190 Croome *et al Tax Law: An introduction* 387.

191 Honiball and Olivier *The Taxation of Trusts in South Africa* 84.

192 Croome *et al Tax Law: An introduction* 387.

193 Honiball and Olivier *The Taxation of Trusts in South Africa* 84; There are, however, various other prerequisites stipulated for the application of the various sections, but in essence the section in its whole aims to prevent tax avoidance and that is why the goal or intention of avoidance of tax liability is crucial.

This section is inseparable from section 25b, but in order to answer the research question that relates to the possible abolishment of the conduit pipe principle, it is assumed, with regard to the rest of this discussion as well as for the case study in chapter 5, that none of the provisions of section 7 is applicable. Therefore it is assumed that there are no scams or tax avoidance practices in relation to the *inter vivos* discretionary trusts being analysed in this dissertation.

This limits the discussion to discretionary trusts where the tax liability can only rest with either the trusts itself or the beneficiaries of that trust. The possible tax liability of the founder/donor in accordance with section 7 will be ignored as it does not affect the future existence of the conduit pipe and falls outside the ambit of this discussion.

4.4 Paragraph 80 of the Eighth Schedule to the Income Tax Act

Paragraph 80 of the Eighth Schedule to the *ITA*[194] provides for and regulates the attributions of capital gains to the resident beneficiaries of a local trust. Furthermore these paragraphs only apply to capital gains – it does not regulate capital losses and there are no provisions which allow for capital losses to flow to a beneficiary through a trust.[195] The effect hereof is that no matter what gains are distributed or vested in the beneficiaries, the trust will remain with whatever capital losses it incurs.[196]

Assets within a discretionary trust are treated as assets of the trust itself for capital gains tax purposes, until such time as the asset vests in one of the trust's beneficiaries.[197] There will only be a capital gains tax liability for a discretionary trust if the trust made a 'real' or 'deemed' disposal.[198] The vesting of an asset in a beneficiary constitutes a disposal for capital gains tax purposes and will be deemed a

194 58 of 1962.

195 Honiball and Olivier *The Taxation of Trusts in South Africa* 138; There are also no provisions that attribute capital losses of the trust to the donor.

196 Honiball and Olivier *The Taxation of Trusts in South Africa* 138.

197 Marais *The taxation of income and expenditure of trusts in South Africa* 30.

198 Marais *The taxation of income and expenditure of trusts in South Africa* 30.

market value disposal in accordance with paragraph 11(1)(d) read together with paragraph 38 of the Eighth Schedule.[199]

When the court confirmed the conduit pipe principle in the case of *SIR v Rosen* 1971 (1) SA 177 (A),[200] it also stated that the principle is "for general application in our system of taxation in appropriate circumstances".[201] This statement consequently implies that the conduit pipe principle should also be applied in case of capital gains being distributed by the trust to the beneficiaries and that it should retain its nature by means of the conduit pipe.[202]

To understand the function of the conduit pipe principle as codified in paragraph 80, a critical analysis of the wording of the paragraph must be done:[203]

> 80 Capital gain attributed to beneficiary
>
> (1) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary (other than any person contemplated in paragraph 62(a) to (e)) who is a resident, that gain –
>
> (a) must be disregarded for the purposes of calculating the aggregate capital gain or aggregate capital loss of the trust; and
>
> (b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary to whom that asset was so disposed of.
>
> (2) Subject to paragraphs 68, 69, 71 and 72, where a capital gain is determined in respect of the disposal of an asset by a trust in a year of assessment during which a trust beneficiary (other than any person contemplated in paragraph 62(a) to (e)) who is a resident has a vested interest or acquires a vested interest (including an interest caused by the exercise of a discretion) in that capital gain but not in the asset, the disposal of which gave rise to the capital gain, the whole or portion of the capital gain so vested-

199 *ITA* 58 of 1962; According to the provisions in these paragraphs a trust is a connected person in relation to beneficiaries.
200 32 SATC 249.
201 *SIR v Rosen* 1971 1 SA 177 (A), 32 SATC 249 at 267; Honiball and Olivier *The Taxation of Trusts in South Africa* 139.
202 Honiball and Olivier *The Taxation of Trusts in South Africa* 139.
203 Paragraph 80 of the Eighth Schedule of the *ITA* 58 of 1962.

(a) must be disregarded for the purposes of calculating the aggregate capital gain or aggregate capital loss of the trust; and

(b) must be taken into account for the purpose of calculating the aggregate capital gain or aggregate capital loss of the beneficiary in whom the gain vests.

In subparagraph (1) it is clear that the gain that arose from the vesting of an asset in a beneficiary will be included in the aggregate capital gain/loss of the beneficiary whom received the interest in the asset.

Subparagraph (2) stipulates that a capital gain that arises from the disposal of an asset by the trust will be included in the aggregate capital gain/loss of the beneficiary who receives an interest in that capital gain (either vested or discretionary beneficiary) should they receive the interest in the same tax assessment year when the capital gain was realised.

There will be no mention of or discussion on subparagraph (3) due to the fact that it regulates the taxation of amounts representing capital gains of trusts that are non-resident.[204]

From these paragraphs it is clear that the conduit pipe principle with regard to capital gains is similar to the one in terms of trust income. The distribution and time thereof will determine in whose hands the amount will be taxed. The capital gains conduit is however much more restrictive than the income conduit within trusts. The reason therefore can be summarised as follows:[205]

> The reason why this particular statutory conduit principle is more restrictive is that the term 'the trust' in subparagraph 80(1)(a) refers to the same trust as in the opening subparagraph 80(1), namely, the trust that determined the capital gain in respect of the vesting of the asset. Any other trust which receives an asset from the first trust, would require the asset at a base cost equal to market value in terms of paragraph 38 because it would be a beneficiary of the first trust and consequently a connected person in relation to the first trust. Accordingly, there will be no capital gain 'determined' in the beneficiary trust when it onward distributes the asset, as required by subparagraph 80(1).

204 Subparagraph (3) of the Eighth Schedule to the *ITA* 58 of 1962; This discussion is limited to the taxation of resident trusts.
205 Honiball and Olivier *The Taxation of Trusts in South Africa* 141.

Special attention should be paid to the fact that paragraph 81 determines that the contingent interest of a beneficiary in a discretionary trust is treated as having a base cost of nil.[206] That means that the full proceeds that arise from the disposal of the contingent interest will be deemed and treated as a capital gain, irrespective of the nature of the disposal, either real or deemed.[207] This paragraph only applies to discretionary interests in a trust, not the vesting of an interest in a vested trust asset.[208]

The ultimate benefit of the conduit pipe principle with regard to capital gains tax is the fact that if a capital gain is taxed in the hands of a beneficiary. In other words: if the capital gains retains its nature and is not distributed to the beneficiary as ordinary income, the amount is included at the rate of 33.3% in the beneficiary's taxable income after deduction of the R300 000 annual exclusion. This amounts to a substantial tax benefit, because the amount would otherwise have been taxed at an inclusion rate of 66.6% in the trust.

As in the case of the provisions regarding trust income, the Eighth Schedule to the *ITA*[209] also contains certain tax-back provisions in order to counter tax avoidance.[210] These will not be discussed or analysed in order to keep the research relevant within the ambit of the dissertation.

Chapter four clearly set out the current taxation of income and capital gains received and/or distributed by a discretionary *inter vivos* trust. The following chapter sets out to explore the proposed changes to the taxation of these types of trusts and the abolishment of the conduit pipe principle.

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[206] Paragraph 81 of the Eighth Schedule to the *ITA* 58 of 1962; Honiball and Olivier *The Taxation of Trusts in South Africa* 142.

[207] Honiball and Olivier *The Taxation of Trusts in South Africa* 142.

[208] Paragraph 38(1)(b) of the Eighth Schedule to the *Income Tax Act* 58 of 1962 deals with the base cost of the vesting of an interest in a vested trust asset; Honiball and Olivier *The Taxation of Trusts in South Africa* 142.

[209] 58 of 1962.

[210] See paragraphs 70 to 73 of the Eighth Schedule to the *ITA* 58 of 1962 for the various tax-back provisions relating to capital gains within a trust.

CHAPTER 5

Proposed Amendments

5 Proposed amendments

From the previous chapters it follows clearly that trusts are extremely popular instruments for estate and tax planning purposes. Despite their higher tax rate, they entail various mechanisms to curtail high tax liability. Although most of the benefits that come from a trust can be attributed to its unique structure and protective veil, the tax benefits can mainly be ascribed to the conduit pipe principle.

The problem, however, as stated in the introduction of this study, is that the National Budgets tabled in parliament for the past few years indicated that government proposes several legislative measures regarding trusts to eliminate tax avoidance currently associated with trusts.[211]

In the Minister of Finance's, Mr Pravin Gordhan, 2013/2014 National Budget Speech[212] it was announced that the government will initiate tax reviews in order to:

> assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability.

The minister announced the members of the appointed Tax Review Committee, together with the Committee's Terms of Reference on 17 July 2013.[213] At their inaugural meeting on 25 July 2013 it was decided that the committee will be known as the Davis Tax Committee (DTC).[214]

In order to determine the effect of the proposed amendments on the future taxation of trusts, the exact nature of these proposals should be clarified. Therefore the

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211 Marais *The taxation of income and expenditure of trusts in South Africa* 40.

212 Gordhan 2014 *National Budget Speech* National Treasury; DTC *First Interim Report on Estate Duty* September 2015 37-46.

213 DTC *First Interim Report on Estate Duty* September 2015 37-46.

214 DTC *First Interim Report on Estate Duty* September 2015 37-46.

proposed amendments will be listed and critically analysed in the following discussion.[215]

5.1 General background

The National Treasury and SARS are apprehensive about trusts, mostly due to the income-splitting opportunities and tax benefits that trusts offer to taxpayers.[216] The flexibility and flow-through nature of trusts are the essential characteristics of a trust that act in favour of the taxpayer – leaving the fiscus with a smaller tax base.[217] The envisaged amendments to the taxation of trusts will impact South Africa's trust landscape and prove to be troublesome to many carefully drafted trust structures and tax plans.[218] Petersen puts this succinctly:[219]

> It will thus be important for estate owners to consider these envisaged tax amendments when they come into operation, in order to ascertain the full extent of the implications and then it can also further be determined what the impact of these changes will be on the effectiveness of the discretionary family trust as an estate planning instrument in SA in the future.

These proposals are investigated in the following paragraphs.

5.2 Proposals

It can be concluded from the DTC's First Interim Report on Estate Duty[220] (hereafter the report) that the main amendment to the taxation of trusts will be the abolishment of the conduit pipe principle. One of the foremost rationales behind this proposed repeal is due to the estate duty avoidance capability of a trust – hence, the DTC decided to propose very harsh income tax measures to reduce the tax attractiveness of a trust.[221]

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215 Although there were various recommendations and proposals made with reference not only to the conduit pipe, but also the primary abatements, estate duty, etc, only proposals regarding the abolishment of the conduit pipe are relevant for this discussion.

216 Petersen *Taxation of a trust* 10.

217 Petersen *Taxation of a trust* 10.

218 Petersen *Taxation of a trust* 10.

219 Petersen *Taxation of a trust* 10.

220 DTC *First Interim Report on Estate Duty* September 2015 37-46.

221 Price Waterhouse Coopers *Significant changes from an estate planning perspective* 4.

In the report it is stated that:[222]

> Taxpayers who pursue the postponement of estate duty through the use of trusts will remain at liberty to do so. But upon sale of the assets of a trust a higher rate of tax will be imposed, thus compensating for the estate duty loss.

Trusts must be taxed as separate taxpayers at the current flat rate of 40%, which is suggested by the DTC to remain the *status quo*. In order to accomplish this, the DTC would have the flow-through principle, as a result of the provisions in section 25b of the *ITA*, repealed for local/resident trusts.[223]

In truth the DTC recommended the total abolishment of the conduit pipe principle/flow-through mechanism.[224] These proposals will cause all income and capital gains produced by the trust to be taxed in the trust, not allowing for the possibility of distributing the income or capital by means of the conduit pipe principle to beneficiaries of the trust.[225]

Despite the fact that the conduit pipe was labelled as a tax avoidance mechanism in the National Budget Review of 2013,[226] the minister also mentioned the distributions constituting deductible payments, therefore allowing some form of deduction:[227]

> Discretionary trusts should no longer act as flow-through instruments. Taxable income and loss (including capital gains and losses) should be fully calculated at trust level with distributions acting as deductible payments to the extent of current taxable income. Beneficiaries will be eligible to receive tax-free distributions, except where they give rise to deductible payments (which will be treated as ordinary revenue).

The DTC acknowledges that the proposed abolishment will have various and extensive implications for South African taxpayers.[228] They also accepted that a

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222 DTC *First Interim Report on Estate Duty* September 2015 37-46.

223 Price Waterhouse Coopers *Significant changes from an estate planning perspective* 4.

224 Price Waterhouse Coopers *Significant changes from an estate planning perspective* 5.

225 Income/gains can still be distributed to beneficiaries, but will no longer retain their original nature; Price Waterhouse Coopers *Significant changes from an estate planning perspective* 5.

226 On page 23 of the 2013 Budget Speech it is stated that: "The Budget Review outlines various measures proposed to protect the tax base and limit the scope for tax leakage and avoidance. Taxation of trusts will come under review to control abuse".

227 Gordhan 2013 *National Budget Speech Review* National Treasury 2013 10; Price Waterhouse Coopers *Significant changes from an estate planning perspective* 5.

comprehensive consultative process needs to be implemented during the 2015 legislative cycle to address any and all issues involved in this development.[229] The DTC proposes the amendments to be announced in the next National Budget Speech, but only be implemented with effect from 1 March 2016.[230]

Apart from the recommendations and proposals made with reference to section 25b (conduit pipe principle), the DCT also scrutinised section 7 and paragraphs 68 to 72 of the *ITA*[231] and recommended that these be repealed. Section 7 is a so-called anti-avoidance provision which regulates income generated by a trust due to gratuitousness from a person, such as a donation or interest-free loan to the trust.[232] When this section is applied, it deems said income to be taxable in the hands of the person to which the gratuitousness can be attributed to.

These tax avoidance provisions regarding trust income are mirrored in paragraphs 68 to 72 of the *Eighth Schedule* to the *ITA*[233] with regard to capital gains realised in a trust. They have the same attribution objectives as section 7. Estate owners and tax planners have been afforded very attractive concessions within the capital gains tax sphere by means of these 'avoidance' provisions. Their incentive would be to divert the liability of capital gains tax to natural person beneficiaries, since they are taxed at a far lower rate than the trust.[234]

The DTC thus proposes the abolishment of these sections and paragraphs stating:

> The attribution rules in section 7 were originally intended as an anti-avoidance measure aimed at preventing a trust from being used as an income-splitting device. However, today the attribution rules are employed to avoid tax, thereby subverting the very purpose for which they were introduced.

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228 DTC *First Interim Report on Estate Duty* September 2015 37-46.; Price Waterhouse Coopers *Significant changes from an estate planning perspective* 5.
229 DTC *First Interim Report on Estate Duty* September 2015 37-46.; Price Waterhouse Coopers *Significant changes from an estate planning perspective* 5.
230 DTC *First Interim Report on Estate Duty* September 2015 37-46.; Price Waterhouse Coopers *Significant changes from an estate planning perspective* 5.
231 58 of 1962.
232 Section 7 of the *ITA* 58 of 1962.
233 58 of 1962.
234 Price Waterhouse Coopers *Significant changes from an estate planning perspective* 5.

The reason for the DTC's proposed abolishment of the flow-through principle is to prevent the fiscus from settling for less income tax and capital gains tax during the existence of the trust[235] and circumventing the loss of estate duty in both the estates of the beneficiaries and the donor because of the growth-pegging of their assets in the trust.[236]

5.3 Implications of amendments

Van Gijsen[237] depicts the benefit of the conduit pipe by stating that:[238]

> from an income tax and capital gains tax perspective, the flow-through principle provides a means by which an estate owner can procure an immediate personal benefit, namely income-splitting. Income-splitting occurs when the trustees vest the trust's income or gains in one or more beneficiaries with lower marginal rates of tax while not distributing, or restricting distributions, to those beneficiaries with a higher marginal rate of tax, thereby reducing the overall tax liability in respect of the income or gains made.

As discussed in the previous paragraphs, this entire conduit mechanism will be abolished, both with reference to trust income and trust capital.

The DTC is of the opinion that the loss of taxes the fiscus incurs can be rectified by repealing the conduit pipe principle, together with section 7 and paragraphs 68 to 72. In their interim report they further state that:

> Taxpayers must be allowed to make use of trusts when it makes sound sense to do so in the pursuit of a commercial justification or benefit, as opposed to estate duty benefit. However, as is the case with present company tax rates today, the taxpayer must accept any potential adverse tax consequences.

The abolishment of the conduit pipe will consequently result in trusts being only allowed to distribute 'taxable income', since the income generated and distributed to the beneficiaries will no longer retain its original nature/identity.[239] Due to the fact

235 Due to the income-splitting and distributions by means of the conduit pipe to taxpayers (beneficiaries) with lower tax rates.

236 Van Gijsen 2015 *The Taxpayer* 112.

237 Francois Van Gijsen, Director: Finlac Risk and Legal Management.

238 Van Gijsen 2015 *The Taxpayer* 110.

239 It was specifically section 25b that allowed for income generated by a trust and distributed to the beneficiaries, within the same year of assessment, to retain its nature. This 'tax instrument'

that the distributions will now act as deductible payments, the beneficiary will be taxed thereon as having received ordinary income – subject to tax on his/her relevant income tax rate.[240] If, for instance, the trust receives interest or dividends, which would have normally been excluded from tax in the hands of the natural person beneficiary, and distributes it to the beneficiary within the application of the conduit pipe principle, the beneficiary will merely receive ordinary income and therefore not be able to make use of any exemptions from income tax on those amounts.[241]

These changes effectively lead to the argument that keeping assets in a trust specifically for tax purposes can become extremely tax-insufficient.[242] It should however be noted that these changes will not apply to trusts that are created to tend to the needs of disabled persons and minor children.[243] Furthermore it should be clear that no argument is being made out against the other numerous benefits of trusts for estate planning purposes. The focus is on the endangerment posed by the changes with regard to the tax benefits previously offered by discretionary *inter vivos* trusts.

To comprehensively understand and evaluate the implications of these proposals and changes to the future taxation of trusts, a case study is conducted in the next chapter, detailing the income tax and capital gains tax implications and the effect of the abolishment of the conduit pipe on the taxation of trusts and their beneficiaries.

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ensured the safekeeping of the income's identity to ensure tax benefits for both the trust and the beneficiaries. Section 25b will be repealed and this benefit will no longer exist.

240 Brink and Willemse 2014 *JEF* 802.

241 Due to the fact that the income no longer retained its nature as either interest or dividends.

242 Marais *The taxation of income and expenditure of trusts in South Africa* 41.

243 Marais *The taxation of income and expenditure of trusts in South Africa* 41.

CHAPTER 6

Case study

6 Case study

The following case study resembles the case study done by Brink and Willemse in their "Investigation into the future of discretionary trusts in South Africa – an income tax perspective". The case study was however done in 2014 and therefore relies mostly on the speculations of the possible abolishment of the conduit pipe while the DTC had published their interim report finalising the abolishment in 2015.

Their case study therefore serves only as a guideline and will be adapted to represent the true effect that the abolishment of the conduit pipe will have on the taxation of discretionary trusts and their beneficiaries.

Firstly the tax liability of the discretionary *inter vivos* trust and its beneficiaries will be calculated in the light of the existing conduit pipe principle (in other words the application of section 25b and paragraph 80 as is the *status quo*). Secondly the tax liability will be calculated again,[244] but the abolishment of the conduit pipe and the DTC's proposed changes and amendments are taken into account.

6.1 Income tax of a discretionary trust and beneficiary where the trustees distribute all accruals to the beneficiary[245]

The Swart Family Trust is a discretionary *inter vivos* trust. The trust has one beneficiary who is a natural person, aged 23, and a South African resident. The trust received the following amounts during the 2014 year of assessment:

- Proceeds from the disposal of a capital asset of the trust R1 500 000
- Interest received from South African investments R50 000
- Dividends received from South African investments (gross) R50 000

[244] On the same set of facts in order to show what the effect of the DTC's proposals will have on the tax liability of trusts and their beneficiaries.

[245] As per the case study of Brink and Willemse 804-807 with the conduit pipe still in effect.

Assume for this scenario that the capital asset is not an allowance asset and that it has a base cost of R500 000. Table 1 depicts the income tax calculation of the trust and beneficiaries if the trustees decide to distribute all of the accruals in the trust to the beneficiary during the 2014 year of assessment.

Table 1: Current income tax liability

Income tax liability of the **discretionary trust**	Amount (R)
Taxable income	0
The Swart Family Trust has no taxable income, as all the mentioned accruals vest in the beneficiary in the same year of assessment in which the amounts were received by or accrued to the trust.[246] At discretion of the trustees, the amounts vested in the beneficiary.[247] It is assumed in the scenario that the beneficiary receives no other income.	
Income tax of the **beneficiary**	Amount (R)
Gross income:	100 000
Dividends	50 000
Interest	50 000
Less: Exemptions	73 800
Basic interest exemption (section 10(1)(i))[248]	23 800
Dividend exemption (section 10(1)(k))[249]	50 000
Income	26 200
Add: Taxable capital gain (section 26A)[250]	323 010[251]
Taxable income[252]	349 210
Ordinary income tax	80 234[253]
Less: Primary rebate	12 080
Tax liability towards SARS	68 154
All accruals of the Swart Family Trust vest in the beneficiary in accordance with section 25b(2) and are therefore taxable in the hands of the beneficiary. The conduit pipe principle and flow-through nature of the trust ensures that the accruals retain their original nature through distribution into the hands of the beneficiary. The beneficiary is thus entitled to the basic interest exemption, dividend exemption and the annual exclusion of R30 000 for capital gains tax purposes, together with the primary rebate of R12 080.	

246 Section 25b(2) of the *ITA* 58 of 1962.
247 Brink and Willemse 2014 *JEF* 804.
248 Of the *ITA* 58 of 1962.
249 Of the *ITA* 58 of 1962.
250 Of the *ITA* 58 of 1962.
251 The calculation of the capital gain: ([1 500 000 – 500 000] –R30 000) x 33.3% = 323 010.
252 Assume that the beneficiary had no other income or accruals during the year of 2014.
253 The calculation of the normal income tax: 53 096 + 30% x (R349 210 – 258 750) = 80 234.

6.2 Income tax of discretionary trust and beneficiary where the trustees do not distribute any accruals to the beneficiary[254]

Table 2 illustrates the income tax liability should the trustees decide not to distribute any of the accruals to the beneficiary. In other words: all of the accruals are retained in the trust for the 2014 year of assessment.

Table 2: Current income tax liability

Income tax liability of the **discretionary trust**	Amount (R)
Gross income	100 000
Dividends	50 000
Interest	50 000
Less: Exemptions Dividend exemption (section 10(1)(k))[255]	50 000 50 000
Income Add: Taxable capital gain (section 26a)[256]	50 000 666 000[257]
Taxable income	716 000
Ordinary income tax	286 400[258]
Tax liability towards SARS	286 400
None of the accruals were distributed to the beneficiary (none were vested in the beneficiary) and therefore the amounts will not be taxed in the beneficiary's hands, but in the hands of the trust.[259] Due to the fact that the trust is not a natural person, it does not qualify for the basic interest exemption – only for the dividend exemption.[260] The annual exclusion and primary rebate is not available to the discretionary trust.[261]	

254 As per the case study of Brink and Willemse 804-807 with the conduit pipe still in effect.
255 Of the *ITA* 58 of 1962.
256 Of the *ITA* 58 of 1962.
257 The calculation of the capital gain: [1 500 000 – 500 000] x 66.6% = 666 000.
258 The calculation of the normal income tax: 716 000 x 40% = 286 400.
259 Section 25b(2) of the *ITA* 58 of 1962.
260 Brink and Willemse 2014 *JEF* 805.
261 Brink and Willemse 2014 *JEF* 805.

6.3 *Income tax of discretionary trust where the trustees distribute all accruals to the beneficiary*[262] *(after abolishment of conduit pipe)*

For the following calculation of the income tax treatment of the discretionary trust and its beneficiary, the same set of facts and amounts will be used as in paragraphs 6.1 and 6.2, except that the income tax liability will be calculated in the light of the DTC's proposed changes and amendments (the abolishment of the conduit pipe principle)

Table 3 indicates what the income tax treatment of the trust and the beneficiary will be if the trustees would decide to vest all of the accruals in the beneficiary in the 2014 year of assessment.

Table 3: Income tax liability after abolishment of conduit pipe principle

Income tax liability of the **discretionary trust**	Amount (R)
Gross income	100 000
Dividends	50 000
Interest	50 000
Less: Exemptions Dividend exemption (section 10(1)(k))[263]	50 000 50 000
Income Add: Taxable capital gain (section 26a)[264]	50 000 666 000[265]
Taxable income Deduct: Distribution to beneficiary of taxable income[266]	716 000 716 000
Tax liability of trust towards SARS	0
There will be no income tax consequences for the trust, because the distribution of the taxable income to the beneficiary is deemed a deduction for the determination of the trust's taxable income. R716 000 will be taxed in the hands of the beneficiary. With the abolishment of the conduit pipe principle, the income (interest and dividends) does not retain its nature. The combination of capital and exempt income accruals is distributed to the beneficiary as normal taxable income.	

262 As per the case study of Brink and Willemse 804-807 with the application of the DTC's proposed amendments.
263 Of the *ITA* 58 of 1962.
264 Of the *ITA* 58 of 1962.
265 The calculation of the capital gain: [1 500 000 – 500 000] x 66.6% = 666 000.
266 The effect of the new amendments and proposals will be that the distribution of taxable income to a beneficiary will be deemed a deduction against the taxable income of the trust.

6.4 *Income tax of beneficiary where the trustees distribute all accruals to the beneficiary (after abolishment of conduit pipe)*[267]

Table 4 illustrates what the income tax liability will be for a discretionary trust and its beneficiaries when the DTC's proposed amendments take effect. It depicts how the calculation of taxable income will function from March 2016, after the changes in legislation have been enacted.

Table 4: Income tax liability after abolishment of conduit pipe principle

Income tax liability of the **beneficiary**	Amount (R)
Taxable income received from discretionary trust	716 000
Taxable income	716 000
Normal tax	216 165
Less: Primary rebate	12 080
Tax liability of beneficiary towards SARS	204 085
The trust will not be liable for payment of any income tax, because the distribution of the taxable income to the beneficiary is deemed a deduction against the taxable income of the trusts for the relevant year of assessment. The amount distributed to the beneficiary vests in the beneficiary and therefore is taxable in the beneficiary's hands. Due to the abolishment of the conduit pipe principle, the accruals do not retain their original nature and that is why the beneficiary does not qualify to make use of the R30 000 annual exclusion, or the inclusion rate of 33.3% of net capital gains for purposes of capital gains tax. The beneficiary also cannot use the dividend or interest exemptions, since the beneficiary only received 'taxable ordinary income' under the new rules of taxation of trusts.	

267 As per the case study of Brink and Willemse 804-807 with the application of the DTC's proposed amendments.

CHAPTER 7

Analysis of Abolishment's Effect

7 Analysis of the proposed abolishment's effect

In order to analyse the effect of the proposed amendments on the taxation of discretionary trusts, one needs to examine the change in the manner of the taxation of accruals received by the trust – both in the instances of the accruals remaining in the trust or distributed to the beneficiaries.

From the case study it is clear that accruals will no longer retain their original nature due to the abolishment of the conduit pipe principle, which means that trusts will no longer act as flow-through instruments. This in effect means that discretionary trusts will only be able to distribute taxable income. Brink and Willemse summarises the effect by concluding that the following will happen:[268]

> The scrapping of the conduit pipe principle, meaning that the amounts distributed to the beneficiaries will no longer retain their original identity and those amounts will become income in nature in the hands of the beneficiary. The beneficiary therefore does not qualify for the basic interest exemption, annual exclusion of R30 000 or the inclusion rate of 33.3% of net capital gains for purposes of capital gains tax. Any distributions to beneficiaries would be treated as a deductible payment by the trust to the extent that there is current taxable income.

When the conduit pipe principle is applied to the above-mentioned scenario, the effective payment owed to SARS by the beneficiary for accruals received from the trust, amounts to R68 154. On the other hand, with the proposed abolishment thereof, the same beneficiary who received the exact same amount will have income tax liability towards SARS to the amount of R204 085. This is an alarming increase of about 200% in income tax.

It is clear to see that the DTC's proposed amendments to the taxation of discretionary trusts will have a drastic negative effect for the beneficiaries of such trusts. When discretionary trusts lose their ability to act as flow-through instruments

[268] Brink and Willemse 2014 *JEF* 812.

and able to only distribute taxable income, the beneficiaries are disqualified of making use of the basic-interest exemption, the dividend exclusion and the capital gains tax concessions that were usually available for natural persons. These amendments to the taxation of trusts will nullify any and all tax advantages that discretionary *inter vivos* trusts offered to natural person beneficiaries.

The use of the discretionary *inter vivos* trust as an estate planning instrument for the purposes of tax advantages will become very unfavourable due to the changes in the taxation of accruals. Furthermore, once the amendments are enacted into income tax legislation, it will be necessary for the legislator to expand the special inclusion paragraphs with reference to the definition of gross income in section 1 of the *ITA*, to make provision for a taxable income item labelled as 'taxable income received from a discretionary trust'.

CHAPTER 8

Conclusion

8 Conclusion

Estate planning as a field of law is unequivocal in relation to other fields. The reason for this is the fact that every person is constantly structuring, building or diminishing his/her estate without necessarily realising it. Every financial decision influences a person's estate – either immediately or in future. That is why in-depth knowledge of estate planning instruments, such as trusts, are indispensable.

Constant research needs to be done in order to improve planning instruments and structures to equip estate owners and planners with the best tools and techniques for arranging appropriate estate plans. It is imperative to stay abreast of all changes made to estate planning which are brought about by many role-players and factors including SARS, the legislator, the financial condition of the country and the personal lifestyle and circumstances of an estate owner.

Trusts have proven to be extremely popular estate planning instruments due to their various benefits – especially with regard to the tax benefits offered by the conduit pipe principle within discretionary *inter vivos* trusts. Although trusts are subject to a higher tax rate, the possibility exists for both income-splitting and the conduit pipe principle as tax-related benefits, which allows for amounts accrued to a trust to flow through the trust to the beneficiaries while retaining their nature. This ultimately leads to an overall lower tax liability for the trust and its beneficiaries, since the beneficiaries, who are often natural persons, are not only subject to lower tax rates, but also entitled to more tax rebates and exclusions.

Unfortunately for taxpayers, SARS is constantly attempting to close the tax 'gaps' created by tax-beneficial instruments and structures, such as the conduit pipe principle. During the past few years the Minister of Finance revealed in the National Budget Speeches the intent to scrutinise the taxation of trusts, since trusts are being abused specifically for their tax avoiding possibilities. After the appointment of the

Davis Tax Committee, a 'first project' was launched to investigate the taxation of trusts, which resulted in a conclusion to abolish the conduit pipe principle.

This dissertation firstly explored current tax benefits posed by the conduit pipe principle; secondly it investigated the proposal regarding the abolishment of the conduit pipe principle; and ultimately it examined the effect that the abolishment will have on the taxation of income accrued to a trust and distributed to its beneficiaries.

The first two chapters, regarding estate planning and trusts as estate planning instruments, purported a theoretical foundation and background to the research. It has been ascertained that estate planning is crucial for anyone attempting to create a sustainable lifestyle and desires to secure the ultimate value from one ' s assets in their everyday life and to provide for loved ones once they pass away. Furthermore the study proved, by means of case law and the academic opinions of experienced estate law practitioners, that trusts are one of the most utilised estate planning tools.

The goal of the fourth chapter was to discover where the conduit pipe principle initially came from, how it was applied in case law and later codified in legislation. This chapter also focused on section 25b, the legislative conduit pipe, as well as paragraph 80 of the Eighth Schedule to the *ITA*. The fifth chapter investigated the proposed amendments to the taxation of trusts as stated in the National Budget Speech. The conclusion drawn from the research is definitely that the abolishment of the conduit pipe principle is one of the proposed amendments. The remainder of chapter five discussed the implications of this abolishment.

Chapter six was devoted to the illustration of the effect of the abolishment of the conduit pipe principle on the taxation of income accrued to a trust and distributed to its beneficiaries. The calculations were done in a scenario where the conduit pipe principle still finds application in order to depict the current taxation of trusts and its beneficiaries. Thereafter the same calculations were done, but with application of the proposed amendments, to illustrate the negative effect the abolishment of the flow-through nature of trusts will have on the tax liability of the involved parties. Due to the mathematical nature of the sixth chapter, chapter seven reduced the mathematical findings of the previous chapter into comprehensible literature. This chapter indicated that the proposed amendments will lead to a 200% percent increase in income tax liability for natural person beneficiaries with regard to income received by a trust.

It is clear from this study that the abolishment of the conduit pipe principle will adversely impact the taxation of trusts and their beneficiaries. Although trusts should never be created solely for the goal of attaining tax benefits, it was indicated throughout the study that the tax benefits posed by discretionary *inter vivos* trusts contributed greatly to its popularity as an estate planning instrument. The use of this type of trust will still prove to be an extremely beneficial estate planning instrument, due to its numerous other advantages, but estate planners and owners need to heed the word of caution with reference to the changes in the taxation of trusts. They need to be aware of these changes in order to make informed decisions as to who will receive income and capital and consequently who will carry the tax liability. SARS will always be skeptical towards trusts and this complication may prove to be only the beginning of a greater assault on trusts as the most effective and beneficial estate planning instruments for South African estate owners and trust parties.

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LIST OF ABBREVIATIONS

DTC	Davis Tax Commission
ITA	Income Tax Act 58 of 1962
JEF	Journal of Economic and Financial Sciences
JEPL	Journal of Estate Planning Law
SARS	South African Revenue Service
TPCA	Trust Property Control Act 57 of 1988