Taxing Trusts Effectively – The Changes SARS Ought To Make

By Franscois van Gijsen[1]

It is by now old news for most practitioners that Treasury is seeking ways to more effectively tax trusts. However, it is the manner in which they have proposed to do this that has the various professions up in arms.

Although no draft legislation has as yet been released, according to the *Budget Review* of 27 February 2013, Treasury intends to prevent discretionary trusts from acting as conduits for tax purposes in future. The following was stated in the *Budget Review*:

> 'Discretionary trusts should no longer act as flow-through vehicles. 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 included as ordinary revenue).'[2]

Apparently these proposals will not apply 'to trusts established to attend to the legitimate needs of minor children and people with disabilities'.[3]

It is a common practice, among 'users' of discretionary trusts, to avail themselves of the conduit principles embodied in section 25B of and paragraph 80 of the Eighth Schedule to the Income Tax Act, 58 of 1962, as amended, ('the Act') in order to obtain a tax advantage. In terms of this practice, the whole or a portion of the trust's income or capital gain is allocated to a specific beneficiary in order to have the amount of income or capital gain taxed in the hands of the beneficiary in terms of the provisions of the aforementioned sections. However, instead of paying the said amount to the beneficiary in question, it is frequently credited to the beneficiary on loan account with the trustees retaining control over the funds on behalf of that beneficiary.

Based on the above quotations, it would seem to be this practice of allocating trust income or capital gain without distributing it that Treasury wishes to halt, thereby preventing erosion of the tax base.

The conduit principle is, however, so entrenched in respect of the taxation of trusts that the proposed changes thereto provoked concern among practitioners, resulting in a meeting of a number of professional bodies (among others the SAIT, the Fiduciary Institute of Southern Africa and the Financial Planning Institute of South Africa) with representatives from the National Treasury and SARS on 14 June 2013. This meeting was reported on to members of the South African Institute of Tax Practitioners by Dr Beric Croome in the *Tax Talk Professional Edition* of 1 July 2013. Among the topics discussed was future interaction between the Master's Office and SARS, and the likelihood that changes will be made to the tax returns to be submitted by trusts. These returns are expected to become more onerous in order to ensure greater disclosure regarding the activities of trusts and to ensure that these are fully disclosed to SARS.

In this article I intend to explain why I believe that it is not necessary for Treasury to make the proposed changes in order to more effectively tax

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[2] *Budget Review*, 27 February 2013, Chapter 4: Revenue Trends and Tax Proposals, *sub nom* 'Protecting the Tax Base'.

[3] *Ibid*.

the income and/or capital gains in the hands of discretionary trusts instead of having it flow through to the beneficiaries to be taxed at such beneficiaries' lower tax rates.

The concept of the 'protective trust'

One of the notable aspects of the definition of 'trust' in section 1 of the Trust Property Control Act, Act 57 of 1988, is that, to qualify as a trust, the donor is required to make over or bequeath the trust assets and to fully divest himself of the ownership thereof. However, experience suggests that clients who use trusts for tax and estate planning purposes are often reluctant to relinquish control over the trust assets. As a result they look for ways in which to retain control of the assets, and to 'protect' the trust assets from third parties, as also ways of 'protecting' beneficiaries from themselves.

Possibly the most frequent way in which this is done is by means of the inclusion of clauses in the trust deed providing for forfeiture by the beneficiary of benefits under the trust (*a*) in instances where there is an attempt to cede rights under the trust without the permission of the trustees or (*b*) in the event of insolvency: the so-called 'protective trust'. The following serves as an example of such a clause in a trust deed:

> '1. The capital and/or income to which any beneficiary is/may be entitled to in terms of the conditions of this deed cannot, before being paid or distributed to him by the trustees, be:
> (*a*) ceded, transferred or pledged by such beneficiary;
> (*b*) seized by any creditor of such beneficiary or vested in his curator on his/her insolvency.
> 2. If, before any capital and/or income as mentioned above, is paid to any beneficiary:
> (*a*) he/she pretends or tries to cede, transfer or pledge such capital or income or any part of it; or
> (*b*) he/she is declared insolvent or surrenders his/her estate,
> then such beneficiary's right to the capital and/or income will end immediately and vest in the other beneficiaries as if such beneficiary had died before it had vested in him/her.'

There is nothing wrong with the founder providing for a forfeiture of benefits if the beneficiary fails to observe a stated condition. However, for the condition to be enforceable, it must be imposed in the interests of some other person and should provide for a gift over to that person in the instance that the condition is not observed.[4]

Taxability: 'received by or accrued to' in the context of a forfeiture condition

Treasury, as stated above, seems to be mainly interested in curtailing the use of the conduit principle in instances where the income or capital gain is allocated but not actually paid over or distributed. For the purposes of this article, then, we are interested only in those amounts that may be said to have accrued to a beneficiary but which have not been received by such beneficiary.

The Act requires that, for an amount to be taxable, it has to be either 'received by or accrued to or in favour of' the taxpayer. After some debate it was decided in *Commissioner for Inland Revenue v Peoples Stores (Walvis Bay) Pty Ltd* 1990 (2) SA 353 (A) that an amount 'accrues' to the taxpayer when he becomes (unconditionally) entitled thereto. The 'entitled to' principle, originally articulated in *Lategan v Commissioner for Inland Revenue* 1926 CPD 203, and later confirmed in *Peoples Stores supra*, was expanded on in the case of *Mooi v Secretary for Inland Revenue* 1972 (1) SA 675 (A), in which it was held that a benefit only accrued when the taxpayer became *unconditionally* entitled thereto.

However, if an amount is 'allocated' to a beneficiary, but not yet received by him or her, and if such amount is subject to a forfeiture condition – such as in the case of a protective trust – can it be

[4] See: *Raubenheimer v Raubenheimer and Others* 2012 (5) SA 290 (SCA) at 297E-H; *Aronson v Estate Hart* 1950 (1) SA 539 A at 552; and *Jewish Colonial Trust Ltd v Estate Nathan and Others* 1940 AD 163 at 180.

said that such beneficiary is unconditionally entitled to such amount, as signified by the word 'accrued' in the definition of 'gross income' in section 1 of the Act?

A clause in a trust deed providing for forfeiture, such as the above example, embodies a resolutive condition, as opposed to a suspensive condition. A resolutive condition is one where the contract becomes immediately binding upon the parties and all the rights and obligations in terms of the agreement arise immediately, but should the condition at some later stage be fulfilled then the agreement will dissolve immediately and with retrospective effect. De Wet and Van Wyk in *Die Suid Afrikaanse Kontrakte Reg en Handelsreg*[5] explain as follows:

> 'Die toestand van onsekerheid wat hangende die voorwaarde bestaan het, word ook beëindig deur die ontbreking van die voorwaarde. Die voorwaarde ontbreek by die positiewe voorwaarde wanneer dit vasstaan dat die gebeurtenis nie meer kan plaasvind nie, en by die negatiewe voorwaarde wanneer die gebeurtenis wel plaasvind …
>
> Die voorafgaande geld én vir die gewone opskortende voorwaarde én vir die gewone ontbindende voorwaarde gerig op die weeropheffing van die ingetrede gevolg van die ooreenkoms. By 'n ooreenkoms met so 'n gewone ontbindende voorwaarde tree die normale gevolge van die ooreenkoms dadelik in, maar die weeropheffing van daardie gevolge word afhanklik gemaak van die plaasvind van 'n onsekere toekomstige gebeurtenis, m.a.w. die weeropheffing word opgeskort. Daar bestaan dus van die begin af aan die moontlikheid van weeropheffing, en daarmee samehangende opskortend voorwaardelike verbintenisse tot teruggawe en herstel.'

Cameron *et al* in *Honorés South African Law of Trusts*[6] comment as follows on the forfeiture of benefits in terms of a protective trust:

> 'When the beneficiary's interest is not forfeited under a valid protective trust or other substitute provision it may be taken in execution by the beneficiary's creditors and falls into his or her insolvent estate. This follows from the general rule that any vested right is available to creditors.'

The beneficiary's rights to the amounts allocated in terms of a protective trust remain contingent on the fulfilment, or non-fulfilment, of the condition in respect of insolvency, etc. This will be the case until such time as it is clear that the beneficiary will not go insolvent, ie on death. Before such time, the beneficiary has no vested right to the benefit. This provides protection in case of insolvency, but simultaneously excludes an accrual as contemplated in the Act.

The changes SARS should consider

The use of protective trusts is ubiquitous in South Africa, so much so that one scarcely comes across a discretionary trust where such a condition is not included.

It is suggested that, in order to more effectively tax discretionary trusts, SARS need only determine whether or not such a forfeiture condition exists. If it does, then SARS should tax the trust accordingly, ie by taxing the beneficiary where he or she has received payment of the amount in question on the basis of a 'receipt', and by taxing the trust where the amount has been allocated but not yet paid to the beneficiary by reason of the fact that the beneficiary is not yet unconditionally entitled to the amount in question.

It need also not be difficult for SARS to determine whether or not this is the case. Requesting the following information in the trust's tax return should enable SARS to readily determine whether or not a beneficiary to whom income or a capital gain has been allocated has an unconditional right to such

[5] 5 ed, vol 1, p153.

[6] E Cameron *et al Honorés South African Law of Trusts* 5 ed (2007) 616, citing *Cairncross v Van der Westhuizen* 1913 CPD 639; *Bosman v Bredell* 1932 CPD 385; *CIR v Polonsky* 1942 TPD 249 253; *Trustee of Van der Byl v Executor Michau* (1883) 2 SC 430.

income or capital gain:

- Enquire whether or not the trust is a discretionary trust;
- If yes, enquire whether the trust provides for the forfeiture of benefits in certain circumstances, such as the beneficiary's insolvency, or the beneficiary attempting to cede rights to income or capital prior to receipt of such amounts;
- If yes, enquire whether or not the trustees have, when allocating the said amounts to the said beneficiary, waived the said forfeiture condition/s;
- If yes, require the resolution by virtue of which such allocation and waiver has been made. If it is clear from the resolution that the amount is allocated to the beneficiary free from any resolutive forfeiture conditions, then tax in the hands of the beneficiary in terms of the conduit principle. If, however, the resolution does not specifically waive the resolutive condition, then the beneficiary cannot be said to be unconditionally entitled to the amount, and the amount should be taxed in the hands of the trust.

Conclusion

It is suggested that, by adopting the course of action suggested above, Treasury and SARS could save themselves a great deal of aggravation and succeed in taxing discretionary trusts as they seem to wish to do.

The same approach could also be used to 'retrospectively' re-assess discretionary trusts.

In the writer's view, these outcomes could be achieved in terms of the law as it stands, without the trouble and expense of amending the Act, and without the concomitant uncertainty and upheaval that would no doubt be occasioned by legislative amendments in the financial community at large.

Penalties – Tax Administration Act Or Income Tax Act?

By Peter Dachs

The purpose of this article is to highlight some of the differences between the 'old' penalty provisions contained in the Income Tax Act and the 'new' provisions set out in the Tax Administration Act.

The understatement penalty provisions are contained in sections 221 to 223 of the Tax Administration Act, 28 of 2011, as amended, ('the TAA'). These provisions essentially replace the penalty provisions previously contained in section 76 of the Income Tax Act.

Section 76 of the Income Tax Act

Section 76(1) of the Income Tax Act provided that a taxpayer:

> 'shall be required to pay in addition to the tax chargeable in respect of his taxable income:
>
> (*a*) if he makes a default in rendering a return in respect of any year of assessment, an amount equal to twice the tax chargeable in respect of his taxable income for that year of assessment; or
>
> (*b*) if he omits from his return any amount which ought to have been included therein, an amount equal to twice the difference between the tax as calculated in respect of the taxable income returned by him and the tax properly chargeable in respect of his taxable income as determined after including the amount omitted;
>
> (*c*) if he makes an incorrect statement in any return rendered by him which results or would if accepted result in the assessment of the normal tax at an amount which is less than the tax properly chargeable, an amount equal to twice the difference between the tax as assessed in accordance with the return made by him and the tax which would have been properly chargeable.'

The purpose of additional tax levied by section 76 of the Income Tax Act, as expounded by the Court in *ITC 1430* 50 SATC 51, is threefold. Mullins J stated at 54 *inter alia* that: