AN INVESTIGATION INTO THE FUTURE OF DISCRETIONARY TRUSTS IN SOUTH AFRICA – AN INCOME TAX PERSPECTIVE

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Abstract

Trusts have long been associated with elaborate tax avoidance schemes, primarily as a result of their flow-through nature. In the National Budget the Minister of Finance indicated that the government was proposing several legislative measures during 2013/2014 regarding trusts to control abuse. At this stage the proposals are vague and confusing, but it is intimated that the conduit pipe principle may be under review as the proposals state that trusts should no longer act as a flow-through vehicle, meaning that the amounts distributed to the beneficiaries will no longer retain their original identity. The main objective of the research was to clarify the proposed changes to the taxation of trusts, to investigate the potential impact(s) of these proposals (albeit unclear and consequently based on certain assumptions), and to assess whether discretionary trusts still have a future in South Africa given these proposals. In order to meet this objective, a qualitative approach based on a literature study of pure theoretical aspects was used. It was found that should the proposals become law the beneficiaries will be worse off.

Keywords

Income Tax Act No. 58 of 1962, discretionary trusts, conduit pipe principle, interest, dividends, capital gains, tax avoidance

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1. INTRODUCTION, BACKGROUND AND PROBLEM STATEMENT

During the 2013 budget speech, Finance Minister Pravin Gordhan indicated that the government was proposing several legislative measures during 2013/2014 regarding the taxation of trusts, which have 'long been a problem for global tax enforcement due to their flexibility and flow-through nature' (BDO, 2013). Treasury also intends to review the estate duty planning functionality of trusts as it indicated its concern regarding the use of trusts to avoid estate duty (Croome, 2013). It was however indicated that the proposals would not apply to special trusts catering for the needs of minor children and disabled persons (Croome, 2013).

Treasury is seeking additional sources of income due to the shortfalls in revenue collections. It therefore proposes to 'tighten up on revenue collections' by adopting measures which include, among others, 'the curtailing tax avoidance associated with trusts and the taxation of trusts' (Caroll, 2013). Trusts have long been associated with elaborate tax avoidance schemes, and the perception exists that trusts are misused by wealthy South Africans or so-called 'high net worth individuals' (BDO, 2013). Therefore it was expected that the government would take extreme measures proposing that trusts would be liable to pay tax in their own right without the possibility of passing income and capital gains through to beneficiaries (Croome, 2013).

On 14 June 2013 representatives of the National Treasury and the Commissioner of the South African Revenue Service ('SARS') together with representatives of the Fiduciary Institute of Southern Africa, Financial Planning Institute, Law Society of South Africa, South African Institute of Chartered Accountants, South African Institute of Tax Practitioners and the Society of Trust and Estate Practitioners, held a meeting to discuss the future of the taxation of trusts. Feedback from the meeting led Paulsen and Botha (2013) to believe that National Treasury seems to have a lack of understanding of the operation of trusts, and little consideration has been given to the serious consequences of imposing the trust reform proposals. National Treasury therefore seeks to understand the current position of trusts and the relevant tax consequences.

It was expected that the trust reform proposals would be included in the 2013 draft Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill (issued during July 2013), as the draft legislation usually gives effect to tax proposals announced during the Budget Review. The draft legislation, however, did not include any trust reform information or specifics, which has resulted in National Treasury indicating that the trust reform proposals require more consultation and will be dealt with later in 2013 or as part of 2014's process (National Treasury, 2013).

The problem that arises from all of the abovementioned developments, processes and statements issued by National Treasury is that they confuse taxpayers, tax practitioners and the general public alike as to what exactly the proposals are and what the future of trusts in South Africa is. The proposals are vague and confusing (Caroll, 2013), and the only reference to trust reform in the 2013 Budget speech document is the following: 'The taxation of trusts will come under review to control abuse' (Gordhan, 2013:21). These reforms might have a significant impact on tax planning and structuring, estate planning and the existence of trusts. According to Haupt (2013:778) a discretionary trust is currently preferred for estate planning purposes, as the assets in the trust do not form part of the estate of the beneficiary and so cannot be subject to estate duty in his hands. The trustees would then give the beneficiary only income and capital for his needs. The impact of the proposed amendments might significantly change this school of thought, as it seems at this stage that the amendments are to apply to discretionary trusts

(Seccombe, 2013:37). The article therefore aims to clarify the proposed changes to the taxation of trusts, investigates the potential impact(s) of these proposals (albeit unclear and consequently based on certain assumptions), and assesses whether discretionary trusts still have a future in South Africa given these proposals.

2. RESEARCH OBJECTIVES AND METHODOLOGY

The article primarily investigates the question whether discretionary trusts have a future in South Africa. Firstly, the investigation aims to clarify what exactly the taxation of trusts reforms is and secondly what the potential impact of these proposals could be. The impacts are based on the assumptions applied in the clarification process found in section 6 of the article. In summary, the potential problems associated with the taxation of trusts reforms are highlighted and the result of the investigation could assist tax practitioners and taxpayers in effective tax and estate planning. Relevant issues for future consideration are therefore identified to potentially assist the taxpayer in deciding whether a discretionary trust is appropriate for his or her objectives and needs.

The article makes use of a qualitative approach based on a literature study of pure theoretical aspects. A documentary analysis is used as the research method. Hutchinson and Duncan (2012:101) describe the research strategy followed (which is doctrinal in nature) as research which provides a systematic exposition of the rules governing a particular legal category, analyses the relationships between rules, explains areas of difficulty and, perhaps, predicts future developments.

The problem-based doctrinal research methodology applied in this article includes the following steps (Hutchinson & Duncan, 2012:106):

- Gathering of all relevant and applicable facts;
- Identification of the specific requirements;
- Analysis of the issues from a legislative perspective;
- Studying of sources such as academic text books, journal articles as background;
- The identification of primary sources including case law and legislation;
- Synthesising of all the relevant issues within the correct context; and
- The drawing of an effective and sensible conclusion.

To achieve the abovementioned objectives the article makes use of the following structure:

- A discussion of the reasons for and costs of establishing a trust;
- A concise discussion on the current income tax treatment of trusts in South Africa;
- Clarification of the taxation of trusts amendment proposals;
- Practical examples of the potential implications of the proposed taxation on trusts amendments;
- An international perspective on the taxation of trusts, specifically with regard to the tax treatment of trusts in Australia;
- Summary, conclusion and recommendations.

3. SCOPE AND LIMITATIONS OF THE INVESTIGATION

This article focuses exclusively on the potential impacts of the proposed amendments in respect of a discretionary trust. Furthermore, consideration is given only to ordinary trusts. Special trusts are therefore excluded from the scope of this article. For purposes of the discussion on the international treatment of trusts, relevant legislation and the practice of Australia are specifically used. Reasons for the selection of Australia as a source for this comparative study are provided under section 7 of this article. It is also stated that the outcome of the article is based upon certain key assumptions that are discussed under section 6.

4. THE REASONS FOR AND COSTS OF ESTABLISHING A TRUST

It is important to understand the reasons for establishing a trust as well as the costs associated with the establishment and management thereof, before one can investigate the potential impacts of the proposed amendments. This is deemed important, as the taxpayer will have to consider the costs versus the benefits of establishing and making use of a trust.

4.1 Reasons individuals make use of trusts

According to Hill (2012) trusts are commonly used to 'freeze' the value of assets where a natural person does not want the assets to form part of his deceased estate. The transferor will usually sell his assets to the trust, and any further growth in the value of the assets will accrue to the trust. The effect is to reduce the dutiable estate of the seller over time and effectively the estate duty arising upon his death as well. Estate duty is often called a wealth tax, and trusts could therefore assist in the reduction of wealth taxes as well as executors' fees. This ultimately results in the heirs receiving a larger inheritance (Hill, 2012). Another reason for accumulating assets in a trust is the deceased's potential liability for capital gains tax. For capital gains tax purposes a deceased person is deemed to have disposed of his assets to his deceased estate for proceeds equal to their market value at the date of his death (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks & De Swardt, 2013:996). Hill (2012) states that there are seven main reasons for establishing a trust:

1. *Trusts offer protection against other types of tax* – should the deeming provisions in section 7 of the Income Tax Act No. 58 of 1962 ('Act') not apply, tax savings might be available. For example, income can be distributed to trust beneficiaries who might fall under a lower tax bracket than the original owner of the assets. Capital gains can also be distributed to such beneficiaries. Furthermore, if the trustees do not wish that beneficiaries use the cash immediately (for various reasons), income and gains can be vested in such beneficiaries and physical payment made later, for example, at a time when they reach an age of understanding, or the monies are needed to fund education;

2. *Trusts can reduce the costs of winding up a deceased estate* – executor's fees and other winding-up costs can reduce the available cash balance in an estate. Trusts do not die and would therefore not incur such costs;

3. *Trusts offer protection against the uncertainties of life* – trusts offer protection against claims arising against a personal owner of assets during his lifetime. At death, compensation in the form of life assurance proceeds is usually available, but, during life, a

large claim against one's estate, possibly leading to personal sequestration, results in no assurance compensation. A trust is consequently a useful risk management tool;

4. *Trusts offer protection against the uncertainties of death* – trustees who are skilled in financial planning and wealth management can materially enhance the long-term financial well-being of current and future generations;

5. *Trusts can buy time* – the winding-up process of an estate can be a lengthy process of six to eight months or even longer. During this time, a business owned personally by the deceased, or a company of which he was the sole director, is at risk. In such circumstances, normal commercial decision-making is suspended, which can lead to customer shrinkage and a potential drop in the value of business assets. Should the deceased's business have been placed in a trust beforehand, no such time constraints are applicable. Hill (2012) also argues that it makes more sense to reduce one's personal assets and liabilities to manageable portions, while building up trust assets which the trustees can continue to manage after a person's death, unconstrained by legislated timetables;

6. *Trusts can mitigate or avoid the common shortfalls in cash in a deceased estate* – most estates require the executor to sell assets to generate sufficient funds to discharge debt. The timing of the sale is not a luxury available to the executor, and so, quite often, valuable assets realise far less on a forced sale than they would under normal circumstances. This means that even more assets have to be sold (again at lower prices) to make up for any shortfalls;

7. *Trusts permit 'one owner, many users'* – management, registration, accounting, expense and financial records can be centralised, thus saving costs, while trust beneficiaries can enjoy the advantages of ownership on an equitable basis.

Finally, the conduit pipe principle applied to trusts offer a further advantage with regard to potential tax savings. In *Armstrong v CIR* [1938] 10 SATC 1 ('Armstrong') it was determined that the income of a trust retains its identity until it reaches the parties (beneficiaries) in whose hands it is taxable. A trust is therefore a mere conduit pipe through which the income flows. This means that if income accrues to a trust and the trustees distribute it to one or more beneficiaries in the same year, the income retains its nature in the hands of the beneficiary (Holdstock, 2013). For example, if a trust receives interest, dividends or a capital gain and distributes these to a beneficiary, the amounts retain their identity and the beneficiary will receive interest, dividends or a capital gain respectively (Seccombe, 2013:36). When a trust distributes income or capital out of a trust, the amounts will no longer be subject to tax in the trust, but will be taxed in the hands of the beneficiary (Seccombe, 2013:36). The trust law therefore provides for income-splitting opportunities (Holdstock, 2013) – this is the main reason why trusts can be used efficiently for tax purposes.

Based on the conduit or flow-through principle when the accrual of the income is to a beneficiary, any exemption from tax provided in the Act applying to the income will be available to that beneficiary. For example, if the beneficiary receives local dividends as a distribution from the trust the section 10(1)(k) exemption will be available to the beneficiary. If the beneficiary receives interest as a distribution from the trust, the beneficiary will be entitled to the section 10(1)(i) exemption (Stiglingh et al., 2013:807).

If a beneficiary receives a distribution of capital gain the income will not be treated as ordinary income but will retain its identity as a capital gain. The Eighth Schedule to the Act provides specifically for this application. Paragraph 80(2) is applicable when a beneficiary acquires a vested interest in a capital gain (as a result of the trustees exercising their discretion to distribute the gain) made by the trust on the disposal of an asset. Paragraph 80(2) states that in this scenario the capital gain vesting in the beneficiary must be disregarded in the trust but taxed in the hands of the beneficiary in whose hands the gain vests. The capital gain will be included at the inclusion rate of 33.3% in the beneficiaries' taxable income after deducting the annual capital gains tax exclusion of R30 000. Natural persons can therefore benefit from the tax exemptions related to the income derived from a specific asset class, while housing the said assets in a trust.

4.2 Costs related to the establishment and management of a trust

The cost for the establishment of a trust is currently in the vicinity of R4 500 (including VAT and master's fee) (Rall-Willemse, 2013). A trustee is not automatically entitled to compensation, but trustees are often lawyers or other professionals who cannot afford to work for nothing. Therefore, a trust deed usually makes provision that trustees are entitled to reasonable payment for their work (Sebenza, 2013). Trustees' fees could therefore vary from trust to trust.

Before 23 February 2011, a substantial difference existed between the amount of transfer duty levied on the acquisition of a property by a natural person and by a trust. A natural person was taxed on a sliding scale ranging from 0%-8% of the property purchase price, while a trust was taxed at a fixed rate of 8% of the property purchase price. After 23 February 2011, however, companies and parties other than natural persons (including a trust) have been taxed on the same sliding scale (ranging from 0%-8%) as natural persons (SARS, 2013). Depending on the nature and extent of the activities of the trust, additional costs such as administration or management fees, accounting fees and legal fees might also be incurred. Finally, a trust (other than a special trust) is taxed at a flat rate of 40%, and its inclusion rate for purposes of capital gains tax is 66.6%.

5. CURRENT INCOME TAX TREATMENT OF TRUSTS IN SOUTH AFRICA

As stated in the scope and limitations section of this article, the income tax treatment of special trusts are not considered for the purposes of this article. The article therefore focuses on an ordinary trust that, by default, is a trust that is not a special trust as defined. Special trusts are taxed at the rates applicable to individuals. The tax rate for an ordinary trust is fixed at 40% (Stiglingh et al*.,* 2013:805). According to Haupt (2013:777) there are two types of ordinary trusts, namely a testamentary trust (this is a trust created in terms of a will) and an *inter vivos* trust (this is a trust created by contract during the lifetime of the creator). In each of these trusts there are two types of rights a beneficiary can have:

- a vested right – which means that either the income or the capital of the trust must be paid to the particular beneficiary. The trustees are therefore merely administering the capital or income for the beneficiary; or
- a contingent right – which means that no particular beneficiary is entitled to any income or capital unless the trustees decide to make a distribution to the beneficiary. In this case there is a chance that the beneficiary will never receive any portion of the income or capital in the trust (Haupt, 2013:777).

In the aforementioned instance, the trustees are administering the capital and income for the beneficiaries as a group with no certainty as to which beneficiaries will ultimately benefit from the funds in the trust, and to what extent (Haupt, 2013:778).

A trust is not regarded as a natural person and does not qualify for the primary, secondary or tertiary rebate (Stiglingh et al., 2013:805). A trust also does not qualify for the annual capital gains tax exclusion (currently R30 000 for the 2014 year of assessment) available to a natural person (Seccombe, 2013:36). In addition, the trust will not qualify for the general exemption in respect of local interest in terms of section 10(1)(i) (currently R23 800 for taxpayers under 65 and R34 000 for taxpayers 65 and over for the 2014 year of assessment), as this exemption is available only to natural persons (Stiglingh et al., 2013:805; Seccombe, 2013:9).

As a taxpayer in its own right a trust pays tax at a flat rate of 40% of taxable income – representing the highest rate of tax (Seccombe, 2013:9, 36). A trust is also taxed at the highest rate for capital gains purposes. With effect from 1 March 2012 an inclusion rate of 66.6% is applied to a net capital gain of a trust, causing a taxable capital gain in the trust, which will be subject to tax at 40%, resulting in an effective rate of capital gains tax of 26.6%. As of 1 April 2012 a resident trust receiving local dividends from a South African company investment will be subject to a 15% dividend tax, and once the dividend tax has been withheld the trust receives a local dividend exempt from normal tax in terms of section 10(1)(k)(i) (Seccombe, 2013:9). Section 10(1)(k)(i)(ee) has been created with effect from 1 April 2012 as an anti-avoidance provision to eliminate tax avoidance by means of a cession of the dividend stream (Seccombe, 2013:9). This specific exception to the general rule, whereby local dividends will remain taxable, deals with two main scenarios, namely dividends received by or accrued to a company in consequence of any cession of the right to that dividend or the exercise of a discretionary power by any trustee of a trust, unless that cession or exercise is part of the disposal of all rights attaching to the share (SAICA, 2013:2).

In summary, a trust will be taxed on receipts and accruals which have not vested in any beneficiary during the year of assessment in which they were so accrued or received by the trust. This result is achieved by section 25B of the Act. In essence, section 25B provides that (subject to section 7) the income of the trust is taxed either in the trust or in the hands of the beneficiaries (Haupt, 2013:796). It effectively means that, should dividends, interest and/or capital gains accrue to a trust during any year of assessment, and none of those amounts vest in any beneficiary, the trust cannot make use of any of the concessions available to a natural person in respect of those amounts. Section 7(1) applies where the beneficiary has a vested right to the income retained in the trust. In other words, the beneficiary is certain to get the income at some time in the future; his enjoyment of it has merely been postponed. If he dies before the income is paid to him, it will go to his estate. Therefore, as the income is effectively the beneficiary's, he will be taxed on it (Haupt, 2013:803).

With regard to a discretionary trust, section 25B(2) states that the exercise of the trustees' discretion qualifies as a vesting event. Williams (2009:577) states that the decision in the case *SIR v SIR v Rosen* [1971] 32 SATC 249 ('Rosen') held that a trust deed may entitle or oblige trustees to administer the trust income in such a way that the trust is not a mere conduit for passing it on to the beneficiary and suggested that, in this event, income of the trust may lose its character as 'income'. It is argued that this applies specifically to discretionary trusts, as the trustees can decide whether or not to distribute any amounts to the beneficiaries and are thus not merely a 'flow-through' mechanism. The judge in Rosen raised, but left open, the question whether trust income would change its character to capital where the trustee did not distribute such income and accumulated it in the trust. According to Williams (2009:577) the later decisions in *Estate Dempers v SIR* [1977] 39 SATC 95 ('Estate Dempers') and *SIR v Sidley* [1977] 39 SATC 153 ('Sidley') suggest that, if income is accumulated in this way, trust income retains its character as 'income' but left open the question whether it would retain its character as such if it was distributed in a later year of assessment. Should a discretionary trust receive dividends and or interest during a year of assessment, and the trustees decide not to distribute these amounts to beneficiaries, the decisions in Estate Dempers and Sidley imply that those amounts remain dividends and interest in the trust's hands. If, however, the trustees exercise their discretion in the same year of assessment in which the amounts are received or accrued, the amounts vest in the beneficiaries and based on the conduit pipe principle retain their nature in the hands of the beneficiaries.

6. CLARIFICATION OF THE TAXATION OF TRUSTS AMENDMENT PROPOSALS

Although it is not clear at this stage what exactly is intended, it is intimated that the conduit pipe principle may be under review, as the proposals state that trusts should no longer act as a flow-through vehicle, meaning that the amounts distributed to the beneficiaries will no longer retain their original identity (BDO, 2013) and that a trust should be taxed as a separate and distinct entity (Croome, 2013). The proposals suggest that taxable income/losses and capital gains/losses will be taxed in the trust, with distributions acting as deductible payments to the extent that there is current taxable income (Caroll, 2013). Where distributions are deductible payments for the trust, the beneficiary would then be taxed thereon as having received ordinary income (the effect of the income not retaining its original identity) (BDO, 2013). This interpretation of the proposed amendments is similar to the one supported by Seccombe (2013:36) (as discussed in the next paragraph). It is important to note that these proposals are not intended to affect special trusts (Caroll, 2013).

Seccombe's (2013:36) suggestion as to what the proposal encompasses is that if the application of the conduit pipe principle is scrapped it will imply that discretionary trusts will only be able to distribute 'taxable income'. Therefore, if the trustees of a discretionary trust exercise their discretion to distribute amounts to beneficiaries in the same year of assessment in which the amounts are received or accrued, a normal income tax calculation for the trust needs to be done. The result of this calculation should be the theoretical taxable income of the trust if no distributions were to be made and none of the receipts and accruals vested in any beneficiaries during that same year of assessment. The term 'taxable income' is defined in section 1 of the Act as:

> the aggregate of the amount remaining after deducting from the income of any person all the amounts allowed...to be deducted from or set off against such income; and all amounts to be included or deemed to be included in the taxable income of any person in terms of this Act.

The taxable income of a trust must therefore be calculated by including all receipts and accruals (certain of these receipts and accruals may be exempt from tax, for example local dividends), claiming certain expenses as deductions and including any taxable capital gain (66.6% of the net capital gain). After calculating the taxable income of the trust, the trustee can make distributions to the beneficiaries. Once the amount of taxable income has been distributed out of the trust, the amount will be subject to tax in the hands of the beneficiary and not in the trust. Any distributions to beneficiaries would therefore be treated as a deductible payment by the trust (BDO, 2013).

A further contention is that the receipts and accruals are taxed at entity level (Croome, 2013) in the trust's hands irrespective of whether the trustees exercise their discretion or not. This contention ignores any vesting of amounts in the beneficiaries. Once the trust is taxed in its own capacity, distributions to beneficiaries are treated as after-tax distributions and non-taxable in their hands. This treatment is similar to the treatment of dividends distributed to a beneficial owner by a company. The company is taxed on its taxable income, with dividends distributed to beneficial owners which are exempt from normal tax in their hands. The onus of the tax liability in this case falls on the trust, as opposed to Caroll and Seccombe's contention that the tax liability will lie with the beneficiary.

With the abovementioned interpretations taken into consideration, the following key assumptions are made for purposes of this article:

Interpretation 1

- The proposed amendments will apply to discretionary trusts only.
- If amounts accrue to (or are received by) a discretionary trust during a year of assessment and the trust makes distributions to beneficiaries in that same year of assessment, those amounts are deemed to be income in nature (irrespective of its original nature) in the hands of the beneficiary. From this it follows that the taxable income of the beneficiary resulting from the distribution is calculated as if it is the taxable income of the trust.
- If none of a discretionary trust's receipts and accruals vest in any beneficiary during the year of assessment, the trust will be taxed on those amounts.
- The amount of the distribution that is taxable in the beneficiaries' hands is determined by calculating the trust's taxable income. Only that portion of the distribution which equals the taxable income of the trust is included as taxable income in the beneficiaries' hands.
- The article focuses purely on the *income tax treatment* of the distribution and does not take into consideration the actual cash flow to the beneficiaries.

Interpretation 2

- The proposed amendments will apply to discretionary trusts only.
- If amounts accrue to (or are received by) a discretionary trust during a year of assessment, those receipts and accruals are taxed at entity level in the trust's hands irrespective of whether the trustees exercise their discretion or not.

The following section makes use of practical examples illustrating the probable implications of both interpretations of the proposed amendments. The current income tax treatment and the proposed income tax treatment for different scenarios are investigated and compared. Tax rates, concessions and exemption thresholds applicable to the 2014 year of assessment are used for the purpose of the examples.

6.1 Practical examples of the probable implications of the proposed amendments

To illustrate the practical impact of the proposed amendments the following scenarios should be considered:

Scenario 1 – Current income tax treatment of discretionary trusts where the trustees exercise their discretion

ABC Trust is a discretionary trust. The trust has one beneficiary, who is a natural person, under the age of 65 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	R1,5 million
▪ Interest received from South African investments	R50 000
▪ Dividends received from South African investments (gross)	R50 000

Assume that the capital asset is not an allowance asset and that its base cost is R500 000. TABLE 1 illustrates the income tax calculation of the trust and the beneficiary if the trustees of the trust decide to distribute all of the receipts and accruals in the trust to the beneficiary during the 2014 year of assessment:

Table 1: Current income tax treatment – all receipts and accruals vest in beneficiary

Income tax treatment of the discretionary trust	*Amount (R)*
Taxable income	-
The ABC Trust has no taxable income, as all receipts and accruals vest in the beneficiary in the same year of assessment in which those amounts were received by or accrued to the trust. The exercising of the trustees' discretion is a vesting event.	
Income tax treatment 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))	23 800
Dividend exemption (section 10(1)(k))	50 000
Income	26 200
Add: Taxable capital gain (section 26A)[1]	323 010
Taxable income[2]	349 210
Normal income tax[3]	80 234
Less: Primary rebate	12 080
Normal tax payable to SARS	68 154

All receipts and accruals of the ABC Trust vest in the beneficiary in terms of section 25B(2) and are therefore taxable in the beneficiary's hands. The conduit pipe principle ensures that the receipts and accruals retain their original nature in the hands of the beneficiary. The beneficiary is therefore entitled to the basic interest exemption, dividend exemption, and annual exclusion of R30 000 for capital gains tax purposes as well as the primary rebate of R12 080.

1. ([R1 500 000 – R500 000] – R30 000) x 33,3% = R323 010
2. Assume that the beneficiary had no other receipts and accruals for the 2014 year of assessment.
3. R53 096 + 30% x (R349 210 – R258 750) = R80 234

Source: Authors' calculations

The overall effect is that an amount of R68 154 is payable to SARS. The following scenario illustrates the income tax effect where the trustees do not exercise their discretion with regard to distributions to the beneficiary.

Scenario 2 – Current income tax treatment of discretionary trusts where the trustees do not exercise their discretion

Assume the same information as in Scenario 1, except that the trustees do not exercise their discretion during the 2014 year of assessment with regard to distributions to the beneficiary. TABLE 2 illustrates the current income tax consequences of the instance where the trustees do not exercise their discretion during the 2014 year of assessment. The amounts received by the ABC Trust are therefore retained in the trust and none of it vests in the beneficiary.

Table 2: Current income tax treatment – no amounts vest in beneficiary

Income tax treatment of the discretionary trust	*Amount (R)*
Gross income	100 000
Dividends	50 000
Interest	50 000
Less: Exemptions	50 000
Dividend exemption (section 10(1)(k))	50 000
Income	50 000
Add: Taxable capital gain (section 26A)[1]	666 000
Taxable income	716 000
Normal income tax[2]	286 400
Normal tax payable to SARS	286 400

None of the receipts and accruals of the ABC Trust vest in the beneficiary in terms of section 25B(2) and are therefore taxable in the trust's hands. The trust is entitled only to the dividend exemption, as it is not a natural person and therefore does not qualify for the basic interest exemption, the annual exclusion of R30 000 for capital gains tax purposes or the primary rebate of R12 080. There are no income tax consequences for the beneficiary, as no receipts or accruals vest in his hands.

1. [R1 500 000 – R500 000] x 66,6% = R666 000
2. R716 000 x 40% = R286 400

Source: Authors' calculations

The overall effect is that an amount of R286 400 is payable to SARS. The same result will be achieved where the contention that the trust must be taxed at entity level is followed (refer to

Scenario 5). The following scenario illustrates the income tax effect of both interpretations of the proposed amendments.

6.1.1 Interpretation 1

Scenario 3 – Proposed income tax treatment of discretionary trusts where the trustees exercise their discretion

Assume the same information as in Scenario 1, except that the income tax treatment is dealt with in accordance with the proposed amendments discussed earlier and that the trustees exercise their discretion during the 2014 year of assessment with regard to distributions to the beneficiary. Table 3 illustrates the proposed income tax consequences for the ABC Trust of the instance where the trustees exercise their discretion during the 2014 year of assessment.

TABLE 3: Proposed income tax treatment of the trust – all receipts and accruals vest in beneficiary

Income tax treatment of the discretionary trust	*Amount (R)*
Gross income	100 000
Dividends	50 000
Interest	50 000
Less: Exemptions	50 000
Dividend exemption (section 10(1)(k))	50 000
Income	50 000
Add: Taxable capital gain (section 26A)[1]	666 000
Taxable income[2]	716 000
Deduct: Distribution to beneficiary of taxable income[3]	716 000
Taxable income	-

The trust is entitled only to the dividend exemption, as it is not a natural person and therefore does not qualify for the basic interest exemption, the annual exclusion of R30 000 for capital gains tax purposes or the primary rebate of R12 080. There are no income tax consequences for the trust, as the distribution of taxable income is deemed to be a deduction for purposes of the calculation of the trust's taxable income. The amount of the taxable income distributed to the beneficiary is taxable in the beneficiary's hands as taxable income. The conduit pipe principle is not applied and the distribution loses its original nature consisting of a combination of capital and exempt income receipts and accruals.

1. [R1 500 000 – R500 000] x 66,6% = R666 000
2. The taxable income of the trust represents the amount of the distribution that can be made to the beneficiary which would qualify as a deduction in the trust's hands.
3. Under the new proposed amendments, the distribution of taxable income of the trust to a beneficiary will qualify as a deduction against the trust's taxable income.

Source: Authors' calculations

TABLE 4 illustrates the income tax effect of the proposed amendments of Scenario 3 for the beneficiary.

TABLE 4: Proposed income tax treatment of the beneficiary – all receipts and accruals vest in beneficiary

Income tax treatment of the beneficiary	*Amount (R)*
Taxable income received from discretionary trust	716 000
Taxable income[1]	716 000
Normal tax[2]	216 165
Less: Primary rebate	12 080
Normal tax payable to SARS	204 085

There are no income tax consequences for the trust, as the distribution of taxable income is deemed to be a deduction for purposes of the calculation of the trust's taxable income. The amount of the taxable income distributed to the beneficiary is taxable in the beneficiary's hands as taxable income. The conduit pipe principle is not applied, and the distribution loses its original character, consisting of a combination of capital and exempt income receipts and accruals. 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.

1. Assume that the beneficiary had no other receipts and accruals for the 2014 year of assessment.
2. R185 205 + 40% x (R716 000 – R638 600) = R216 165

Source: Authors' calculations

The overall effect is that an amount of R204 085 is payable to SARS. In terms of the current income tax treatment of this scenario, a total amount of R68 154 (refer to calculation in TABLE 2) would have been payable to SARS. The result is an alarming increase of almost 200% in the overall income tax liability caused by the exercising of the trustees' discretion. The proposed amendments directly disqualify the beneficiary from making use of both the basic interest exemption and the capital gains tax concessions available to a natural person. From the calculations performed in the tables above it can be clearly seen what drastic negative effect the proposed amendments have on the taxation of the relevant receipts and accruals. In conclusion, these proposals will have a significant impact on the taxation of trusts and trust beneficiaries (Deloitte, 2013:23). If these proposals should become law, the beneficiaries will be worse off from a financial perspective and this could ultimately lead to the end of discretionary trusts. The negative and adverse income tax consequences could therefore nullify any other non-income tax advantages, such as the protection of assets and effective wealth management on behalf of the beneficiaries. It seems, however, that non-discretionary trusts are unaffected by the proposed amendments and that distributions made to beneficiaries from those trusts will retain their original character and be treated as such from an income tax perspective.

Scenario 4 – Proposed income tax treatment of discretionary trusts where the trustees do not exercise their discretion

The income tax consequences where the trustees do not exercise their discretion and retain all receipts and accruals in the trust are exactly the same as in Scenario 2 under the proposed amendments.

6.1.2 Interpretation 2

Scenario 5 – Proposed income tax treatment of discretionary trusts if the trust is taxed at entity level

The trust would in this instance be taxed on the receipts and accruals in the 2014 year of assessment irrespective of whether those amounts vest in the beneficiary. The income tax consequences of this scenario are exactly the same as in Scenario 2. The beneficiary would then receive the distribution tax free from the trust, as the amount would already have been subject to normal income tax in the trust.

The following section investigates the income tax treatment of discretionary trusts from an international perspective (specifically that of Australia). This is done to obtain an understanding of how discretionary trusts are treated outside of South Africa and to possibly identify certain principles or practices that could lead to a more effective, efficient, equitable and reasonable income tax treatment of discretionary trusts and its beneficiaries.

7. THE TAXATION OF TRUSTS FROM AN AUSTRALIAN PERSPECTIVE

7.1 Motivation for using Australia for purposes of comparison

According to Haupt (2013:5), South African income tax legislation originated from the Australian New South Wales Act of 1895, and is therefore similar in a number of respects. In *CIR v Manganese Metal Co (Pty) Ltd* [1996] 58 SATC1 it was also stated that the South African income tax structure is comparable to that of Australia's. In addition, Australia is described as a 'first world country' and is also a member of the Organisation for Economic Cooperation and Development ('OECD'), which are trendsetters with regard to the establishment of uniform economic standards and the application of prudent, sensible economic practice in the fields of economics, taxation and accounting (OECD Member Countries, [s.a.]). An investigation into the treatment of discretionary trusts for Australian income tax purposes is therefore deemed insightful and could possibly lead to identifying useful principles that can be successfully applied within a South African income tax context. For the purpose of this article, the relevant Australian income tax legislation to be investigated is the Income Tax Assessment Act 1936 ('ITAA36').

7.2 Introduction and background

For Australian income tax purposes a trust is an intermediary between individuals and underlying business or investment assets. The ultimate aim of the rules governing the taxation of income derived through a trust is to tax individual beneficiaries. The rules therefore trace income through the trust, or, where the trust is subject to separate taxation, through imposition of tax liability on the trustee, and ultimately reconcile the tax imposed at the trustee and beneficiary level (Woellner, Barkoczy, Murphy, Evans & Pinto, 2013:781).

A discretionary trust is one of five types of trusts used in Australia. The trustee of a discretionary trust has the discretion to decide how the income and/or capital is distributed between the beneficiaries. This may enable the trustee to distribute the trust income in such a way as to minimise the overall tax liability on the total trust income or on the total income of the beneficiaries (Woellner et al., 2013:785). The taxation of trust income is governed by Section 95-

102 of Division 6 (Part III) of the ITAA36. Section 97 of the ITAA36 determines the extent to which beneficiaries are taxed on trust distributions. For the purposes of section 97, a beneficiary's proportionate entitlement to a share of the 'income of a trust' is established by the trustee and then that share is applied to the net income (taxable income in accordance with section 95) in order to ascertain the amount of taxable income of the beneficiary (Timms, 2010).

7.3 Current income tax treatment of receipts and accruals of a discretionary trust

Beneficiaries are taxed on a share of the trust's net income, based on their present *entitlement* to a share of the income of the trust estate. Trustees are taxed (as representatives of the trust) on the net income that is not taxed in the hands of the beneficiaries. Capital gains and other amounts can be streamed to beneficiaries. These amounts retain their tax character when taxed in the hands of the beneficiaries (Australian Treasury, 2012:9).

With regard to capital gains and capital losses, unless there is a beneficiary with absolute entitlement to the asset, a capital gain or capital loss realised on a trust asset is generally included in the trust's net capital gain or net capital loss calculation for the year. If the trust deed specifically provides for a beneficiary's entitlement to capital gains, these gains can be allocated to the beneficiaries for tax purposes. If no beneficiary is specifically entitled to a capital gain, it is allocated proportionately to all beneficiaries based on their entitlement to income of the trust (Australian Government, 2013). Capital gains would then be included in a beneficiary's taxable income respectively under the specific capital gains tax provisions (Australian Government, 2013). These distributions therefore retain their original nature and are taxed as such in the beneficiaries' hands.

If no beneficiary is entitled to the trust's income, the trustee will accumulate the trust's income and the trustee is liable for tax (on behalf of the trust) on the trust's net income. A trust is generally assessed at the highest individual marginal rate of tax (Australian Government, 2013), which is 45% for the 2013/2014 year of assessment (Power, 2013). It is argued that entitlement and vesting carry the same meaning and have the same effect for income tax purposes. Both of these events indicate that the income tax consequences of the receipt or accrual lie with the beneficiary once it has taken place. TABLE 5 indicates, among other things, the current income tax treatment of receipts and accruals of a discretionary trust in Australia. From the table it can be seen that Australia's current income tax treatment of discretionary trusts is materially similar to that of South Africa's as it seems to apply the same fundamental principle of receipts and accruals retaining their original character or nature. It can therefore be argued that Australia also makes use of the conduit pipe principle and it can further be inferred from the Australian proposals summarised in Table 5 that the conduit pipe principle is still deemed relevant and applicable.

7.4 Entity taxation proposal

On 13 August 1998 the Australian Government announced its intention to adopt a more consistent regime for the taxation of entities by developing a single entity tax regime (Woellner, Barkoczy, Murphy & Evans, 2004:1050, 1060). The single entity tax regime proposed to tax discretionary trusts like companies. Under this regime discretionary trusts will be taxed at entity level and impute the tax paid to the beneficiaries of the trust. Discretionary trust distributions in the form of payments of money, the transfer of property or certain other specified transactions that are comparable to deemed dividends would be subject to entity taxation. The trustee would be liable for tax on any income not distributed and there would be no other tax consequences for the after-tax profits retained in the trust (Woellner et al., 2004:1060-1061). Distributions to beneficiaries would be treated as coming from profits (to the extent of the trust's available profits), and when available profits are exhausted, distributions would be treated as coming from contributed capital (Woellner et al., 2004:1061). It is argued that this proposal is the same as the one presented under Interpretation 2, where it was assumed that the trust is taxed on all receipts and accruals irrespective of whether they vested in the beneficiary of the trust, or not. The result is that the onus of the tax liability is on the trust, with the beneficiary receiving a non-taxable distribution. The distribution would have been subject to normal income tax in the trust's hands.

In October 2000 the Australian Government released exposure draft legislation providing for the taxation of trusts like companies (Atherton, 2013), and the new entity tax regime was to commence on 1 July 2001 (Woellner et al., 2004:1050). Following the release of the exposure draft legislation, the government received a great number of submissions which raised technical problems particularly in relation to distinguishing the source of different distributions, and valuation and compliance issues that meant that the draft legislation was not workable. The Taxation Institute of Australia ('TIA') raised the following concerns relating to the provisions in the exposure draft legislation in a letter to the Australian Treasurer. The TIA stated that the provisions are incomplete; add substantial complexity to the tax law; impose massive compliance burdens; are inequitable; impose double tax; and are unworkable due to the inability of the drafters to determine key definitions. The Australian Board of Taxation was of the view that the efficiency and equity of the tax system would not necessarily be improved by aligning the tax treatment of trusts and companies. The Board also noted that any proposal to tax discretionary trusts like companies could impose significant transitional costs on the economy and on those individuals who have structured their affairs under existing rules. The Australian government heeded advice from the Board of Taxation, which recommended that the Bill should not proceed and suggested investigating alternative approaches (Atherton, 2013). The Australian government announced on 27 February 2001 that it would not proceed with proposals in the draft New Business Tax System (Entity Taxation) Bill 2000. Instead, the government proposed consultations on ways to address tax abuse in the trust area (Woellner et al., 2004:1050).

7.5 Reform of the taxation of trust income (update and rewrite of existing provisions)

In December 2009, *Australia's Future Tax System Review* recommended that the rules relating to the taxation of trusts be updated and rewritten to reduce complexity and uncertainty around their application (Australian Treasury, 2012:7). An initial consultation paper (*Modernising the taxation of trust income — options for reform*), which outlined three possible models for taxing trust income, was released by the Australian government in November 2011. The Australian government also highlighted that the reform options would not include taxing trusts like companies.

Based on stakeholder consultation forums and written submissions on the *Modernising the taxation of trust income — options for reform* (Australian Treasury, 2012) the Australian Treasury released a Policy Options Paper in October 2012 outlining two potential options for trust tax reform. The Australian government has not yet announced its preferred option. The proposed new regime is intended to commence from 1 July 2014 (PricewaterhouseCoopers, 2013).

The two models developed are the economic benefits model ('EBM') and the proportionate assessment model ('PAM'). The EBM uses tax concepts to determine amounts for tax purposes, while the PAM uses general concepts of profit to determine tax outcomes. Both models still require compliance with the trust deed and trust law, but move away from relying on the trust deed's labelling of amounts as income or capital to determine tax outcomes (Australian Treasury, 2012:8). TABLE 5 illustrates the difference between the current law and the two models.

TABLE 5: Comparison of current law with two proposed new models

	Current law	*Economic benefits model*	*Proportionate assessment model*
Basis for taxation	Beneficiaries are taxed on a share of the trust's net income, based on their present *entitlement* to a share of the income of the trust estate. Trustees are taxed on the net income that is not taxed in the hands of the beneficiaries.	Beneficiaries are taxed on amounts *distributed or allocated* to them that represent amounts of the trust's taxable income. The trust's taxable income is calculated as if the trust were a resident taxpayer (Australian Treasury, 2012:16). Trustees are taxed on amounts representing taxable income that are not distributed or allocated to beneficiaries.	Beneficiaries are taxed on a share of the trust's taxable income based on their present *entitlement* to a share of the trust profit or class amounts. Trustees are taxed on taxable income that is not taxed in the hands of the beneficiaries.
Character retention and streaming	Capital gains (among other amounts) can be streamed to beneficiaries. These amounts retain their tax character when taxed in the hands of the beneficiaries.	Amounts representing the trust's taxable income retain their tax character when distributed or allocated to beneficiaries (except where other parts of the tax law limit character retention). All amounts can be streamed to beneficiaries.	Classes of taxable income taxed in the hands of the beneficiaries retain their tax character (except where other parts of the tax law limit character retention). All amounts can be streamed to beneficiaries.

Source: Australian Treasury, 2012:9

In summary, from the table above it can be seen that Australia still makes use of a principle similar to that of the conduit pipe principle as it is currently used in South Africa, and through consultation and various review processes abandoned the concept of taxing a trust at entity level in the same manner as a company. It is therefore argued that if a first world country and leader in economic guidelines and principles, such as Australia, still makes use of the conduit pipe principle and applies trust taxation legislation effectively and efficiently, it would be cumbersome and ineffective for South Africa not to follow the same route. It is submitted that current legislation regarding the taxation of discretionary trusts in South Africa is adequate, and that a more effective application of current anti-avoidance rules and mechanisms by SARS would discourage taxpayers from abusing trusts. To punish discretionary trusts in the manner proposed therefore seems heavy-handed and unnecessary given the current legislation and structures available to the revenue authority at present.

8. SUMMARY, CONCLUSION AND RECOMMENDATIONS

Although the trust reform proposals are vague, the article clarified the proposed changes to the taxation of trusts. Two possible interpretations can be derived from the literature review, namely:

1. 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 be 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.
2. A trust should be taxed as a separate and distinct entity, meaning that trusts would be liable to pay tax in their own right without the possibility of passing income and capital gains through to beneficiaries. Therefore, irrespective of whether the trustees exercise their discretion or not, amounts received by the trust will be taxed in the trust's hands and distributions made to beneficiaries would be tax-free in their hands.

The use of a discretionary trust might become extremely unfavourable should the radical proposed amendments be applied. It is important to note that a trust cannot simply be terminated owing to a change in tax legislation. The Trust Property Control Act makes no provision for deregistration of a trust (Grobbelaar, 2013). The common law, however, makes provision for the termination of a trust by operation of law. A trust can be terminated only in the following circumstances – by statute, fulfilment of the objectives of the trust, failure of the beneficiary, renunciation or repudiation by the beneficiary, destruction of the trust property, or the operation of a resolutive condition (Department of Justice and Constitutional Development, 2013). Therefore before terminating a trust the trustees must ensure that the termination is in line with the termination requirements and the conditions relating to termination contained in the trust deed (Lester, 2013). If the trust deed does not contain any termination specifics or requirements, the trust deed needs to be altered (Fouche Attorneys, 2013). This may require the consent of all the trustees and/or the beneficiaries. The trustees must also act in the beneficiaries' best interests, which are not necessarily the best interests of the donor/settlor.

In view of the new tax proposals it might make good sense to terminate a trust and to return the trust assets to the donor/settlor, but this might not be in the best interests of a beneficiary (Lester, 2013). It is important to note that the termination of a trust will have capital gains tax implications. In most instances the termination of a trust will constitute a 'disposal' of all the assets of the trust for capital gains tax purposes, causing capital gains tax to be charged on all capital appreciation within the trust. The disposal value will be determined at current market value (Lester, 2013).

Legislation has changed over the years to protect the tax base against tax avoidance from the use of discretionary trusts (Alexander Forbes, 2013). According to Seccombe (2013) National Treasury's proposed amendments are unnecessary, as the Act already contains efficient and suitable anti-avoidance measures such as section 7 and the general anti-avoidance rules contained in sections 80A to 80L (commonly known as the 'GAAR'). In essence, section 7 of the Act is an anti-avoidance provision aimed at taxing, in the hands of the donor, any income which has resulted from a donation or similar disposition. It is important to note that the provisions of section 7 are not concerned with who formed or created the trust but rather with the person who transferred assets into the trust. Section 7 effectively seeks to tax the person who introduced the assets into the trust on the income generated by those assets (Haupt, 2013:797). Furthermore, section 10(2)(b) of the Act negates the conduit pipe principle in relation to income which is exempt under section 10(1)(h) and (k) where the trust receives dividend income and distributes it in the form of an annuity (Williams, 2009:577). Despite the fact that section 25B makes a trust a legal person and not a mere conduit, the section implicitly seems to leave intact the conduit pipe principle except in situations, such as those mentioned above, where it is statutorily negated, and this was confirmed in the SARS Practice Note 23 (Williams, 2009:577):

> Income of the trust which is not distributed to beneficiaries but is accumulated in the trust and 'capitalised', retains its character as income.

Practice Note 23, however, has been withdrawn by SARS, but does in any case offer some insight into their interpretation of the abovementioned issue.

Should the proposed amendments be enacted into South African income tax legislation it might be necessary to expand the special inclusions paragraphs with regard to the gross income definition in section 1 of the Act to make provision for an taxable income item (taxable in the beneficiary's hands) referred to as 'taxable income from a discretionary trust'. This addition to the gross income definition will require an amendment to the current Act. Although the cost of establishing a trust might seem immaterial, other costs associated with the administration of trusts and ensuring compliance could have a material effect in deciding whether to make use of a discretionary trust or not. The taxpayer will therefore in consultation with his or her tax advisor seriously have to consider the costs versus the benefits of the discretionary trusts, should the proposals become effective. The taxation proposals and result thereof could ultimately nullify other benefits of a discretionary trust, such as the protection of assets and effective wealth management of specifically minors or beneficiaries who have no financial planning skills. These proposals will have a significant impact on the taxation of trusts and trust beneficiaries (Deloitte, 2013:23). If these proposals should become law the beneficiaries will be worse off.

Against the background of the summary and conclusion above, the following recommendations are made with regard to the proposed amendments:

- To prevent the loss of nature or character of a receipt or accrual with regard to a discretionary trust, it is proposed that amounts such as capital receipts and interest, which would be adversely affected by the amendments, immediately vest in beneficiaries and that this vesting is not conditional based on the exercising of the trustees' discretion. Capital and interest receipts should therefore not be subject to the trustees' discretion. This would circumvent the new proposed amendments, as those amounts would retain their nature and character in the hands of the beneficiary;
- Alternatively, taxpayers should in future no longer make use of discretionary trusts;
- Assets should be bequeathed directly to heirs (beneficiaries) and not via a trust;
- National Treasury should scrap the new proposals to ensure and promote equitability;

- To deter taxpayers from abusing discretionary trusts with regard to tax avoidance, SARS should apply current anti-avoidance rules more efficiently and strictly;
- The administration of discretionary trusts should be monitored more efficiently by adhering to the trust deed, and the intention of the creator of the trust should be clear, unambiguous and adhered to. In addition, the exercising of the trustees' discretion should be well and timeously documented in the correct and relevant year of assessment; and finally
- The proposals tabled in Australia should be considered for South African tax purposes. This will require an adequate, thorough review process where all options and outcomes are considered.

In conclusion, this article has aimed to clarify the proposed amendments and also indicate the potential impact of these proposals. Although at this stage there is no finality with regard to the proposed amendments, this article could serve as a potential problem or risk indicator for future use. Taxpayers and tax experts alike could use this article as a guideline and additional source to take into consideration when deciding whether or not to make use of a discretionary trust in South Africa.

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