# A CRITICAL ASSESSMENT OF THE IMPACT OF THE AMENDMENT TO SECTION 25B OF THE INCOME TAX ACT, NO. 58 OF 1962, ON NATURAL PERSON NON-RESIDENT INCOME BENEFICIARIES OF SOUTH AFRICAN RESIDENT TRUSTS

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By

ROBIN JOHN GALLOWAY

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## ABSTRACT

In 2023, section 25B of the South African Income Tax Act, No. 58 of 1962, was amended by the insertion of the words “who is a resident”, which resulted in the “conduit pipe” principle only applying to resident beneficiaries. The effect of this is that trustees can no longer vest income for tax purposes in non-resident beneficiaries. The primary aim of the research was, therefore, to critically evaluate whether, as claimed by the South African National Treasury, Article 1(2) of the OECD Model Tax Convention on Income and on Capital (2017) and Article 3(1) of the Multilateral Instrument will provide relief to non-resident beneficiaries of South African resident trusts from economic double taxation resulting from the 2023 amendment to section 25B of the Income Tax Act. To achieve this aim, a literature review was undertaken to describe the tax treatment of trusts and parties to trusts in South Africa, prior to and after the amendment. Thereafter, a hypothetical simulation was used to illustrate the total economic impact of the amendment on natural person non-resident beneficiaries. The simulation involved the distribution of several types of income and capital gains by a South African discretionary trust to three natural person beneficiaries resident in the United Kingdom, Australia, and the Netherlands, respectively. The simulation evaluated the total economic taxation payable directly and indirectly by each non-resident beneficiary before and after the amendment to section 25B of the Income Tax Act in both South Africa and their respective countries of residence to test the validity of the claim by the South African National Treasury.

The research was undertaken using a doctrinal methodology, situated within the interpretivist paradigm, where a combination of qualitative and comparative data analysis techniques was used to analyse publicly available documentary data. Detailed calculations were performed based on the simulation, together with the assumptions made for this purpose.

The findings of the research revealed that the domestic tax treatment of amounts distributed by a South African resident trust can differ greatly from country to country, which could lead to economic double taxation in certain instances, notwithstanding the relevant Double Tax Agreement, the OECD Model Tax Convention and the Multilateral Instrument. The South African National Treasury’s claim that the effect of Article 1(2) of the OECD Model Tax Convention and Article 3(1) of the Multilateral Instrument would be that non-resident beneficiaries would be provided relief from economic double taxation arising from the South African tax paid by the South African resident trust, was shown not to be correct in every circumstance.



**Key words**: economic double taxation, income tax, Multilateral Instrument, non-resident beneficiaries, OECD Model Tax Convention on Income and on Capital, South African resident trusts, trust distributions.

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# LIST OF ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| CGT | Capital Gains Tax |
| DTA | Double Taxation Agreement |
| Hague Convention | Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition |
| HMRC | His Majesty's Revenue & Customs |
| Income Tax Act | Income Tax Act, No. 58 of 1962, as amended |
| Income Tax Assessment Act | Income Tax Assessment Act, 1936 |
| MTC | Model Tax Convention on Income and on Capital 2017 |
| Multilateral Instrument | The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion And Profit Shifting |
| Non-resident | A person that does not meet the definition of the term “resident” in section 1 of the Income Tax Act, No. 58 of 1962. |
| OECD | Organisation for Economic Co-Operation and Development |
| POEM | Place of Effective Management |
| SA | South Africa or South African |
| SA-Australia DTA | Double Tax Agreement Between South Africa and Australia |
| SA-Dutch DTA | Double Tax Agreement Between South Africa and The Netherlands |
| SA-UK DTA | Double Tax Agreement Between South Africa and The United Kingdom |
| SARS | South African Revenue Service |
| Tax Administration Act | Tax Administration Act, No. 28 of 2011, as amended |
| UK | United Kingdom |
| Vienna Convention | Vienna Convention on the Law of Treaties, 1969 |

# CHAPTER 1: INTRODUCTION

## 1.1 CONTEXT OF THE RESEARCH

Historically, trusts have been widely used in South Africa as a popular estate planning tool, particularly for wealthy families. Trusts offer several tax benefits, even though these benefits have been largely curtailed over the years, where the prevailing perception is that the South African Revenue Service ("SARS") views trusts with "a degree of suspicion and mistrust" (Kruger, Stein, Dachs, & Davey, 2012: 188). Notwithstanding recent amendments to legislation aimed at curbing tax abuse, the number of trusts registered as taxpayers with SARS has steadily increased over the last several years. For instance, in the 2022/2023 year of assessment, SARS recorded an increase in the number of trusts registered for income tax from 373 084 as of March 2022 to 379 280 as of March 2023 (South African National Treasury and SARS, 2023: 5). In addition, the SARS Commissioner recently confirmed that the number of taxpayers emigrating from South Africa has increased substantially, where from the 2017 year of assessment to the 2022 year of assessment, more than 45,000 individual taxpayers indicated on their personal income tax returns that they ceased to be tax resident in South Africa (South African National Treasury and SARS, 2023: 44).

Many expatriates who have placed their non-resident tax status on record with SARS remain income beneficiaries of South African resident trusts. It is against this backdrop that the government has recently legislated a tax amendment that will significantly impact how South African resident trusts and non-resident beneficiaries of South African resident trusts will be taxed on income subject to South African resident trusts going forward. Before the amendment that took effect on 1 March 2024, subject to certain requirements, the effect of section 25B of the Income Tax Act, No. 58 of 1962, as amended (the "Income Tax Act"), was such that local or foreign income that was received by, accrued to, or in favour of a trust that vested in a beneficiary in the same year of assessment, was deemed to be an amount that was received by, accrued to, or in favour that beneficiary. This is widely known as the "conduit pipe" principle or the deemed income rule.

In its previous form, section 25B of the Income Tax Act did not distinguish between resident and non-resident beneficiaries. This meant that taxable income subject to a trust that vested in a non-resident beneficiary in the same year of assessment would be taxed in the non-resident beneficiary's hands at the personal income tax rates that currently range between 18% and

45%, where the beneficiary was a natural person, and not at a current flat rate of 45% in the hands of the trust.

Furthermore, another significant benefit was that foreign-source income subject to a trust that vested in a non-resident beneficiary was previously not taxed in the non-resident beneficiary's hands in terms of South African tax legislation, as foreign income that is vested in a non-resident beneficiary does not fall within the definition of "gross income" in section 1 of the Income Tax Act.

The Taxation Laws Amendment Act, No. 17 of 2023, was promulgated on 22 December 2023 and included a much-publicised amendment to section 25B of the Income Tax Act. The amendment has resulted, by the insertion of the words "who is a resident", in the conduit pipe principle in section 25B of the Income Tax Act only applying to resident beneficiaries. The effect is that, whilst trustees can still legally distribute amounts to non-resident beneficiaries, for tax purposes, trustees are now only permitted to vest income for tax purposes in resident beneficiaries and not non-resident beneficiaries. This aligns with the current tax treatment of capital gains, where trustees are only permitted to vest capital gains in resident beneficiaries for tax purposes in terms of paragraph 80 of the Eighth Schedule to the Income Tax Act. Therefore, with effect from 1 March 2024, any income subject to a South African resident trust that the trustees distribute to a non-resident beneficiary will be taxed in the hands of the trust and not the non-resident beneficiary, subject to various allowances, deductions, exemptions, and exclusions.

In the Final Response Document on the 2023 Draft Taxation Laws Amendment Bill (the "Final Response Document"), issued on 2 February 2024, the South African National Treasury confirmed that the reasons for the proposed change to section 25B of the Income Tax Act were threefold as follows (South African National Treasury, 2024: 59):

> The gradual relaxation of exchange control regulations has led to an increase in applications for confirmations of tax compliance status of persons by SARS for purposes of transferring funds offshore via authorised dealers.
>
> Government is concerned about the difference between the rules covering the normal tax treatment of income attributed to beneficiaries of trusts in section 25B of the Act and the rules covering the tax treatment of capital gains in relation to beneficiaries in paragraph 80 of the Eighth Schedule to the Act.

> The flow through of amounts by South African trusts to non-residents places SARS in a difficult position to collect income tax from those beneficiaries as they may not be taxed on foreign sourced amounts, tax recovery actions may be difficult and in the case of non-resident trusts that are beneficiaries, SARS may not have information on the persons in whom the foreign trusts vest the income.

The main comment noted by the South African National Treasury in the Final Response Document concerning the amendment to section 25B of the Income Tax Act, was in connection with the concern that was expressed that the amendment would potentially lead to economic double taxation from the perspective of non-resident income beneficiaries. The comment was as follows (South African National Treasury, 2024: 59-60):

> *Comment*: This proposed amendment could result in economic double taxation for foreign beneficiaries of South African trusts because when the South African trust distributes a taxable amount to a non-resident beneficiary, the trust will be subjected to tax on the amount distributed in South Africa and the non-resident beneficiary may also be subject to tax on the amount received in another country.

Because the South African resident trust and not the non-resident beneficiary will be subject to tax in South Africa on the income distributed, there may be instances where the foreign jurisdiction may also tax the distribution received by or accrued to the non-resident beneficiary and may not allow the tax payable by the trust in South Africa to rank as a tax credit or tax deduction on the non-resident beneficiary's foreign income tax return. This may lead to economic double taxation from the perspective of the non-resident beneficiary. The South African National Treasury noted this concern in the Final Response Document and commented as follows (South African National Treasury, 2024: 60)

> *Response:* Noted. Article 1(2) of the OECD Model Tax Convention would address this situation for entities or arrangements that one or both States treat as wholly/partly fiscally transparent. On 30 September 2022 South Africa deposited its instrument of ratification for the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). The MLI entered into force in South Africa on 1 January 2023. Article 3(1) of the MLI applies to transparent entities and states that the income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be the income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that Contracting State, as the income of a resident of

> that Contracting State. <u>The effect thereof would be that the resident is allowed relief from economic double taxation with reference to the South African tax paid by the South African trust.</u> (Own emphasis)

Article 1(2) of the Organisation for Economic Co-operation and Development (the "OECD") Model Tax Convention (the "OECD MTC") dealing with Income and Capital (OECD: 2017) contains very similar wording to Article 3(1) of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument") and provides relief in respect of income derived by or through an entity or arrangement (for example, a South African resident trust) that one or both Contracting States regard as wholly or partly fiscally transparent. Where this is the case, Article 1(2) of the OECD MTC essentially deems the income derived by the fiscally transparent entity (for example, the South African resident trust) to be the income of a resident (the non-resident beneficiary) of a Contracting State (the foreign jurisdiction where the beneficiary is resident) to the extent that the income is treated as the income of a resident (the non-resident beneficiary) by that State (the foreign jurisdiction) for the purpose of taxation in that State (the foreign jurisdiction). Where this is found to be the case, the treaty relief from double taxation provided for in the relevant Double Tax Agreement ("DTA") should be available to the non-resident beneficiary in respect of the South African tax paid by the South African resident trust, thereby eliminating economic double taxation.

The present study critically evaluates whether, as claimed by the South African National Treasury, Article 1(2) of the OECD MTC read with Article 3(1) of the Multilateral Instrument and the relevant DTA will provide non-resident beneficiaries of South African resident trusts relief from economic double taxation with reference to the South African tax paid by the South African resident trust. In this regard, a hypothetical case study will be used to determine the total economic taxation arising from two simulated distributions before ("Scenario 1") and after ("Scenario 2") the amendment to section 25B of the Income Tax Act took effect. Both scenarios will involve the same set of facts and assumptions so that the findings can be interpreted accurately. The distributions will involve a South African discretionary trust distributing several types of income and capital gains to three natural person beneficiaries who are tax resident in the following three jurisdictions: the United Kingdom, Australia, and the Netherlands. The total economic taxation payable by each beneficiary before and after the amendment to section 25B of the Income Tax Act in both South Africa and each non-resident beneficiary's respective country of residence will be evaluated to test whether the amendment will result in economic double taxation in the hands of the beneficiary. To make the research as relevant as possible, the United Kingdom and Australia were selected as a result of being the top two countries where South African citizens reside abroad (Statistics South Africa, 2023: 59). In addition, similar to South Africa, the United Kingdom, and Australia both have common law legal systems that recognise trusts, whilst the Netherlands was chosen to serve as an example of a country that utilises a civil law legal system. In addition, these three jurisdictions were chosen as a result of being signatories to the OECD MTC, signatories to the Multilateral Instrument, and have entered into DTAs with South Africa.

## 1.2 GOALS OF THE RESEARCH

The primary goal of the research is to critically evaluate whether, as claimed by the South African National Treasury, Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument will address the potential problem of economic double taxation in the hands of non-resident beneficiaries of South African resident trusts in the selected countries, in the context of the amendment to section 25B of the Income Tax Act. The research will only focus on natural person non-resident beneficiaries of South African resident trusts and will not extend to other types of beneficiaries like trusts or companies.

The sub-goals that will address the primary goal can be expressed as follows:

(a) describing the legal nature of the South African trust entity as well as how South African resident trusts and persons subject to South African resident trusts are taxed in South Africa;

(b) discussing the South African tax implications that the amendment to section 25B of the Income Tax Act will have on natural person non-resident beneficiaries of South African resident trusts in terms of South African domestic legislation through the use of a case study that will involve two simulated distributions; and

(c) discussing the foreign tax implications that the amendment to section 25B of the Income Tax Act will have on natural person non-resident beneficiaries who are tax resident in each of the three selected jurisdictions by applying the relevant foreign legislation to the simulated distributions.

## 1.3 METHODS, PROCEDURES AND TECHNIQUES

The research will be situated in the interpretivist paradigm, where interpretivist research "is guided by the researcher's set of beliefs and feelings about the world and how it should be understood and studied" (Denzin & Lincoln, 2005: 22). Interpretivist research seeks to understand, describe, and interpret (Babbie & Mouton: 2009). The interpretivist research paradigm is appropriate as the research will essentially determine, through an in-depth analysis, whether Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument will prevent economic double taxation in the context of the December 2023 amendment to section 25B of the Income Tax Act. By using both a legal interpretive approach as well as a comparative approach, legal material in the form of local and foreign tax legislation, DTAs, the OECD MTC, the Multilateral Instrument, and Commentaries on the Articles of the OECD MTC will be consulted to determine the tax treatment of simulated distributions by a South African resident trust to three natural person beneficiaries who are resident in each of the abovementioned three jurisdictions, before and after the amendment to section 25B of the Income Tax Act took effect. The results will then be interpreted by means of a hypothetical example to determine whether Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument will prevent the incidence of economic double taxation as claimed by the South African National Treasury. As the population of sample countries has not been selected randomly, the findings and results of the research will not be able to be generalised outside the population of jurisdictions, given the different types of tax regimes that governments utilise globally. Because of the detailed discussions, setting out of the assumptions and explanations supporting the calculations, this research is likely to be replicable by other researchers using the same methodology and techniques.

## 1.4 ETHICAL CONSIDERATIONS

The research was undertaken using data that are entirely publicly available (low risk desktop research). Accordingly, no ethics application form was submitted using the Rhodes University Ethical Review Application System. Instead, an ethics application was submitted to the supervisor and Departmental Ethics Representative for noting and filing.

## 1.5 OVERVIEW OF THE CHAPTERS

Chapter 2 provides an overview of the legal concept of the South African trust entity, as well as an overview of how South African resident trusts and parties subject to South African resident trusts are taxed in South Africa.

Chapter 3 critically evaluates the South African impact that the amendment to section 25B of the Income Tax Act will have on South African resident trusts and non-resident natural person beneficiaries of South African resident trusts, through the use of simulated distributions involving several types of local and foreign income and capital gains made to three non-resident natural person beneficiaries before and after the amendment to section 25B of the Income Tax Act.

Chapter 4 critically evaluates the foreign tax treatment of the simulated distributions in the hands of each of the three the non-resident natural person beneficiaries of the South African resident trust in their respective countries of residence before and after the amendment to section 25B of the Income Tax Act to determine whether, as claimed by the South African National Treasury, Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument will provide the non-resident beneficiaries with relief from economic double taxation with reference to the South African tax paid by the South African Trust.

Chapter 5 concludes the research by discussing the findings of the research by summarising the extent of economic taxation payable by each beneficiary before and after the amendment. The chapter also includes a summary of the chapters explaining how the research goals were addressed, discusses the limitations of the research, and makes recommendations for further research.

The next chapter will discuss the South African tax treatment of South African Trusts and parties to South African trusts.

# CHAPTER 2: THE SOUTH AFRICAN TAX TREATMENT OF SOUTH AFRICAN RESIDENT TRUSTS AND PARTIES TO SOUTH AFRICAN RESIDENT TRUSTS

## 2.1 INTRODUCTION

This chapter addresses the first sub-goal of the research, which is to describe the legal nature of the South African trust entity, as well as how South African resident trusts and persons subject to South African resident trusts are taxed in South Africa. The chapter begins by introducing the basic concept of the South African trust entity. The chapter continues to discuss general principles relating to trusts, the nature of tax residency and provides a brief comment on the principles of DTAs. The income tax treatment of trusts and parties to trusts in terms of section 25B, section 7, and the Eighth Schedule to the Income Tax Act is discussed in this chapter. Thereafter, the chapter turns to the South African impact that the December 2023 amendment to section 25B of the Income Tax Act has on South African resident trusts and non-resident natural person beneficiaries of South African resident trusts.

## 2.2 THE SOUTH AFRICAN TRUST ENTITY

South African trust law was initially imported from British law during the 19th century when Britain colonised South Africa (Williams & Mazansky: 2018). Over time, the courts were called upon to decide on various cases that involved South African trusts. The common law process gradually made South African trust law unique relative to trusts formed in the United Kingdom and other Commonwealth Countries like Australia and Canada (Williams & Mazansky: 2018). Before the term "trust" was defined in the Income Tax Act, Solomon J defined the basic tenet of the South African trust entity as follows in *Estate Kemp And Others v McDonald's Trustee*, 1915 AD 491 (at 507):

> The underlying conception in these and other cases is that while the legal dominium of property is vested in the trustees, they have no beneficial interest in it but are bound to hold and apply it for the benefit of some person or persons or for the accomplishment of some special purpose.

South African trusts can be created in several ways. In *Thorne and Molenaar NNO v Receiver of Revenue*, 1976 SA 50, 38 SATC 1, Van Winsen J made the following comment (at 6):

> … in general, a trust is created by contract, very often by a contract of donation or in virtue of an antenuptial contract or by way of a will. It is created in respect of defined property transferred to a trustee, who is burdened with the obligation to administer the property for the benefit of a third person, the latter being accorded a right against the trustee to enforce the trustee's compliance with his obligations towards the beneficiary concerned. Generally, trusts contemplate an extended continuation of the administration of the trust property in favour of the beneficiary until terminated on the happening of some specified future event. A trust can also, of course, be created by statute.

In *Commissioner for Inland Revenue v Friedman and others NNO*, 1993 SA 353, 55 SATC 39, Winsen J made the following comment on the South African trust entity (at 47): "'Trust' is not defined in the 1962 Act. It must therefore be given its common law meaning, viz an entity whose assets and liabilities vest in its trustee for purposes of administration …".

Thereafter, the Income Tax Act was amended by the Income Tax Act, No. 141 of 1992, and the term "trust" was defined as follows in section 1 of the Income Tax Act: "'**trust**' means 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".

After the term had been defined in the Income Tax Act, in *Land and Agricultural Bank of SA v Parker and Others*, 2005 SA 77, Cameron JA made the following comment in relation to the concept of a South African trust entity (at 83):

> It is an accumulation of assets and liabilities. These constitute the trust estate, which is a separate entity. But though separate, the accumulation of rights and obligations comprising the trust estate does not have a legal personality. It vests in the trustees, and must be administered by them – and it is only through the trustees, specified as in the trust instrument, that the trust can act.

Even though trusts are not recognised as separate juristic persons in terms of common law, paragraph (c) of the definition of a "person" in section 1 of the Income Tax Act specifically includes a trust. The effect of this inclusion is that, although the trust entity is not a juristic person and is therefore not a separate legal entity in terms of South African common law, the Income Tax Act deems a trust to be a separate legal entity that is subject to tax in its own right for the purposes of the Income Tax Act. Therefore, where an entity falls within the definition of a trust, it will be subject to tax in its own right, subject to the attribution rules in section 7 of the Income Tax Act, Part X of the Eighth Schedule to the Income Tax Act, and the deeming provisions in section 25B and the Eighth Schedule to the Income Tax Act.

The administration of South African trusts is governed by the Trust Property Control Act, No. 57 of 1988, which was enacted "to regulate the control of trust property and to provide for matters connected therewith" (preamble to the Trust Property Control Act).

Several types of trusts are recognised by South African common law. Given the goals of the present research, this chapter will not address the different types of trusts in depth, other than briefly in the paragraph below.

In the case of an ownership trust, the ownership of the assets transferred to the trust by the founder of the trust vests in the trustees, but the trustees do not have beneficial ownership of the income or assets, which lies with the beneficiaries (De Koker & Williams: 2021). In the case of a "bewind" trust, the ownership of the assets transferred to the trust vest in the beneficiaries, but the control of the assets lies with the trustees and not the beneficiaries (De Koker & Williams: 2021). Trustees are required to keep the assets of a trust separate from their personal assets (Williams & Mazansky: 2018). An *inter vivos* trust, which is a form of ownership trust, is created during the lifetime of the founder, where the founder (who may also be referred to as the settlor or donor) generally donates the initial capital to be held in trust for the benefit of the beneficiaries (Clegg & Stretch: 2021). The initial donation is transferred to the trustees of the trust, who administer the trust fund and income for the benefit of the beneficiaries (Williams & Mazansky: 2018). The initial trustees are generally appointed by the founder and are mandated to administer the assets and income of the trust estate for the benefit of the beneficiaries in line with the trust instrument (Clegg & Stretch: 2021). A testamentary trust on the other hand comes into effect on the death of a testator or testatrix in terms of his or her will (De Koker & Williams: 2021).

## 2.3 GENERAL TAX PRINCIPLES RELATING TO TRUSTS

South African tax legislation is drafted in such a way that the same income is only taxed once in the trust relationship (Clegg & Stretch: 2021). Income that is taxable in one person's hands cannot be subject to income tax in another person's hands. Because several types of trusts are recognised in South African common law, the point of departure when determining the tax treatment of trusts and beneficiaries of trusts in terms of the Income Tax Act is to first determine whether the entity in question falls within the meaning of the term "trust" for the purpose the Income Tax Act. The Income Tax Act has specific provisions that apply to trusts and where the entity falls within the definition of a trust as defined in section 1 of the Income Tax Act, the application of the provisions that relate to trusts must be considered.

The term beneficiary is defined as follows in section 1 of the Income Tax Act: "'**beneficiary**' in relation to a trust means a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust …". A beneficiary of a trust is a "connected person" in relation to that trust in terms of paragraph (b)(i) of the definition of the term "connected person" in section 1 of the Income Tax Act.

The assets and income of trusts are administered by trustees in a fiduciary capacity for the benefit of one or more beneficiaries, and section 1 of the Income Tax Act defines a trustee as follows:

> "**trustee**", in addition to every person appointed or constituted as such by an act of parties, by will, by order or declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interest or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability.

This study will focus on the tax treatment of income distributions made by trustees of South African resident trusts to non-resident natural person beneficiaries. In view of the fact that South Africa adopted a residence-based system of taxation with effect from 1 January 2001, determining a person's residency status is critical in establishing the South African tax treatment of income that is received by or accrues to that person in terms of the definition of gross income in section 1 of the Income Tax Act, which is defined as follows:

> "**gross income**", in relation to any year or period of assessment, means—
>
> (i) in the case of <u>any resident</u>, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) in the case of <u>any person other than a resident</u>, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic … (Own emphasis)

The effect of the definition of gross income is that persons, for example, individuals and trusts, who are tax resident in South Africa are generally subject to tax on their worldwide income, irrespective of the source of the income, whilst non-residents are generally only subject to tax on amounts that are from a South African source or amounts that are deemed to be from a South African source in terms of section 9 of the Income Tax Act. It is often the case that non-resident natural person beneficiaries of South African resident trusts are not aware of their tax residency status in South Africa, where for example:

a. they were born in South Africa and then emigrated from South Africa to make their permanent home abroad, but have, for whatever reason, failed to place their non-residence status (also referred to as "tax emigration") on record with SARS; or
b. they temporarily moved abroad for several years to work with the ultimate intention of returning to South Africa; or
c. they immigrated to South Africa and, after living in South Africa for some time, emigrated from South Africa (permanently returned abroad).

After it is established that a trust entity falls within the definition of a trust, the second step in the determination of the tax treatment of income derived by the trust is to establish the tax residency status of the trust, the funders of the trust, and the trust beneficiaries, in order to determine the South African tax treatment of the amounts subject to the trust.

### 2.3.1 Tax Residency

Section 1 of the Income Tax Act provides the following definition of a resident that distinguishes between natural persons and entities that are not natural personas:

> "**resident**" means any—
>
> (a) natural person who is—
>
> (i) ordinarily resident in the Republic; or
>
> (ii) not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic—
>
> (aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and

(bb) for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment,

(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic…

but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation

**Tax residence and natural persons**

Prior to 1 January 2001, the South African income tax system was source-based, taking into account a few concessions, where residency was not the main measure used to determine a person's taxable income in South Africa. An amount was only taxed in South Africa where it was from a South African source, regardless of a taxpayer's residency. With effect from 1 January 2001, South Africa adopted a residence-based system of taxation. In terms of the definition of "gross income" in section 1 of the Income Tax Act, a South African tax resident is subject to tax on worldwide income, whereas a non-resident is only subject to tax in South Africa on income earned from a South African source, subject to certain exemptions, exclusions, deductions and allowances in the Income Tax Act, and the provisions of the relevant DTA. The concept of residency is, consequently, critical in determining a person's South African tax obligations.

In the case of a natural person, the definition of "resident" in section 1 of the Income Tax Act provides two tests to be applied in order for the natural person to be regarded as a resident for tax purposes. A natural person is tax resident in South Africa where –

a. that person is ordinarily resident in South Africa; or
b. that person is not ordinarily resident in South Africa but meets the requirements of the physical presence test.

These South African statutory tests are mutually exclusive and will not apply where the natural person is found to be exclusively resident in a country outside of South Africa in terms of the application of a DTA. The result is that even where it is found on the facts that a natural person meets either one of the South African statutory tests, he or she will not meet the definition of a resident if it is found that he or she is deemed to be exclusively resident in another country by virtue of the relevant provisions of a DTA.

Test 1: Ordinarily Resident

The first statutory test to be applied to natural persons to determine whether they are tax resident in South Africa is to determine whether they are ordinarily resident in South Africa. The term "ordinarily resident" is a common law concept that is not defined in the Income Tax Act. In *Cohen v Commissioner for Inland Revenue*, 1946 AD 174, 13 SATC 362, it was stated that the question of whether a person is ordinarily resident is one of fact. It was found (at 371):

> But his ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings, as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home.

In *Cohen v Commissioner for Inland Revenue*, Schreiner JA was of the view that the precise effect to be given to the term "ordinarily" is linked with the question of whether a person can be "ordinarily resident" in more than one country, and that the meaning of the term ordinarily resident is narrower than the term resident, stating as follows (at 371):

> If, though a man may be "resident" in more than one country at a time, he can only be "ordinary resident" in one, it would be natural to interpret "ordinary" by reference to the country of his most fixed or settled residence . . . If this suggested meaning were given to "ordinary" it would not, I think, be logically permissible to hold that a person could be "ordinary resident" in more than one country at the same time.

In *Commissioner for Inland Revenue v Kuttel*, 1992 SA 242, 54 SATC 298, the court held that a person is "ordinarily resident" where he has his usual or principal residence, that is, what may be described as his real home. The Canadian case of *Thomson v Minister of National Revenue*, 2 DTC 812 (SCC), provided a general rule in relation to the determination of whether a natural person is ordinarily resident as follows (at 813) "…one is ordinarily resident in the country where, in the settled routine of one's life, you regularly, normally or customarily live". De Koker and Williams (2021:5.2A) make the following comment: "The question of whether a person is 'ordinarily resident' in a country is one of fact, one relevant fact being the subjective state of mind of that person in regard to whether he or she regards South Africa as their 'real home' to which they will return after their wanderings".

In addition to considering the principles established by the courts, it is also useful to consider the guidance provided by SARS in Interpretation Note 3 (issue 2) which was updated in 2018

(SARS: 2018). Whilst it does not set a precedent, the Interpretation Note states, *inter alia*, that the circumstances of the individual must be examined as a whole, and the personal acts of the individual must receive special attention.

Where it is found that a person is ordinarily resident in South Africa and is not deemed to be exclusively resident in another jurisdiction in terms of a DTA, the inquiry into that person's residency status ends there. Persons who are ordinarily resident in South Africa cease to be ordinarily resident when they make another country their real or principal home with no intention to return to South Africa on a permanent basis, or if they are regarded as exclusively resident in another country in terms of the application of a relevant DTA. Section 102 of the Tax Administration Act, No. 28 of 2011, as amended (the "Tax Administration Act"), places the burden of proof on the taxpayer to prove, on a balance of probabilities, where they are ordinarily resident. Where it is found on the facts that a natural person is not ordinarily resident in South Africa (the first test), the next step will be to determine whether the individual meets the physical presence test (the second test).

Test 2: Physical Presence Test

The physical presence test can only be applied from the first year of assessment that a natural person is not ordinarily resident in South Africa. This test is a time-based test that is based on the number of days that a taxpayer is physically present in South Africa, and needs to be applied annually to confirm whether a person remains a non-resident. The following criteria are necessary for the physical presence test to apply:

- the taxpayer needs to be physically present in South Africa for more than 91 days in the relevant year of assessment; and
- the taxpayer needs to be physically present in South Africa for more than 91 days in each of the five preceding years of assessment; and
- the taxpayer needs to be physically present in South Africa for more than 915 days in aggregate during the five preceding years of assessment.

Should all three of these requirements be met, the taxpayer will be deemed to be a tax resident of South Africa from the first day of the relevant tax year in which all three requirements are first met. The physical presence test can only be applied from the sixth tax year that a taxpayer has been present in South Africa, as the test applies to the current year and the five preceding years of assessment. In terms of paragraph (B) of the definition of the term "resident" in section

1 of the Income Tax Act, a natural person who is a resident by virtue of the physical presence test ceases to be a resident if the person is physically outside South Africa for a continuous period of at least 330 full days, where the continuous period begins on the day after the day on which the person physically left South Africa.

Both of the statutory tests require a factual inquiry into the natural person's residence status. Where the person is not ordinarily resident in South Africa and does not meet the physical presence test, the factual inquiry into the person's South African tax residency status will end there and the person will be regarded as non-resident for tax purposes in South Africa. Where the individual meets either of the statutory tests and –

- that person is not a resident in terms of another jurisdiction's domestic laws; or
- that person is a resident in terms of another jurisdiction's domestic laws and South Africa has not entered into a DTA with that jurisdiction,

the factual inquiry into the person's South African tax residency status will end there and the person will be regarded as a tax resident of South Africa.

Where it is found on the facts that the person is a dual resident, that is, a person is tax resident in South Africa and the individual is also tax resident in terms of another jurisdiction's domestic laws, where there is a DTA between South Africa and that other jurisdiction, it will be necessary to determine where that person is "treaty resident" (the third test). The person will be a treaty resident where that individual is deemed to be exclusively resident in terms of the tie-breaker clause of the relevant DTA entered into between South Africa and the other jurisdiction. Where it is found that the dual resident is a treaty resident of another country, the person will not be regarded as a resident for tax purposes in South Africa.

In terms of section 23 of the Tax Administration Act, a person is required to update their residency status with SARS within 21 business days of ceasing to be a resident in South Africa. A person may be considered to be non-resident even if the person has not placed their non-resident status on record with SARS, as a person's tax residency status in South Africa is a question of fact and not disclosure to SARS.

**Tax residence and trusts**

The South African domestic law tests that determine the tax residency status of entities that are not natural persons are different from the tests that apply to natural persons. Paragraph (b) the definition of the term resident in section 1 of the Income Tax Act includes a "person" other than a natural person that is either incorporated, established, or formed in South Africa, or has its place of effective management ("POEM") in South Africa as follows: "'**resident**' means any— (b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic".

In terms of the definition of a resident, therefore, a trust will be regarded as a tax resident in South Africa for income tax purposes if it:

- is incorporated, established or formed in South Africa; or
- has its POEM in South Africa,

provided that a trust will not be a resident of South Africa if it is deemed to be exclusively resident of another country for purposes of the application of a DTA.

It is generally straightforward to determine whether a trust is incorporated, established, or formed in South Africa by establishing whether the trust was established in terms of South African trust law. Where a trust is not incorporated, established, or formed in South Africa, it will be necessary to determine whether the trust's POEM is in South Africa in order to determine whether the trust falls within the definition of a resident. The term POEM is not defined in the Income Tax Act. In terms of Interpretation Note 6 (Issue 3) (SARS: 2023), SARS is of the view that an entity's POEM is where key management and commercial decisions necessary for the conduct of its business are in substance made, which aligns with the guidelines formulated by the OECD. In *Oceanic Trust Co Ltd NO v Commissioner for South African Revenue Service*, 74 SATC 127, it was noted that the POEM of an entity is the place where the key management and commercial decisions that are necessary for the conduct of the business are made. It was further noted that an entity's POEM must be objectively determined on a case-by-case basis based on the specific set of facts and circumstances. Following the principles set out in this case, in the case of a trust formed outside of South Africa, where it is found on the facts that the trustees make key management and commercial decisions from South Africa, the POEM of the trust is likely to be in South Africa, and the

DTA between South African and the jurisdiction in which the POEM is located will need to be considered to determine where the trust is treaty resident.

On the other hand, where the key management and commercial decisions of a trust formed in South Africa are made by trustees outside of South Africa and it is found, for example, that one or more trustees are "calling the shots" from outside of South Africa and the trustee meetings are conducted outside of South Africa, the POEM of the South African trust is not likely to be in South Africa. In this instance, the DTA between South Africa and the jurisdiction in which the POEM is located will need to be consulted to determine where the trust is treaty resident.

Because it is commonplace for trustees to conduct meetings virtually across multiple jurisdictions, it is not always straightforward to determine where a trust's POEM is located, and the POEM of a trust is not always where the trustees meet. In a foreign case, *Wensleydale's Settlement Trustees v Inland Revenue Commissioners*, 1996 STC 241, it was found that, even though the trustees met and made certain decisions from Ireland, the "shots were called" by an advisor based in England, who undertook the "effective management" of the trust's business from the United Kingdom. The court found that, although some of the administrative functions of the trust had occurred in Ireland, there was no substantive input from Ireland. Based on these considerations, the court found that the POEM of the entity was the United Kingdom and not Ireland. De Koker and Williams (2021:14.42) make the following comment in relation to establishing the POEM of a trust:

> …for a trust to have a place of effective management in the other contracting state, it is necessary to show not only that trustee decision-making genuinely takes place in that other state, but also that there is no scheme of management in – or orchestration of steps from – South Africa, even if that takes the form of professional advice which is properly considered by the overseas trustees… the essential question is, where are the most important decisions relating to the governance or management of the trust taken? The real top management decisions, or the realistic, positive management decisions of the trust, must be taken in the other country.

**Overriding Provisions of Double Taxation Agreements**

Where a person's residence status falls within paragraph (a) or paragraph (b) the definition of a resident in section 1 of the Income Tax Act and also falls within the domestic law definition of a resident in another jurisdiction that has entered into a DTA with South Africa, the person will not meet the definition of a tax resident if the person is deemed to be exclusively a resident of another country for the purposes of the DTA.

Once the residency status of the trust and the beneficiaries of the trust have been determined, the tax treatment of income and capital gains subject to the trust must be determined.

### 2.3.2 The Taxation of Parties to a Trust

When determining the South African tax treatment of income and capital gains that are the subject of a South African resident trust, due regard must be had to the following three considerations (Clegg & Stretch: 2021):

a. the provisions of the relevant trust instrument;
b. the legal principles that relate to the vesting of rights; and
c. the relevant provisions of the Income Tax Act and the relevant DTA (where applicable).

These three considerations are discussed briefly below.

**The provisions of the relevant trust instrument**

It is generally the case that the terms of a South African resident trust are codified in the form of what the Trust Property Control Act Trust, No. 57 of 1988 defines as a "trust instrument". The trust instrument is colloquially referred to as the trust deed and sets out, *inter alia*, the legal nature of the trust, the rights of the beneficiaries, as well as the powers and responsibilities of the trustees (Clegg & Stretch: 2021). The trustees must act and make decisions in line with the provisions of the trust deed, and any actions taken outside the provisions of the trust deed may be invalid or void in law (Clegg & Stretch: 2021).

**Rights of beneficiaries: the legal principles that relate to the vesting of rights**

The trust deed will generally set out the rights of a beneficiary or certain classes of beneficiaries. The trustees will be required to determine the nature of the rights of each beneficiary with respect to the assets held by the trust, the trust income, and capital gains arising in the trust, in order to make decisions regarding managing the assets, the trust fund, and income and capital gains of the trust for the benefit of the relevant beneficiaries (Clegg & Stretch: 2021). It is clear from the definition of the term "beneficiary" in section 1 of the Income Tax Act, that a beneficiary can have a vested or contingent "interest" in all or a portion of the receipts or accruals or the assets of the trust. The terms "contingent" and "vested" are not defined in the Income Tax Act. In *Income Tax Case* 76, 1927 3 SATC 68, it was held (at 70) that a contingent right was "merely a spes – an expectation which might never be realised". In *Jewish Colonial Trust Ltd v Estate Nathan*, 1940 AD 163, the following meaning was given to the term vested right (at 175): "When it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right – that he has all rights of ownership in such right including the right of enjoyment." A vested right includes situations where the trust deed (in the case of a vesting trust) or the trustees (in the case of a discretionary trust) have postponed enjoyment or possession in respect of the beneficiary's interest (Clegg & Stretch: 2021).

**The relevant provisions of the Income Tax Act**

Once the trustees of a trust understand the rights of the beneficiaries of the trust in terms of the trust instrument, they will be in a position to administer the assets, the trust fund, the income, and capital gains arising in the trust. Where income is derived by the trustees of a trust in their capacity as trustees, the following persons may be subject to taxation in South Africa on the income so derived, depending on the facts and circumstances:

a. the beneficiary;
b. the trust;
c. the donor or funder; or
d. the trustees.

The Income Tax Act has specific provisions in section 25B, section 7, and the Eighth Schedule to the Income Tax Act that pertain to the taxation of trusts, funders of trusts, and beneficiaries of trusts. The main provision is section 25B of the Income Tax Act, which codifies the conduit-pipe principle and reads as follows:

> **25B.Taxation of trusts and beneficiaries of trusts.**—(1) Any amount (other than an amount of a capital nature which is not included in gross income or an amount contemplated in paragraph 3B of the Second Schedule) 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 is a resident and 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 that trust.

> (2) Where a beneficiary who is a resident 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.

**Taxation of the beneficiary**

The trust instrument will set out who the beneficiaries of a trust are and will set out the rights of the beneficiary or class of beneficiaries in respect of the income and capital of the trust in question. A beneficiary can have discretionary rights, vested rights, or a combination of these rights to the income or accruals of a trust, the assets of a trust, or the trust fund. Where the trustees of a trust vest an amount in a beneficiary in line with the provisions of the trust deed, the award will be exempt from donations tax in terms of section 56(1)(l) of the Income Tax Act. However, where the trustees of a trust vest an amount to a beneficiary or other person outside of the provisions of the trust instrument, the amount may be subject to donations tax.

<u>The deemed income rule:</u>

The effect of section 25B of the Income Tax Act is that local and foreign income that is received by, accrues to, or in favour of, a trust that vests in a resident beneficiary in the same year of assessment either in terms of the trust deed (in the case of a vesting trust) or as a result of the trustees exercising their discretion to vest the amount in terms of the trust deed (in the case of a discretionary trust), is deemed to be an amount that was received by, accrued to, or in favour of that beneficiary (De Koker & Williams: 2021). This has been referred to as the "deemed income rule". It is apparent from the wording of section 25B of the Income Tax Act that there must be an "ascertained beneficiary" who has a "vested right" to an amount for the deemed income rule to apply.

The timing of the vesting is also important; the vesting must take place in the same year of assessment that the income is received by or accrues to the trust. It is the trust deed that sets out the rights of a beneficiary to income arising in the trust. A beneficiary can acquire a vested right to the income of a trust in two ways. In the case of a vesting trust, a beneficiary acquires a vested right to the income, capital gains, or assets of a trust in terms of a trust deed. In the case of a discretionary trust, a beneficiary acquires a vested right to the income, capital gains, or assets of the trust when the trustees exercise their discretion to vest an amount in the discretionary beneficiary, where they are permitted to do so in terms of the trust deed (Van der

Merwe: 2000). In the case of a discretionary trust, trustees usually have the discretion regarding to whom, how much, and when the discretionary beneficiary can receive income, capital gains or the assets of the trust (Clegg & Stretch: 2021).

Where a trust deed empowers the trustees to exercise their discretion regarding, for example, to whom to make the income distribution, the trustees are only permitted to exercise their discretion to the extent of the provisions of the trust deed (De Koker & Williams: 2021). In the case of a vesting trust, where for example the relevant beneficiary has a vested right to the income or a portion of an income of the trust, vesting happens automatically as soon as the income is received by or accrues to the trust (Van der Merwe: 2000). However, in the case of a discretionary trust, vesting requires the trustees to vest the right to the amount in favour of an ascertained beneficiary in the same year of assessment the income arises. This generally occurs by way of a trustee resolution. Where this is the case, the income does not accrue to the trustees of the trust in their representative capacity. Rather, the income so vested is deemed to have been received by or accrued to the beneficiaries who acquired a vested right and thus the beneficial ownership of the amount in question. The trustee is a mere conduit pipe in respect of the income that is vested in the beneficiary. From a common law perspective, it was held in *Armstrong v Commissioner for Inland Revenue*, 1938 AD 343, and later confirmed in *Secretary for Inland Revenue v Rosen*, 1971 1 SA 173, that income that is the subject of a trust which vests in a beneficiary in the same year it arises, retains its nature until it reaches the ultimate beneficiary.

In terms of South African law, an interest can vest in a beneficiary notwithstanding the fact the enjoyment or possession has been postponed in terms of the trust instrument (Clegg & Stretch: 2021). In the context of section 25B of the Income Tax Act, it is not a requirement that the income is to be distributed or paid to the beneficiary in the year that the amount arises for the amount to vest in the beneficiary, provided that vesting has taken place in the year the income was subject to the trust. In this way, the trust deed can permit trustees to accumulate vested amounts for the benefit of the relevant beneficiary and thereafter award these amounts to beneficiaries in future years of assessment by way of a resolution. The beneficiaries would then have a personal right against the trustees in respect of the payment of the unpaid distributions until such time that the amount is paid to the beneficiary, which would then constitute a capital receipt in the hands of the beneficiary (see *Secretary for Inland Revenue v Rosen*). The effect of section 25B of the Income Tax Act is that the beneficiary will be taxed on the amount in the year of assessment that the amount arises in the trust and vests in the beneficiary and the trustees will be a conduit-pipe through which the income flows.

The deemed expenditure rule

Where income is deemed to be the income of a resident beneficiary in terms of section 25B(1) of the Income Tax Act, the effect of section 25B(3) of the Income Tax Act is that subject to certain limitations, any deductions and allowances attendant on that income will be allowable in the hands of the beneficiaries in the determination of their taxable income (Clegg & Stretch: 2021). Depending on the wording of the trust deed, the trustees could vest the taxable income (gross income, less allowable deductions, exemptions, exclusions and allowances), or the gross income in the relevant beneficiary (De Koker & Williams: 2021). Each of these situations will result in the same taxable income in the beneficiary's hands but will impact the way that the amounts are disclosed on the trust and beneficiary's tax returns.

Before the amendment to section 25B of the Income Tax Act that came into effect on 1 March 2024 in terms of the Taxation Laws Amendment Act, No. 17 of 2023, section 25B of the Income Tax Act did not distinguish between resident and non-resident beneficiaries. Trustees of South African resident trusts could therefore vest income in both resident and non-resident beneficiaries. With effect from 1 March 2024, trustees are now only permitted to vest income subject to a South African resident trust in resident beneficiaries for tax purposes and not non-resident beneficiaries. Trustees can still distribute amounts to non-resident beneficiaries for legal purposes, but not for tax purposes. Any income that trustees distribute to a non-resident beneficiary will first be taxed in the hands of the trust and not the non-resident beneficiary and the capital amount net of any tax payable by the trust will be paid to the relevant non-resident beneficiary.

**Taxation of capital gains arising in a trust**

In *The Thistle Trust v Commissioner for the South African Revenue Service*, 2024 ZACC 19, it was held that the taxation of capital gains subject to a trust is not dealt with in terms of section 25B of the Income Tax, which deals with income subject to a trust. Rather, the tax treatment of capital gains arising in a trust is dealt with in terms of the conduit-pipe principle in paragraph 80 of the Eighth Schedule to the Income Tax Act. Where the trustees of a trust deal with a capital gain either by vesting an asset in a resident beneficiary in terms of paragraph 80(1) or by the disposal of an asset owned by the trust, which vests in a resident beneficiary in the same year it arises in the trust in terms of paragraph 80(2), the capital gain must be disregarded by the trust and is taxable in the hands of the resident beneficiary, subject to relevant exemptions and exclusions. Paragraph 80 is specifically subject to paragraphs 68, 69, and 71 of the Eighth Schedule, which comprise the attribution rules that essentially attribute the capital gain to a person other than the trust in specific circumstances. Any capital gains arising in a trust that do not vest in a beneficiary in the same year, and are not subject to the attribution rules, are taxable in the hands of the trust at a current effective Capital Gains Tax ("CGT") rate of 36% (the 80% inclusion rate x the 45% tax rate applicable to trusts). The tax treatment of capital gains arising in a trust, as well as the attribution rules that apply to capital gains arising in a trust, will not be discussed further.

**Taxation of the trust**

Subject to certain provisions, where income is received by or accrues to trustees of a trust *inter vivos* in their capacities as trustees and is not taxable in the hands of a resident beneficiary in terms of section 25B of the Income Tax Act, or a funder of the trust in terms of section 7 of the Income Tax Act, the income will be subject to tax in the hands of the trust at a current rate of 45%, subject to various allowances, exemptions, exclusions and deductions.

**Taxation of the donor (funder)**

The deemed income rule in section 25B of the Income Tax Act is specifically subject to the deeming provisions in section 7 of the Income Tax Act. Once the trustees have determined the nature of the rights of each beneficiary to the income, capital gains, and assets under the trust deed, the next step would be for the trustees to determine whether any of the deeming provisions in section 7 and Part X of the Eighth Schedule to the Income Tax Act apply to the income or capital gains arising in the trust. The attribution rules deem income or capital gains to have accrued to the funder of a trust in certain instances, even though the income or capital gain was received by or accrued to another person. Section 7 of the Income Tax Act and the relevant paragraphs of the Eighth Schedule to the Income Tax Act are anti-avoidance provisions that apply in the event of a donation, settlement, or other disposition, in certain circumstances. Where it is found that a donation, settlement, or other disposition has occurred in respect of a trust, the donor (also referred to as the funder, settlor, or founder) will be taxed on the income or capital gains arising from the donation, settlement, or other disposition, and not the trustees in their representative capacities, or the beneficiaries. Where, for example, the settlor of a trust donates an income-generating commercial property to the trust and the trust deed stipulates that the settlor's grandchildren, as beneficiaries, are only entitled to receive the rental income generated by the trust in respect of the property when they reach the age of 25, subject to certain limitations, section 7(5) of the Income Tax Act will deem the income generated by the trust in respect of the property to be income in the hands of the settlor until the beneficiaries in question reach the age of 25 or the settlor dies, whichever event occurs first. Section 7 and Part X of the Eighth Schedule to the Income Tax Act will not be discussed in further detail.

**Taxation of the trustees**

Trustees who are not beneficiaries and receive amounts as representative taxpayers are generally not subject to tax because they are not the beneficial owners of the amounts. As representative taxpayers of the trust in terms of paragraph (c) of the definition of the term "representative taxpayer" in section 1 of the Income Tax Act, however, trustees have a fiduciary responsibility to ensure that the tax affairs of the trust are in good order, which includes, *inter alia*, filing income tax returns correctly and on time, settling tax liabilities when they become due and payable, and representing the trust on any tax-related matters in line with the applicable legislation in the Income Tax Act and the Tax Administration Act (Clegg & Stretch: 2021). The trustees of a trust are required to nominate a representative taxpayer with SARS. The trustees of a trust will generally appoint a trustee to act as the representative taxpayer of the trust in terms of the Tax Administration Act. Trustees can be taxed in their personal capacities on income subject to a trust as representative taxpayers of the trust in terms of section 155 of the Tax Administration as follows:

> **155. Personal liability of representative taxpayer**.—A representative taxpayer is personally liable for tax payable in the representative taxpayer's representative capacity, if, while it remains unpaid—
>
> (a) the representative taxpayer alienates, charges, or disposes of amounts in respect of which the tax is chargeable; or
>
> (b) the representative taxpayer disposes of or parts with funds or moneys, which are in the representative taxpayer's possession or come to the representative taxpayer after the tax is payable, if the tax could legally have been paid from or out of the funds or moneys.

## 2.4 CONCLUSION

The chapter began by describing the basic concept of the South African trust entity for tax purposes in the historical context in which trust law has developed in South Africa. It was noted that, when dealing with a trust entity for income tax purposes, the process starts by determining whether the entity in question falls within the meaning of a trust as defined in section 1 of the Income Tax Act. Thereafter, the general tax principles that relate to trusts are to be taken into account. As South Africa applies a residence-based system of taxation, establishing the tax residency status of trusts, as well as beneficiaries of trusts, is important in view of the fact that the amendment to section 25B of the Income Tax Act has resulted in the conduit pipe (flow-through) principle only applying to resident beneficiaries of South African resident trusts.

Thereafter, the taxation of parties to a trust was described in detail with regard to the tax treatment of income and, to a lesser extent, capital gains subject to a South African resident trust. It was noted that the three main considerations that trustees must bear in mind when making decisions concerning the administration of income, capital gains, trust capital, and trust assets are the relevant provisions of the trust instrument, the rights of the relevant beneficiaries (that is, the legal principles that relate to the vesting of rights), and the relevant provisions of the Income Tax Act.

Finally, the chapter described the tax treatment of income and capital gains subject to a South African resident trust in the hands of a) beneficiaries of the trust in the context of the conduit pipe principle before and after the amendment to section 25B of the Income Tax Act; b) the trust in the context of undistributed income and capital gains; c) the funder/s of trusts in the context of the attribution rules in section 7 of the Income Tax Act and Part X of the Eighth Schedule to the Income Tax Act; and finally, d) the personal tax liability of trustees as representative taxpayers of trusts.

Having discussed the South African tax treatment of trusts and the parties to trusts in this chapter, the following chapter will introduce a case study involving simulated trust distributions before and after the amendment to section 25B of the Income Tax Act to illustrate the South African tax implications of the amendment for South African resident trusts and non-resident beneficiaries of South African trusts.

# CHAPTER 3: SOUTH AFRICAN TAX TREATMENT OF THE SIMULATED DISTRIBUTIONS

## 3.1 INTRODUCTION

The second sub-goal of the research is to critically evaluate the South African tax impact that the amendment to section 25B of the Income Tax Act will have on South African resident trusts and non-resident beneficiaries of South African resident trusts. This will be achieved through the use of simulated distributions involving several types of local and foreign income, and a local capital gain made by a South African resident trust, to three non-resident natural person beneficiaries before and after the amendment to section 25B of the Income Tax Act.

In addressing the sub-goal, this chapter focuses on the South African tax treatment of two simulated distributions made by the trustees of a fictional South African resident trust (referred to as the "ABC Trust") to three natural person beneficiaries who are tax resident in the United Kingdom, Australia, and the Netherlands before (referred to as "Scenario 1") and after (referred to as "Scenario 2") the date that the amendment to section 25B of the Income Tax Act took effect. The simulation sets out various facts and assumptions that aim to emulate a scenario indicative of many South African discretionary trusts commonly used by families for investment purposes. The simulation aims to objectively illustrate the total economic impact that the amendment to section 25B of the Income Tax Act will have on non-resident natural person beneficiaries of South African resident trusts, both directly and indirectly (that is, tax paid by ABC Trust attributable to each beneficiary's share of the capital distribution) in an objective manner.

## 3.2 THE SIMULATED DISTRIBUTIONS

As noted in Chapter 1, the United Kingdom, Australia, and the Netherlands were chosen for the study as they are among the three top countries to which South African expatriates emigrate. This selection was made to ensure the relevance of the simulation. In addition, except for the Netherlands, which is a civil law jurisdiction, the United Kingdom and Australia, like South Africa, have common law legal systems that recognise the trust entity. Testing the direct economic impact of the amendment (at the natural person level) and indirect economic impact of the amendment (at the South African resident trust level) will require an analysis from a South African perspective before and after the amendment (Chapter 3), as well as in each of the three jurisdictions before and after the amendment (Chapter 4). In this regard, the use of simulated distributions was identified as a suitable method to evaluate the impact of the amendment.

This chapter involves a detailed analysis of the South African impact of fictional distributions before and after the amendment, where both scenarios will include the same set of variables. The case study is based on several assumptions that aim to simplify the local and foreign tax implications of the distributions to avoid an almost infinite number of permutations. The simulated distributions involve several types of local and foreign sources of income common to family investment trusts in South Africa, as well as a local capital gain arising in the trust. The set of facts and assumptions listed below have been carefully considered to strike a balance between ensuring that the simulation remains relevant and successfully evaluates the total economic impact of the amendment from an income tax perspective, and at the same time avoiding complex tax considerations in the relevant jurisdictions.

### 3.2.1 Facts and assumptions of the case study

The facts and assumptions of the case study are as follows:

1) Mr X established ABC Trust under South African trust law. ABC Trust is both domiciled and tax resident in South Africa.
2) All the trustees of ABC Trust are residents of South Africa and the POEM of ABC Trust is South Africa.
3) ABC Trust is a discretionary trust *inter vivos* in respect of its income, capital gains, assets, and trust capital.
4) ABC Trust has no liabilities.
5) Mr X, the donor of ABC Trust, as well as all the other economic funders of ABC Trust are deceased. Furthermore, the beneficiaries of ABC Trust were not heirs of Mr X's estate (this is relevant from a Dutch perspective).
6) Mr X established ABC Trust for the sole benefit of his three grandchildren ("the beneficiaries") by way of a R50 million initial donation made on 1 January 2000, which comprised the original *corpus* of ABC Trust.
7) The beneficiaries are not tax residents for South African tax and exchange control purposes.
8) The beneficiaries are all between the ages of 20 and 30 years old. The beneficiaries are professional students studying in their respective countries of birth. The beneficiaries

have always lived in their countries of birth and have not spent an extended amount of time abroad, other than for vacation purposes.

9) None of the beneficiaries earn any other income apart from an annual trust distribution received from ABC Trust, and they depend on the annual trust distribution from ABC Trust to fund their student lifestyles.

10) None of the beneficiaries are married. Therefore, none of the beneficiaries file joint tax returns in their respective countries of residence.

11) The beneficiaries were born in their respective jurisdictions as follows:
   a) Mr A (United Kingdom);
   b) Ms B (Australia); and
   c) Ms C (the Netherlands).

12) None of the beneficiaries have any dependents.

13) The income and capital distributions are paid by the trustees in the same tax year as the amounts are vested in the beneficiaries, that is, the distribution of the amounts occur in the same year as vesting. The result is that the net income and capital reserves of the trust ("trust capital") are paid every year and only the original *corpus* in the form of investments is retained by the trust at year-end.

14) The trust deed of ABC Trust gives the trustees the discretion to distribute either –
   a) gross income;
   b) taxable income (that is, gross income net of any deductions, exemptions, exclusions, and allowances); or
   c) accumulated income ("trust capital") in the form of capital distributions.

15) The trustees of ABC Trust have complete discretion in relation to how much, what types of income and capital each beneficiary gets, and when to make distributions. It is their practice to make distributions in the same proportion (one-third per beneficiary).

16) The trustees make a single payment from ABC Trust's bank account to each beneficiary once a year that comprises an income distribution, a capital distribution, or a combination of income and capital distributions. The proportions, source, and nature of the income and capital distributions are clearly set out in an annual trustee resolution.

17) To simplify the simulation further, it is assumed that ABC Trust does not pay any local or foreign withholding tax on the local and foreign income it receives. Therefore, no foreign tax credits will be taken into account from a South African perspective. ABC Trust is also assumed not to be subject to tax by the source country on the foreign income it receives.

18) The foreign income earned by the trust is all from a source other than South Africa, the United Kingdom, Australia, and the Netherlands.

19) ABC Trust has no assessed tax loss or capital loss brought forward from a prior year.

20) ABC Trust received and paid the following income and capital gain distributions in both scenarios discussed below (unless clearly indicated to the contrary, payments to each beneficiary were made net of certain exemptions, deductions, exclusions, allowances and tax payable by the trust):

    a) Rental income from a South African source – R7,500,000;
    b) Dividend income from a South African source – R9,000,000;
    c) Dividend income from a foreign source – R6,750,000;
    d) Interest income from a South African source paid by a South African bank – R1,500,000;
    e) Interest income from a foreign source – R2,625,000; and
    f) A capital gain from the disposal of South African listed shares – R9,000,000.

21) Arbitrary exchange rates will apply as follows for both scenarios:

- United Kingdom: R22.73 to the pound (£) was used for both scenarios;
- Australia: R11.63 to the Australian dollar (AUD).
- The Netherlands: Due to the fact that the distributions were not taxable in the Netherlands in both scenarios, no exchange rate was used for the jurisdiction.

### 3.2.2 Simulation calculations

In terms of section 5(1)(c) of the Income Tax Act, the year of assessment applicable to South African resident trusts begins on 1 March every year and ends on the last day of February every year. The amendment to section 25B of the Income Tax Act came into effect on 1 March 2024. To illustrate the impact of the amendment from a South African perspective, the simulated distributions will take place on two dates before and after the amendment as follows:

a) a distribution dated 29 February 2024, before the amendment took effect ("**Scenario 1**"); and

b) a distribution dated 1 March 2024, the day the amendment took effect ("**Scenario 2**").

In this regard, the relevant provisions of local and foreign legislation and the applicable DTAs are applied to the income and capital gain arising in ABC Trust by illustrating the following tax computations in terms of the simulation:

- the South African tax computation of ABC Trust before the amendment to section 25B of the Income Tax Act (Scenario 1);
- the South African tax computation of ABC Trust after the amendment to section 25B of the Income Tax Act (Scenario 2);
- the South African tax computation of the beneficiaries before the amendment to section 25B of the Income Tax Act (Scenario 1); and
- the foreign tax computations of each of the three beneficiaries before and after the amendment to section 25B of the Income Tax Act (Scenario 1 and Scenario 2).

## 3.3 THE SOUTH AFRICAN TAX TREATMENT OF THE TRUST: SCENARIO 1

The following amounts were distributed to each non-resident beneficiary in terms of section 25B of the Income Tax Act, which represented an income distribution for South African tax purposes:

**Table 3.1: Summary of Income Distribution (Scenario 1)**

| RENTAL INCOME (R) | DIVIDEND INCOME (R) | DIVIDEND INCOME (R) | INTEREST (R) | INTEREST (R) | TOTAL (R) |
|---|---|---|---|---|---|
| **SA-source** | **SA-source** | **Foreign** | **SA-source** | **Foreign** | |
| Taxable income | Net income | Gross income | Taxable income | Taxable income | |
| 1 922 680 | 2 882 216 | 2 250 000 | 480 786 | 845 438 | **8 381 121** |

Source: Own formulation

The South African tax computation of ABC Trust in respect of Scenario 1 is illustrated in Table 3.2 below, which simulates the distribution taking effect on 29 February 2024 (the day before the day that the amendment to section 25B of the Income Tax Act took effect).

### 3.3.1 Tax treatment of income in the hands of the trust

ABC Trust earned a combination of local and foreign source income that is indicative of the types of income generally subject to South African family trusts (**Items 1 and 3** of Table 3.2 below). As a South African tax resident, ABC Trust will be taxable on its worldwide income in terms of the definition of gross income in section 1 of the Income Tax Act. In Scenario 1, the trustees were permitted to vest income arising in the trust in the non-resident beneficiaries for tax purposes, as the amendment had not yet come into effect at 29 February 2024. Therefore, to achieve tax efficiency from a South African perspective, the trustees of ABC Trust elected to vest the net income of ABC Trust in its beneficiaries in equal portions in the same year that the income arose in the trust in terms of section 25B of the Income Tax Act. The income will be deemed to be income in the hands of the beneficiaries and not the trust (refer to the detailed discussion in Chapter 2 in respect of the application of section 25B of the Income Tax Act to trusts, as well as the application of the conduit-pipe principle). The result was that ABC Trust was not subject to income tax in South Africa in respect of Scenario 1.

### 3.3.2 Tax treatment of capital gain in the hands of the trust

A local capital gain of R9 million arose in ABC Trust (**Item 3**). The capital gain does not meet the definition of gross income, which excludes amounts of a capital nature. Because the trust did not have any South African resident beneficiaries in whom to vest the capital gain, the taxable capital gain was included in the taxable income of ABC Trust in terms of section 26A of the Income Tax Act, as the trustees were not permitted to vest capital gains in non-resident beneficiaries in terms of paragraph 80 of the Eighth Schedule to the Income Tax Act. The taxable gain was taxed at an effective rate of 36% in the hands of the ABC Trust (R9,000,000 x 80% x 45% = R3,240,000; **Item 18**).

### 3.3.3 Tax treatment of expenses in the hands of the trust

ABC Trust incurred direct expenses attributable to the income it earned amounting to R1,650,000 (**Item 5**). The direct expenses incurred in respect of each source of income have been deducted against the income source in question where permissible, in terms of section 11(a) of the Income Tax Act, read with section 23(g) of the Income Tax Act.

The simulation also includes indirect expenses amounting to R1,125,000 (**Item 6**) that do not relate to a single source of income and include expenses such as accounting fees, bank charges, and trustee management fees. The indirect expenses are apportioned to each source of income as a percentage of the respective source of income to total income (**Item 2**, and refer to *Secretary For Income Revenue v Guardian Assurance Holdings (SA) Ltd*, 38 SATC 111, 1976 (4) SA 522 (A) for the requirement to apportion indirect expenses on a reasonable basis). After taking the expenses into account, the trust had a net income of R33,600,000 (**Item 7**).

### 3.3.4 Application of relevant tax adjustments

The simulation includes certain tax adjustments (**Items 8 to 11**). The direct and indirect expenses attributable to local divided income were added back for tax purposes as they are not deductible in terms of section 11(a) of the Income Tax Act. Local dividends are exempt from income tax in terms of section 10(1)(k)(i) of the Income Tax Act (**Item 11**), and thus do not meet the definition of "income" in section 1 of the Income Tax Act (**Item 9**). The direct and indirect expenses attributable to foreign dividend income are specifically prohibited as a deduction in terms of section 23(q) of the Income Tax Act and were added back for tax purposes (**Item 9**). In addition, the indirect expenses attributable to the local capital gains were added back for tax purposes, as they are not deductible in terms of section 11(a) of the Income Tax Act (**Item 9**). The capital gain was added back for tax purposes (**Item 10**), as amounts of a capital nature do not fall within the definition of gross income in section 1 of the Income Tax Act, unless the capital amount is specifically included in the definition notwithstanding its capital nature. After the tax adjustments were taken into account, taxable income amounted to R19,946,714 (**Item 12**).

### 3.3.5 Income distribution to beneficiaries

The trustees distributed the taxable income and the exempt local dividend income to the non-resident beneficiaries, net of expenses (**Item 13**). For tax efficiency purposes, the trustees used their discretion to vest and distribute the gross foreign dividend income amounting to R6,750,000 million in the beneficiaries, <u>before</u> taking the exemption available to the trust in terms of section 10B(3) of the Income Tax Act into account, where an exemption of R3,750,000 million (= R6,750,000 million x 25 / 45) was available to the trust (**Item 11**).

### 3.3.6 Capital distribution to beneficiaries

After the income distribution and CGT paid by ABC Trust, cash amounting to R5,216,637 (R5,216,637 / 3 beneficiaries = R1,738,879 per beneficiary) was available for payment to the beneficiaries by way of a capital distribution (**Items 20 to 23**), which represented the trust capital resulting from capital gains net of indirect expenses and capital gains tax payable by the ABC Trust, less disallowed expenses attributable to foreign dividends. The trustees vested the remaining cash in the beneficiaries by way of a capital distribution amounting to R1,738,879 per beneficiary out of ABC Trust's capital.

Therefore, each beneficiary received cash distributions amounting to R10,120,000 (= R8,381,121 income distribution + R1,738,879 capital distribution) in Scenario 1, where the trust paid income tax in the form of CGT amounting to R3,240,000 (R3,240,000 / 3 = R1,080,000 CGT paid indirectly by each beneficiary). After the income and capital distributions, the trust had no remaining cash reserves at 29 February 2024 (**Item 24**).

## Table 3.2: ABC Trust South African tax computation (Scenario 1)

| Item | Narration | Income // Revenue | | | | | Capital Gain | Total |
|---|---|---|---|---|---|---|---|---|
| [1] | | **Rental income (Local)** | **Dividend Income (Local)** | **Dividend Income (Foreign)** | **Interest (Local)** | **Interest (Foreign)** | **Profit / Loss on disposal of listed shares (Local)** | |
| [2] | | 20.62% | 24.74% | 18.56% | 4.12% | 7.22% | 24.74% | **100%** |
| [3] | GROSS INCOME (REVENUE ACCOUNT) // PROFIT ON SALE OF ASSETS (CAPITAL GAIN) | R7,500,000 | R9,000,000 | R6,750,000 | R1,500,000 | R2,625,000 | R9,000,000 | **R36,375,000** |
| [4] | EXPENSES | (R1,731,959) | (R353,351) | (R265,013) | (R57,642) | (R88,686) | (R278,351) | **(R2,775,000)** |
| [5] | Direct expenses | (R1,500,000) | (R75,000) | (R56,250) | (R11,250) | (R7,500) | R0 | **(R1,650,000)** |
| [6] | Indirect expenses | (R231,959) | (R278,351) | (R208,763) | (R46,392) | (R81,186) | (R278,351) | **(R1,125,000)** |
| [7] | NET INCOME/CASH BALANCE | R5,768,041 | R8,646,649 | R6,484,987 | R1,442,358 | R2,536,314 | R8,721,649 | **R33,600,000** |
| [8] | TAX ADJUSTMENTS | R0 | (R8,646,649) | (R3,484,987) | R0 | R0 | (R8,721,649) | **(R20,853,286)** |
| [9] | Add back: Deductions not permitted – section 11(a) / 23(g) / 23(q) / paragraph 20 | R0 | R351,351 | R265,013 | R0 | R0 | R278,351 | **R896,714** |
| [10] | Less: Income - capital in nature - s1 | R0 | R0 | R0 | R0 | R0 | (R9,000,000) | **(R9,000,000)** |
| [11] | Less: dividend exemption - section 10(1)(k)(i) / Section 10B(3) | R0 | (R9,000,000) | (R3,750,000) | R0 | R0 | R0 | **(R12,750,000)** |
| [12] | TAXABLE INCOME IN TRUST BEFORE DISTRIBUTION | R5,768,041 | R0 | R3,000,000 | R1,442,358 | R2,536,314 | R7,200,000 | **R19,946,714** |
| [13] | LESS INCOME VESTED IN AND DISTRIBUTED ("PAID") TO BENEFICIARIES | (R5,768,041) | (R8,646,649) | (R6,750,000) | (R1,442,358) | (R2,536,314) | R0 | **(R25,143,363)** |
| [14] | Mr A (UK resident beneficiary) | (R1,922,680) | (R2,882,216) | (R2,250,000) | (R480,786) | (R845,438) | R0 | **(R8,381,121)** |
| [15] | Ms B (Australian resident beneficiary) | (R1,922,680) | (R2,882,216) | (R2,250,000) | (R480,786) | (R845,438) | R0 | **(R8,381,121)** |
| [16] | Ms C (Dutch resident beneficiary) | (R1,922,680) | (R2,882,216) | (R2,250,000) | (R480,786) | (R845,438) | R0 | **(R8,381,121)** |
| [17] | TRUST TAXABLE INCOME AFTER AWARDS | R0 | R0 | R0 | R0 | R0 | R7,200,000 | **R7,200,000** |
| [18] | TAX THEREON IN THE HANDS OF THE TRUST @ 45% | R0 | R0 | R0 | R0 | R0 | (R3,240,000) | **(R3,240,000)** |
| [19] | EXCESS CASH AVAILABLE FOR DISTRIBUTION TO BENEFICIARY | R0 | R0 | (R265,013) | R0 | R0 | R5,481,649 | **R5,216,637** |
| [20] | CASH DISTRIBUTED IN BENEFICIARIES IN TERMS OF A CAPITAL DISTRIBUTION | R0 | R0 | R265,013 | R0 | R0 | (R5,481,649) | **(R5,216,637)** |
| [21] | Mr A (UK resident beneficiary) | R0 | R0 | R88,338 | R0 | R0 | (R1,827,216) | **(R1,738,879)** |
| [22] | Ms B (Australian resident beneficiary) | R0 | R0 | R88,338 | R0 | R0 | (R1,827,216) | **(R1,738,879)** |
| [23] | Ms C (Dutch resident beneficiary) | R0 | R0 | R88,338 | R0 | R0 | (R1,827,216) | **(R1,738,879)** |
| [24] | CASH REMAINING IN TRUST AFTER CAPITAL DISTRIBUTION | R0 | R0 | R0 | R0 | R0 | R0 | **R0** |

Source: Own Formulation

## 3.4 THE SOUTH AFRICAN TAX TREATMENT OF EACH BENEFICIARY: SCENARIO 1

The South African tax computation of each beneficiary in respect of Scenario 1 is illustrated in Table 3.3 below in terms of the income and capital distribution discussed above, with effect 29 February 2024 (the day before the day that the amendment to section 25B of the Income Tax Act took effect).

The income that the trustees vested in the beneficiaries in terms of section 25B of the Income Tax Act will be deemed to be income that accrued to the beneficiaries and will thus form part of their gross income, as the income in question meets the definition of gross income as defined in section 1 of the Income Tax Act. Non-resident taxpayers are only taxable on income from a South African source or income deemed to be from a South African source (paragraph (ii) of the definition of gross income in section 1 of the Income Tax Act and section 9 of the Income Tax Act). The income that the trustees distributed to the beneficiaries will retain its nature (*Secretary For Inland Revenue v Rosen*), which is relevant in determining whether each type of income received as a distribution constitutes an amount from a South African source, in order to apply the definition of gross income to the amounts in question.

The foreign source dividends and foreign source interest will not be taxable in the hands of the non-resident beneficiaries as the amounts will not fall within the definition of gross income, and thus will not be taxed in South Africa (**Items 3 and 5** of Table 3.3). Only the local rental income, local dividend income, and local interest income will be included in each beneficiary's gross income, as these amounts constitute income from a South African source (**Items 1, 2, and 4**). Therefore, each beneficiary's gross income will amount to R5,285,683 (**Item 6**).

The local dividend income will be exempt from tax in the beneficiaries' hands in terms of section 10(1)(k)(i) of the Income Tax Act (**Item 7**). Section 10(1)(h) of the Income Tax Act exempts local interest income in the hands of non-residents, unless the resident spends 183 days in aggregate in South Africa in the twelve months preceding the date on which the interest is received by or accrues to that person, or where the debt from which the interest arose related to a permanent establishment in South Africa. Given the assumptions listed above, the beneficiaries meet the requirements of the interest exemption in South Africa (**Item 8**). The result is that each beneficiary's income will amount to R1,922,680 (**Item 9**). The beneficiaries will not be subject to CGT on the capital gain that was distributed to them as a capital distribution, as the capital gain was subject to CGT in the hands of the Trust (**Item 10**). Therefore, each beneficiary's taxable income will amount to R1,922,680, which was attributable to the rental income distribution (**Item 11**).

The income (apart from the South African source rental income) was either exempt from tax in South Africa in the hands of the beneficiaries or did not form part of the beneficiaries' gross income (in the case of foreign-source income). To simplify the simulations, the tax considerations relating to withholding taxes for local and foreign interest and dividend income fall outside the scope of this thesis (refer to assumption on page 29 of the thesis). Accordingly, the DTAs between South Africa and the resident states will only be applied in respect of the South African source rental income that is taxable in terms of South African domestic legislation. It must therefore be determined whether the DTAs between South Africa and the resident states allow for the rental income to be taxed in South Africa and, if so, to what extent.

**Application of the DTAs to South African source rental income**

With regard to Mr A, who is tax resident in the United Kingdom, the DTA between South Africa and the United Kingdom (the "SA-UK DTA") must be applied to the South African source rental income in question. Article 6 of the SA-UK DTA deals with income from immovable property, which includes rental income. As the property is situated in South Africa, Paragraph 1 of Article 6 allows South Africa to tax the rental income in terms of its domestic law. Therefore, the rental income will be taxable in the hands of Mr A in South Africa.

With regard to Ms B, who is tax resident in Australia, the DTA between South Africa and Australia (the "SA-Australia DTA") must be applied. Article 6 of the SA-Australia DTA deals with income from immovable property, which includes rental income. As the property is situated in South Africa, Paragraph 1 of Article 6 provides for South Africa to tax the rental income in terms of its domestic law. Therefore, the rental income will be taxable in the hands of Ms B in South Africa.

With regard to Ms C, who is tax resident in the Netherlands, the DTA between South Africa and the Netherlands (the "SA-Dutch DTA") must be applied. Article 6 of the SA-Dutch DTA deals with income from immovable property, which includes rental income. As the property is situated in South Africa, Paragraph 1 of Article 6 provides for South Africa to tax the rental income in terms of its domestic law. Therefore, the rental income will be taxable in the hands of Ms C in South Africa.

Each non-resident beneficiary is subject to normal tax calculated in terms of the progressive income tax rates, and the normal tax in respect of each beneficiary will amount to R674,810 in Scenario 1 (**Item 12**). After taking the primary rebate into account in terms of section 6 of the Income Tax Act (**Item 13**), each beneficiary will be liable for income tax amounting to R692,045 (**Item 14**).

The cash distributions to each beneficiary amounted to R10,120,000 (**Item 15**). After paying income tax to SARS, the trustees will transfer cash amounting to R9,445,190 to each beneficiary's foreign bank account (**Item 16**). The total economic tax liability of each beneficiary in South Africa in Scenario 1 amounts to R1,754,810 (**Item 17**), or 15.67% of each beneficiary's proportional net income (**Item 18**).

**Table 3.3: South African tax computation of each beneficiary (Scenario 1)**

| ITEM | DESCRIPTION | AMOUNT (R) |
|---|---|---|
| [1] | Rental income | 1 922 680 |
| [2] | Dividend income (Local) | 2 882 216 |
| [3] | Dividend income (Foreign) | 0 |
| [4] | Interest income (Local) | 480 786 |
| [5] | Interest income (Foreign) | 0 |
| [6] | **Total Gross Income** | **5 285 683** |
| | **Less: Exempt Income** | |
| [7] | Local dividend exemption | (2 882 216) |
| [8] | Local interest exemption | (480 786) |
| [9] | **Income** | **1 922 680** |
| [10] | Add taxable capital gain | 0 |
| [11] | **Taxable income** | **1 922 680** |
| [12] | Normal Tax | 692 045 |
| [13] | Less Primary rebate | (17 235) |
| [14] | South African tax payable by beneficiary on assessment | 674 810 |
| [15] | Cash distributed to each beneficiary (= R8,381,121 income distribution + R1,738,879 capital distribution) | 10 120 000 |
| [16] | **Cash available for each beneficiary (Scenario 1) after SA tax paid** | **9 445 190** |
| | Total tax payable by each beneficiary directly | (674 810) |
| | Total tax payable by each beneficiary indirectly (via the trust) = R3,240,000 / 3 | (1 080 000) |
| [17] | **Total economic taxation paid by each beneficiary in South Africa (Scenario 1)** | **(1 754 810)** |
| [18] | Total economic taxation payable by each beneficiary in SA as a percentage of their portion of net income = R1,754,810 / R11,200,000 (**Item 7** of Table 3.2) x 100 | 15.67% |

Source: Own Formulation

## 3.5 THE SOUTH AFRICAN TAX TREATMENT OF THE TRUST: SCENARIO 2

The South African tax computation of ABC Trust in respect of Scenario 2 is illustrated in Table 3.4 below, which simulates a distribution on 1 March 2024 (the day the amendment to section 25B of the Income Tax Act came into effect).

Scenario 2 involves ABC Trust receiving the same types and amounts of income (**Items 1 and 3** of Table 3.4), and incurring the same types and amounts of direct and indirect expenses as Scenario 1 (**Items 3 to 6**), which resulted in the same net income of R33,600,000 arising in the trust (**Item 7**). Scenario 2 also involves the same set of tax adjustments as Scenario 1 (**Items 8 to 11**) and taxable income in the hands of the trust before any distributions (**Item 12**). The tax treatment of items 1 to 12 of Scenario 2 (Table 3.4) therefore mirrors items 1 to 12 of Scenario 1 (Table 3.3) and will therefore not be discussed further.

The critical South African effect of the amendment to section 25B of the Income Tax Act is illustrated in **Items 13 to 17** of Table 3.4, where the trustees of ABC Trust were not permitted to vest income arising in the trust in non-resident beneficiaries for tax purposes with effect from 1 March 2024, as a result of the amendment to section 25B of the Income Tax Act. This resulted in taxable income amounting to R19,946,714 remaining in ABC Trust (**Item 17**), since the taxable income arising in the trust was not deemed to be the income of the beneficiaries. The tax treatment of the capital gain arising in the trust in respect of Scenario 1 and Scenario 2 remains the same, as the conduit pipe principle that applies to capital gains derived by a trust is dealt with in paragraph 80 of the Fourth Schedule to Income Tax Act and not section 25B of the Income Tax Act. The taxable gain was taxed at an effective rate of 36% in the hands of the trust (R9,000,000 x 80% x 45% = R3,240,000; **Item 18**).

The result is that the taxable income amounting to R19,946,714 (**Item 17**) was taxable in the hands of ABC Trust at a flat rate of 45% (**Item 18**), resulting in the trust being liable for income tax amounting to R8,976,021 (= R19,946,714 x 45%). This resulted in cash amounting to R24,623,979 remaining in ABC Trust and available for distribution (**Item 19**), comprising of net income less the tax payable by the trust, and each beneficiary received a capital distribution of R8,207,993 (= R24,623,979 / 3; **Items 20 to 23**). After the capital distribution, no cash remained in the trust (**Item 24**).

The total economic taxation paid by each beneficiary indirectly (via the trust) in Scenario 2 amounts to R2,992,007.09 (= R8,976,021 / 3; **Item 18**), and the trustees will transfer cash amounting to R8,207,993 to each beneficiary's foreign bank account (**Items 20 to 23**).

## 3.6 THE SOUTH AFRICAN TAX TREATMENT OF EACH BENEFICIARY: SCENARIO 2

No tax will be payable in South Africa by the beneficiaries in their personal capacities in Scenario 2, as the legal characterisation of the amounts they receive for South African tax purposes will constitute amounts of a capital nature that will not fall within the definition of gross income in section 1 of the Income Tax Act (refer to the discussion on the tax treatment of capital distributions below).

### 3.7 THE SOUTH AFRICAN TAX TREATMENT OF CAPITAL DISTRIBUTIONS

For South African tax purposes, it is important to determine the legal characterisation of the right or interest that vests in a beneficiary. In the case of a discretionary trust, the trustees could vest several types of interests in a beneficiary, including an interest in income, capital gains, trust capital (constituting of, *inter alia*, accumulated income), assets held by the trust, or a combination of these interests. Where the trustees of a discretionary trust exercise their discretion in terms of the trust deed and decide not to vest income or capital gains arising in the trust in a beneficiary in year 1, and decide to retain and accumulate the income or capital gain and thereafter distribute the amount to the beneficiary in year 2, the trust will pay the tax that may be payable on the income or capital gain arising in the trust in year 1, and the accumulated amount (net of any expenses and taxes incurred by the trust) will form part of the trust capital (Clegg & Stretch: 2021). Because the beneficiary will not acquire a vested right to the income in year 1, the income will not be deemed to be the income of the beneficiary in terms of section 25B of the Income Tax Act, which requires the beneficiary to acquire a vested right to the income in the same year that the income arises in the trust. When the beneficiary receives an amount out of trust capital (comprising of, *inter alia*, accumulated income from year 1) in a subsequent year, provided that the amount is not paid as an annuity, the amount distributed will constitute an amount of a capital nature and will that not be taxed again in the hands of the beneficiary, as section 25B of the Income Tax Act and the definition of gross income in section 1 of the Income Tax Act specifically exclude amounts of a capital nature (refer also to *Dempers v Secretary For Inland Revenue*, 1977 (3) SA 410 (A)).

Common law relating to the characterisation of amounts subject to the conduit pipe principle appears to establish that an amount arising in a trust loses its identity when it is accumulated in the trust and distributed to beneficiaries in subsequent years of assessment (*Armstrong v Commissioner for Inland Revenue*, *Secretary for Inland Revenue v Rosen* and *Estate Dempers v Commissioner for Inland Revenue*). An interesting situation arises where the trustees of a discretionary trust resolve to distribute amounts to beneficiaries comprising of income or capital gains in the same year the amounts arise in the trust, and are prevented by statute from vesting that income or capital gain in a non-resident beneficiary for tax purposes. An example of this would be a local or foreign capital gain that the trustees are not permitted to vest in a non-resident beneficiary in terms of paragraph 80 of the Eighth Schedule, which provides that trustees are not permitted to vest capital gains in non-resident beneficiaries for tax purposes. Another example would be income arising in the trust that is distributed to non-resident beneficiaries in the same year of assessment that the income arises in the trust, but after 1 March 2024 when the amendment to section 25B of the Income Tax Act came into effect. In these instances, does the fact that the income or capital gain forms part of the trust's gross income or taxable income mean that the amounts lose their identity immediately and form part of the trust capital, even though the amounts are distributed to the beneficiaries in the same year the amounts arise in the trust? Does the amount received by the beneficiaries in this instance lose its character as income or capital gains and thus represent a capital distribution? It is submitted that it is important to determine the legal nature of the right that vests in the beneficiary, which in this instance would be a specified amount of the trust capital in terms of a trustee resolution. It would be difficult to argue that the amount, after being subject to tax in the trust, would also form part of the non-resident's taxable income in contravention of paragraph 80 of the Eighth Schedule or section 25B of the Income Tax Act, just because the amount was distributed to the non-resident beneficiary in the same year the amount was received by the trust. Not only would this result in economic double taxation, but would also be in contravention of the principle established in *Dempers v Secretary For Inland Revenue*, 1977 (3) SA 410 (A), which provides that, once income has been taxed in the hands of the trust, it cannot be taxed again in the hands of a beneficiary. It is likely that, where the trustees in this instance resolve to make a distribution out of the trust capital, the amount will not form part of the beneficiary's taxable income.

In Scenario 1, the original source of the capital distribution was the capital gain that the trustees were not permitted to attribute to the non-resident beneficiaries for tax purposes. The distribution was therefore arguably paid out of the trust capital. Because the capital gain was taxed in the trust, it is submitted that the portion of the capital distribution that originated from the capital gain was correctly characterised as a capital distribution for South African legal purposes and will therefore not be taxable in the beneficiaries' hands. Where the trustees exercise their discretion as provided for in ABC Trust's trust deed and vest the trust capital (comprising of the net capital gain less disallowed expenses) by way of a trustee resolution, the legal nature of the amounts to which the beneficiaries will acquire a vested right is likely to be characterised as capital and not income. Therefore, the capital distribution will not fall within the definition of gross income and will not be subject to tax in the hands of the beneficiaries in

South Africa. The same tax treatment would apply in relation to the capital distributions in Scenario 2.

A capital distribution by a discretionary trust will not constitute a disposal in terms of paragraph 11 of the Eighth Schedule to the Income Tax Act and therefore the capital distributions in both Scenario 1 and Scenario 2 will not be subject to CGT. In addition, the capital distributions will be exempt from donations tax in terms of section 56(1)(l) of the Income Tax Act.

## Table 3.4: ABC Trust South African Tax Computation (Scenario 2)

| Item | Narration | Income // Revenue | | | | | Capital Gain | Total |
|---|---|---|---|---|---|---|---|---|
| [1] | | **Rental income (Local)** | **Dividend Income (Local)** | **Dividend Income (Foreign)** | **Interest (Local)** | **Interest (Foreign)** | **Profit / (loss) on disposal of listed shares (Local)** | |
| [2] | | 20.62% | 24.74% | 18.56% | 4.12% | 7.22% | 24.74% | 100% |
| [3] | GROSS INCOME (REVENUE ACCOUNT) // PROFIT ON SALE OF ASSETS (CAPITAL GAIN) | R7,500,000 | R9,000,000 | R6,750,000 | R1,500,000 | R2,625,000 | R9,000,000 | R36,375,000 |
| [4] | EXPENSES | (R1,731,959) | (R353,351) | (R265,013) | (R57,642) | (R88,686) | (R278,351) | (R2,775,000) |
| [5] | Direct expenses | (R1,500,000) | (R75,000) | (R56,250) | (R11,250) | (R7,500) | R0 | (R1,650,000) |
| [6] | Indirect expenses | (R231,959) | (R278,351) | (R208,763) | (R46,392) | (R81,186) | (R278,351) | (R1,125,000) |
| [7] | NET INCOME/CASH BALANCE | R5,768,041 | R8,646,649 | R6,484,987 | R1,442,358 | R2,536,314 | R8,721,649 | R33,600,000 |
| [8] | TAX ADJUSTMENTS | R0 | (R8,646,649) | (R3,484,987) | R0 | R0 | (R8,721,649) | (R20,853,286) |
| [9] | Add back: Deductions not permitted – section 11(a) / 23(g) / 23(q) / paragraph 20 | R0 | R351,351 | R265,013 | R0 | R0 | R278,351 | R896,714 |
| [10] | Less: Income - capital in nature - s1 | R0 | R0 | R0 | R0 | R0 | (R9,000,000) | (R9,000,000) |
| [11] | Less: dividend exemption - section 10(1)(k)(i) / section 10B(3) | R0 | (R9,000,000) | (R3,750,000) | R0 | R0 | R0 | (R12,750,000) |
| [12] | TAXABLE INCOME IN TRUST PRIOR TO DISTRIBUTION | R5,768,041 | R0 | R3,000,000 | R1,442,358 | R2,536,314 | R7,200,000 | R19,946,714 |
| [13] | LESS INCOME VESTED IN AND DISTRIBUTED ("PAID") TO BENEFICIARIES | R0 | R0 | R0 | R0 | R0 | R0 | R0 |
| [14] | Mr A (UK resident beneficiary) | R0 | R0 | R0 | R0 | R0 | R0 | R0 |
| [15] | Ms B (Australian resident beneficiary) | R0 | R0 | R0 | R0 | R0 | R0 | R0 |
| [16] | Ms C (Dutch resident beneficiary) | R0 | R0 | R0 | R0 | R0 | R0 | R0 |
| [17] | TRUST TAXABLE INCOME AFTER AWARDS | R5,768,041 | R0 | R3,000,000 | R1,442,358 | R2,536,314 | R7,200,000 | R19,946,714 |
| [18] | TAX THEREON IN THE HANDS OF THE TRUST @ 45% | (R2,595,619) | R0 | (R1,350,000) | (R649,061) | (R1,141,341) | (R3,240,000) | (R8,976,021) |
| [19] | EXCESS CASH AVAILABLE FOR DISTRIBUTION TO BENEFICIARY | R3,172,423 | R8,646,649 | R5,134,987 | R793,297 | R1,394,973 | R5,481,649 | R24,623,979 |
| [20] | CASH DISTRIBUTED IN BENEFICIARIES IN TERMS OF A CAPITAL DISTRIBUTION | (R3,172,423) | (R8,646,649) | (R5,134,987) | (R793,297) | (R1,394,973) | (R5,481,649) | (R24,623,979) |
| [21] | Mr A (UK resident beneficiary) | (R1,057,474) | (R2,882,216) | (R1,711,662) | (R264,432) | (464,991) | (1,827,216) | (8,207,993) |
| [22] | Ms B (Australian resident beneficiary) | (R1,057,474) | (R2,882,216) | (R1,711,662) | (R264,432) | (464,991) | (1,827,216) | (8,207,993) |
| [23] | Ms C (Dutch resident beneficiary) | (R1,057,474) | (R2,882,216) | (R1,711,662) | (R264,432) | (464,991) | (1,827,216) | (8,207,993) |
| [24] | CASH REMAINING IN TRUST AFTER CAPITAL DISTRIBUTION | R0 | R0 | R0 | R0 | R0 | R0 | R0 |

Source: Own formulation

### 3.8. CONCLUSION

Chapter 3 has illustrated the potential South African economic impact of the amendment to section 25B of the Income Tax Act on South African resident trusts and non-resident natural person beneficiaries of South African resident trusts. This was achieved through the use of simulated distributions made by the trustees of a fictional South African resident trust to three natural person beneficiaries tax resident in the United Kingdom, Australia, and the Netherlands, before and after the amendment to section 25B of the Income Tax Act that came into effect on 1 March 2024.

In the context of the case study, Scenario 2 will result in each beneficiary being liable for R1,237,197 more tax in South Africa relative to Scenario 1 (= R2,992,007 total tax paid in Scenario 2 minus R1,754,810 total tax paid in Scenario 1) as a direct result of the amendment to section 25B of the Income Tax Act. This resulted in each non-resident beneficiary being liable for about 70% more South African tax in Scenario 2 than in Scenario 1, which resulted in significantly more tax collected by the SARS.

An analysis of the tax liability in South Africa before and after the amendment in the context of the case study reveals two drivers for the increase in South African tax for each beneficiary. Firstly, foreign-source income vested in beneficiaries in Scenario 1 in terms of section 25B of the Income Tax Act escaped taxation in South Africa in the hands of the ABC Trust and the non-resident beneficiaries, as non-residents are only taxable on South African source income. Foreign source income in Scenario 2 was taxed in the hands of ABC Trust as a tax resident, as the trustees were not permitted to vest income in the non-resident beneficiaries. Secondly, the local source income that was distributed to the beneficiaries and included in gross income in Scenario 1 was subject to tax in terms of the tax tables applicable to individuals that currently range between 18% and 45%, whilst in Scenario 2, ABC Trust was subject to a flat tax rate of 45% applicable to taxable income taxed in the hands of the trust.

In addition to SARS collecting considerably more tax for the fiscus, from an administrative perspective, it is evident that Scenario 2 will be far more straightforward for SARS to administer relative to Scenario 1. This is because, by taxing ABC Trust on the income on a single tax return in Scenario 2, SARS will not need to consider the legal nature of the non-resident beneficiary, the jurisdiction of the ultimate non-resident beneficial owner, the complexities of applying one or more DTAs in respect of the trust income, or the merits of withholding tax credits. Another interesting factor from a tax compliance perspective is that, despite paying more tax on their portion of the trust income and capital gain indirectly through the trust in Scenario 2, the non-resident beneficiaries will benefit from not having to submit South African income tax returns as a result of not earning any gross income (the distributions in Scenario 2 were of a capital nature). This will also relieve SARS' administrative burden, as in certain instances SARS will need to process and verify fewer income tax returns relating to non-resident beneficiaries of South African trusts. Tax compliance as it relates to non-resident beneficiaries of South African resident trusts will become far less cumbersome due to the amendment to section 25B of the Income Tax Act.

In the following chapter, the foreign tax treatment of the distributions in the hands of each of the three non-resident beneficiaries will be discussed with regard to both Scenarios.

# CHAPTER 4: FOREIGN TAX TREATMENT OF THE SIMULATED DISTRIBUTIONS

## 4.1 INTRODUCTION

In addressing the third sub-goal of the research, this chapter investigates the foreign tax treatment of the simulated distributions dealt with in Chapter 3, in the hands of the three non-resident natural person beneficiaries in their respective countries of residence before and after the amendment to section 25B of the Income Tax Act. The key reason for this chapter is to determine whether Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument will provide the non-resident beneficiaries with relief from economic double taxation with specific reference to the South African income tax paid by ABC Trust in Scenario 2. The analysis in this chapter incorporates the same set of facts and assumptions in respect of the simulation as were discussed in Chapter 3.

Given the complexity of interpreting DTAs in the context of international tax law relating to trust distributions, the discussion in this chapter will not include an in-depth technical or theoretical analysis of the relevant DTA or the domestic law of each state in respect of amounts subject to trusts. Rather, the chapter involves a practical discussion of a limited application of the domestic law of each resident state, as well as the applicable DTA, to test whether the South African National Treasury's response to the concern regarding economic double taxation was correct. In the Final Response Document (South African National Treasury, 2024: 60), the South African National Treasury's response to the public's concern that the amendment to section 25B of the Income Tax Act would lead to double taxation in the hands of the non-resident beneficiary was that the effect of Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument would be that "the resident is allowed relief from economic double taxation with reference to the South African tax paid by the South African trust."

The chapter begins by discussing the application of the domestic legislation of each resident state to the trust distributions, including any unilateral relief that may be available to prevent double taxation. Thereafter, DTA relief designed to prevent economic double taxation in the context of trust distributions is discussed with particular reference to Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument. Finally, the foreign tax computations are discussed for each beneficiary with respect to Scenario 1 and Scenario 2.

## 4.2 APPLICATION OF DOMESTIC LAW TO BENEFICIARIES IN THEIR RESIDENT STATES

The application of domestic law in respect of distributions received by each beneficiary is discussed in three steps.

### 4.2.1 Step 1: Applying domestic legislation to determine the foreign tax treatment of income and capital distributions

In addition to being subject to tax in South Africa on certain income, based on the DTA between South Africa and the relevant resident state of each beneficiary (the United Kingdom, Australia, and the Netherlands; collectively referred to as "the resident states"), each non-resident beneficiary may also be subject to tax on the distributions received from ABC Trust in their respective resident state as a result of being tax resident in that state. Developed nations will generally subject tax residents to tax on their worldwide income receipts and accruals, capital gains, and certain capital receipts (De Koker & Williams: 2021).

To determine the foreign tax treatment of the trust distributions received by each beneficiary from ABC Trust, the starting point is to apply the domestic legislation of each resident state to each type of amount vested in or distributed to the beneficiary, subject to the relevant DTA. It will be noted below that amounts that South African law may regard as income or capital in nature may be characterised differently by the resident state, depending on that resident state's domestic legislation. In addition, the resident state may attribute the income or capital to a different taxpayer when applying its domestic legislation. The domestic law of each resident state will be applied to the distributions contemplated in Scenario 1 and Scenario 2 to each beneficiary, which can be summarised as follows:

**Table 4.1: Summary of Cash Distributed to Each Beneficiary**

| | **Scenario 1 (R)** | **Scenario 2 (R)** |
|---|---:|---:|
| SA-source rental income (income distribution) | 1,922,680 | 0 |
| SA-source dividend income (income distribution) | 2,882,216 | 0 |
| Foreign dividend income (income distribution) | 2,250,000 | 0 |
| SA-source interest income (income distribution) | 480,786 | 0 |
| Foreign interest income (income distribution) | 845,438 | 0 |
| **Total income distribution** | **8,381,121** | **0** |
| Capital Distribution | 1,738,879 | 8,207,993 |
| **Total cash distributed** | **10,120,000** | **8,207,993** |

Source: Own formulation

### 4.2.2 Step 2: determine the unilateral relief available in respect of South African tax

Having determined the foreign tax treatment of the amounts distributed to each beneficiary, where the distributed amount in question is also subject to tax in the resident state, it will be necessary to determine whether the beneficiary in question will be entitled to a foreign tax credit, deduction, or exemption in respect of the South African tax, payable both directly and indirectly through ABC Trust. As will be clear from the discussion below, the domestic laws of member states of the OECD often provide several types of unilateral relief in the form of tax rebates comprising foreign tax credits, tax deductions or exemptions, or a combination of these mechanisms (OECD MTC Commentary: 2017). In Scenario 1, the focus will be to determine whether the South African tax payable by each beneficiary on the rental income distribution, and the South African CGT payable by ABC Trust on the capital gain that was distributed to the beneficiaries (net of CGT and disallowed expenses) will be allowed as a foreign tax credit in terms of the domestic legislation of the resident states. In Scenario 2, the particular focus will be to determine whether the tax paid by ABC Trust will be allowed as a foreign tax credit by the resident states, even though the trust and not the beneficiary was liable for the tax in South Africa. Unilateral relief will not be necessary if the resident state does not tax the amount distributed in terms of its domestic legislation (refer to the discussion below relating to Ms C, the Dutch beneficiary).

The total South African tax paid by each beneficiary directly and indirectly through ABC Trust in each of the scenarios is summarised in Table 4.2.

**Table 4.2: Summary of Total South African Tax Paid**

| | **Scenario 1 (R)** | **Scenario 2 (R)** |
|---|---|---|
| SA Tax paid by each beneficiary (income distribution) | 674,810 | 0 |
| SA Tax paid by ABC Trust (capital distribution) | 1,080,000 | 2,992,007 |
| **Total SA tax paid** | **1,754,810** | **2,992,007** |

Source: Own formulation

Where it is found that unilateral relief is available to the non-resident beneficiary in terms of the resident state's domestic legislation, it will not be necessary to determine the bilateral relief discussed in Step 3 below.

### 4.2.3 Step 3: determine the bilateral relief available in respect of the South African tax

Where it is found on the facts that unilateral relief is not available in respect of South African tax (paid directly or indirectly via ABC Trust ), the DTA between South Africa and the relevant resident state will need to be taken into account. The DTA will, in certain circumstances, limit the application of the domestic legislation in order to prevent double taxation. Horak (2023:12:1) explains the purpose of a DTA as follows in *Silke on International Tax*:

> A tax treaty, as a general rule, does not impose tax. Rather, the main purpose is to avoid double taxation of income and capital by modifying the domestic law and thereby limiting the taxes otherwise imposed by the contracting States. In this way, it has the effect of restricting the taxing jurisdiction of the two States, with the primary objective of facilitating cross-border trade and foreign investment and the free movement of labour, and to assist the residents of both States in overseas investments or work-related projects.

South Africa has DTAs with the United Kingdom, Australia, and the Netherlands, the countries selected for this study. These DTAs are largely based on the OECD MTC. DTAs form part of public international law in terms of the Vienna Convention on the Law of Treaties (the "Vienna Convention"). With regard to the interaction between a DTA and domestic legislation when interpreting and applying DTAs to domestic law, Article 26 of the Vienna Convention states that a treaty is binding on a state and requires the contracting states to act in good faith as follows:

> **Article 26**
>
> "Pacta sunt servanda"
> Every treaty in force is binding upon the parties to it and must be performed by them in good faith.

The United Kingdom, Australia, and the Netherlands are all member states of the OECD. Whilst South Africa is not currently a member state of the OECD, South Africa is one of several states that are "OECD key partners" (OECD MTC Commentary: 2017). OECD decisions are only binding on member states (OECD MTC Commentary: 2017). Each member state can either enter reservations where they wish to deviate from certain aspects of the OECD MTC, or observations in respect of the commentary indicating how they will interpret and apply certain provisions of an Article that is subject to the OECD MTC. Therefore, each member state may apply the OECD MTC differently to trusts, in terms of their unique domestic legislation. Due to the fact that the OECD provides very little guidance in respect of amounts subject to trusts. These differences will result in economic double taxation in certain instances. Even though the OECD MTC is only binding on member states, the model is used by many member and non-member states to negotiate and interpret the provisions of DTAs, where the OECD has recommended that OECD members follow the Commentary when interpreting a DTA that was negotiated using the OECD MTC.

The OECD developed the Multilateral Instrument, which South Africa signed on 7 June 2017. The Multilateral Instrument assists states with efficiently modifying their tax agreements that the Multilateral Initiative covers. The South African National Treasury (2022: 1) made the following comment on 1 December 2022: "The overall goal of the BEPS MLI [Base Erosion and Profit Sharing Multilateral Initiative] is to swiftly update the existing network of bilateral tax treaties to reduce opportunities for tax avoidance and base erosion by multinational enterprises. The BEPS MLI will be applied alongside existing tax treaties".

South Africa deposited its instrument of ratification of the Multilateral Instrument with the OECD on 20 September 2022, which came into effect on 1 January 2023. The DTAs that South Africa listed under its Multilateral Instrument Position that may be modified by the Multilateral Instrument include the United Kingdom, Australia, and the Netherlands, which have also acceded to the Multilateral Instrument. The Multilateral Instrument will only have the effect of amending the provisions of a tax treaty where both contracting states elect for the relevant amendments to apply, otherwise the Multilateral Instrument is to be read alongside the relevant tax treaty. Brabazon (2019:5) explains the interaction between Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument as follows:

> Implementing recommendations of the BEPS project under Action 2 on hybrids and Action 6 on treaty abuse, the 2017 update of the OECD Model has introduced a transparent entity clause as Article 1(2), a saving clause as Article 1(3), and a parenthetical qualification in Article 23 A and B which excludes residence-country double tax relief to the extent that the other contracting state has purely residence-based taxing rights. Those changes each have counterparts in the MLI, which serves as a clearing house for modifying existing treaties to implement treaty-related measures of the BEPS project and the 2017 update.

Although South Africa has entered into DTAs with the three states in question, that have also ratified the Multilateral Instrument, interpreting the provisions of the DTAs can often be complex. In applying and interpreting the provisions of the relevant DTA, OECD MTC, OECD

MTC Commentary, Multilateral Instrument, and synthetised texts, to amounts distributed by a non-resident trust to a beneficiary resident in that state, the resident state will determine, *inter alia* (Du Plessis: 2014):

a. the nature of the trust entity and whether the trust entity meets the definition of a "person" as set out in Article 3(1)(a) of the OECD MTC for the purposes of the application of the DTA in terms of Article 1 of the OECD MTC;
b. whether the person in question is a resident of a contracting state as defined in Article 4 of the OECD MTC;
c. whether the person in question is the beneficial owner of the amount in question;
d. the attribution of the amount subject to the trust (that is, whether the amount is attributable to the trust, the beneficiary of the trust, or the founder of the trust for tax purposes);
e. the source of the amount in question; and
f. the characterisation or "nature" of the amount in question.

These elements will not be discussed in any detail, other than where specifically necessary in respect of each resident beneficiary's foreign tax computations. As discussed in Chapter 2, the South African trust entity is a unique form of entity, where the income of the trust can be taxable in the hands of the trust, the beneficiary, or the funder. Each jurisdiction's domestic tax legislation that relates to the taxation of income subject to a trust may be different, which could result in various "mismatches" between how the Contracting States treat the income subject to a trust (De Koker: 2021).

An example of a mismatch that will result in economic double taxation, notwithstanding the provisions of the OECD MTC and Multilateral Instrument that aim to address economic double taxation resulting from hybrid mismatches, is the mismatch of source. Where, for example, a South African resident trust distributes accumulated income and capital gains that were taxed in the hands of the trust in terms of South African domestic law to a beneficiary resident in the United Kingdom, in terms of its domestic legislation, the United Kingdom will disregard the original source of the trust income and capital gains and tax the amount in the hands of the United Kingdom resident beneficiary as a new, distinct, fictional source under a domestic provision that creates the fiction. Because the nexus between the income and capital gain taxed in the trust and the amount included in the United Kingdom resident beneficiary's taxable income is broken, in terms of Article 21 of the UK-SA DTA, the United Kingdom will not be obliged to provide the United Kingdom resident beneficiary with a tax credit in respect of tax paid by the trust in South Africa. This source mismatch will therefore result in economic double taxation.

## 4.3 DOUBLE TAXATION AGREEMENT RELIEF AND TRUSTS

Article 1(2) of the OECD MTC and Article 3 of the Multilateral Instrument have been designed to neutralise economic double taxation as a result of a "hybrid mismatch". Article 1(2) of the OECD MTC has very similar wording to Article 3(1) of the Multilateral Instrument and deals with fiscally transparent or partially fiscally transparent entities such as trusts. Article 1(2) of the OECD MTC reads as follows:

> 2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be the income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

In applying this Article to income and capital gains derived by ABC Trust that were distributed to each non-resident beneficiary, net of disallowed expenses and the tax payable in South Africa, the Article provides that, when applying its domestic law, the resident state (for example, the United Kingdom, Australia, or the Netherlands) must deem the income derived by ABC Trust to be the income derived by the resident beneficiary to the extent that the income is treated, for purposes of taxation by that state (the United Kingdom, Australia, or the Netherlands), as the income of that resident. The Article allows the resident state (the United Kingdom, Australia, or the Netherlands) to grant the resident taxpayer (the resident beneficiary) relief from double taxation in respect of tax paid by the trust on income that was distributed to the beneficiary through the application of the relevant DTA Article that is equivalent to Article 23A of the OECD MTC (the exemption method), or Article 23B of the OECD MTC (the tax credit method).

The response by the South African National Treasury (2024: 60) to the concern that the amendment to section 25B of the Income Tax Act would lead to economic double taxation, was that the effect of Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument is that "…the resident is allowed relief from economic double taxation with reference to the South African tax paid by the South African trust". The results below will illustrate that this will not necessarily always be the case.

It is submitted that DTA relief will not be relevant where:

a. the resident state do not tax the amount in question (for example, it will be noted below that, under the current circumstances, the Netherlands will not tax the income or capital distributions made to the Dutch beneficiary, Ms C, and Ms C will not need to seek unilateral relief or bilateral treaty relief in respect of the amount in the Netherlands); or
b. the resident state grants full unilateral relief in respect of its domestic legislation (for example, it will be noted below that, under the current circumstances, Australia will grant full tax credits in respect of tax paid in South Africa by both the Trust in respect of the capital distributions, as well as tax paid in South Africa by Ms B in respect of the income distribution; Ms B will therefore not need to seek treaty relief in respect of the distributions in either scenario).

Based on the assumptions that form part of the simulation (Scenario 1 and Scenario 2), it will only be necessary to discuss the DTA between South Africa and the United Kingdom in detail, where:

a. the United Kingdom will, under the current circumstances, subject the United Kingdom resident beneficiary, Mr A, to tax in the form of income tax (on the income distributions) and CGT (on the capital distributions); and
b. the United Kingdom will not provide unilateral relief in respect of tax paid by the South African resident trust in terms of its domestic legislation.

Unilateral relief in the form of domestic legislation will be discussed in relation to the beneficiary resident in Australia. Given that the Dutch beneficiary will not be taxed on the income and capital distributions in both Scenarios, unilateral and bilateral relief will not be discussed with respect to the Dutch beneficiary.

The foreign tax treatment of the simulated distributions set out in Scenario 1 and Scenario 2 is discussed below for Mr A (the United Kingdom tax resident), Ms B (the Australian tax resident), and Ms C (the Dutch tax resident).

## 4.4 UNITED KINGDOM TAX IMPLICATIONS

Mr A is a tax resident of the United Kingdom. In terms of section 577(1) of the Income Tax (Trading and Other Income) Act, 2005, tax residents of the United Kingdom are taxable on their worldwide income and capital gains. In addition to South Africa taxing the income distributed to Mr A, the United Kingdom will also subject the amounts distributed to Mr A to tax in terms of its domestic law as the resident state, subject to the DTA between South Africa and the United Kingdom.

Because both South Africa and the United Kingdom will subject the same amounts to tax in terms of each contracting state's domestic law, it will need to be determined whether the United Kingdom will provide relief to its resident, Mr A, in respect of tax paid in South Africa:

a. by Mr A (this relates to South Africa income tax amounting to R674,810 paid by Mr A in respect of the rental income distribution in Scenario 1); and
b. by ABC Trust (this relates to South African tax amounting to R1,080,00 and R2,991,007 paid by the ABC Trust outlined in Scenario 1 and Scenario 2 respectively).

Where the United Kingdom's domestic legislation does not provide domestic relief from double taxation in respect of South African tax paid by Mr A, or economic double taxation in respect of South African tax paid by ABC Trust, the DTA between South Africa and the United Kingdom will need to be considered in respect of bilateral relief from double taxation and economic double taxation.

### 4.4.1 United Kingdom Tax Treatment of Trust Distributions

In terms of section 474(1) of the Income Tax Act, 2007, the trustees of a trust are collectively regarded as a single person ("the trustee") for United Kingdom tax purposes. Unlike South Africa, the trustee and not the trust itself is regarded as a taxpayer in the United Kingdom. In terms of section 496 of the Income Tax Act, 2007, the United Kingdom trustee of a discretionary trust is liable for tax on all income arising in the trust, including income distributed to a discretionary beneficiary. In terms of sections 557(1) and 683(1) of the Income Tax (Trading and Other Income) Act, 2005, the beneficiaries are also taxed on income distributions made by a discretionary trust, but the source of the income is not related to the underlying investments of the trust. Rather, the source of the income distributed by the trust is the trust itself in the form of an annual payment, which is, for United Kingdom tax purposes, regarded as a new, separate source of income.

This differs from the domestic law in South Africa, where undistributed income or capital gains are taxed in the hands of the trust as the taxpayer and not in the hands of the trustees, whilst income or capital gains that are distributed to a beneficiary retain their nature (the conduit-pipe principle) and are not taxed in the hands of the trust, but taxed in the hands in the beneficiary in terms of section 25B of the South African Income Tax Act (in the case of income) and paragraph 80 of the Eighth Schedule to the South African Income Tax Act (in the case of capital gains). It will be apparent below that these differences in the domestic laws of each state will give rise to a mismatch that will result in economic double taxation in the hands of the United Kingdom beneficiary, Mr A, with regard to the capital distributions he received from ABC Trust.

Where the discretionary trust does not have a United Kingdom resident trustee, as is the case of ABC Trust, the source of the income will not be regarded as being from a United Kingdom source (Kessler: 2024).

### 4.4.2 United Kingdom Tax Treatment of the Beneficiary: Scenario 1

The United Kingdom's treatment of both income and capital distributions is analysed below.

**United Kingdom tax treatment of the income distribution**

In Scenario 1 (before the amendment to section 25B of the Income Tax Act), Mr A received an income distribution from ABC Trust amounting to R8,381,121, and he was subject to income tax in South Africa amounting to R674,810. Mr A’s United Kingdom tax computation in respect of Scenario 1 is illustrated in Table 4.3 and Table 4.4 below.

An amount of £368,769 ( = R8,381,121 income distribution received / exchange rate of R22.73) was included in Mr A’s gross income in the United Kingdom in terms of section 577(1) of the Income Tax (Trading and Other Income) Act, 2005 (**Item 1** of Table 4.3).

Because Mr A’s income for the year of assessment was greater than £125,140, he was not eligible for a personal allowance in terms of section 35 Income Tax Act, 2007 (**Item 2**).

Therefore, Mr A's taxable income amounted to £368,769 in terms of Chapter 2, Part 2, of the Income Tax Act, 2007 (**Item 3**).

The taxable income was subject to an income tax sliding scale consisting of three rates, the basic rate (20% applied to the first £37,700; **Item 4**), the higher rate (40% applied to income between £37,701 - £125,140; **Item 5**), and the additional rate (45% applied to amounts above £125,140; **Item 6**).

Therefore, Mr A was subject to income tax in the United Kingdom amounting to £152,149 (= £7,540 at the basic rate + £34,976 at the higher rate + £109,633 at the additional rate; **Item 7**).

In terms of Article 21(2)(a) of the SA-UK DTA, read with section 18 of Taxation (International and Other Provisions) Act, 2010, Mr A will probably be entitled to a tax credit of £29,692 (= R674,810 tax paid in South Africa / R22.73; **Item 8**). However, the availability of the tax credit in this case is not guaranteed, where, for United Kingdom tax purposes, the income distribution is treated as a new source of income and not the same source of income being taxed in South Africa.

Article 21(2)(a) of the SA-UK DTA provides for a tax credit to be granted in respect of South African tax levied against "any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the South African tax is computed" as follows:

> **Article 21**
>
> **Elimination of Double Taxation**
>
> 2. Subject to the provisions of the law of the United Kingdom regarding the allowance as a credit against United Kingdom tax of tax payable in a territory outside the United Kingdom (which shall not affect the general principle hereof):
>
> (a) South African tax payable under the laws of South Africa and in accordance with this Convention, whether directly or by deduction, on profits, income or chargeable gains from sources within South Africa (excluding in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid) shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the South African tax is computed; (Own emphasis).

Where the income tax credit is granted, income tax amounting to £122,458 will be payable by Mr A to His Majesty's Revenue and Customs ("HMRC") in respect of the income distribution received from ABC Trust (£122,458 income tax due = £152,149 total tax, minus £29,692 tax credit; **Item 9**).

**Table 4.3: United Kingdom tax treatment of income distributed to Mr A (Scenario 1)**

| ITEM | NARRATION | SUB-TOTAL (£) | % | TOTAL (£) |
|---|---|---|---|---|
| 1 | Gross income | | | 368 769 |
| 2 | Less: Personal allowance | | | 0 |
| 3 | **Taxable income** | | | 368 769 |
| | Tax calculation | | | |
| 4 | Basic rate | 37 700 | 20 | 7 540 |
| 5 | Higher rate | 87 440 | 40 | 34 976 |
| | | 125 140 | | |
| 6 | Additional rate | 243 629 | 45 | 109 633 |
| | | **368 769** | | |
| 7 | Total tax | | | 152 149 |
| 8 | Less: Credit for SA tax | | | (29 692) |
| 9 | **Income Tax Due** | | | **122 458** |

Source: Own formulation

**United Kingdom tax treatment of the capital distribution**

The United Kingdom generally does not tax capital distributions made by a United Kingdom trust, where the accumulated income or gains would already have been subject to income tax or CGT in the United Kingdom in the hands of the trust. However, certain anti-avoidance rules apply in the case of capital amounts received by United Kingdom residents from foreign (non-resident) trusts. In terms of section 731 of the Income Tax Act, 2007, and section 87 of the Taxation of Chargeable Gains Act, 1992, capital distributions received by United Kingdom resident individuals (Mr A) can be subject to either income tax or capital gains tax. Capital distributions will be subject to income tax in the United Kingdom to the extent that the non-resident trust has "Available Relevant Income" as set out in section 733 of the Income Tax Act, 2007. Broadly, this is income received by the trust that has not been spent or distributed. In the case of the simulation set out in this thesis, all surplus trust income was paid out as income distributions each year and there would not be any "Available Relevant Income" in respect of ABC Trust in Scenario 1. Therefore, Mr A as a United Kingdom resident beneficiary would not be liable to income tax on the capital distribution.

Capital distributions that are not matched with "Available Relevant Income" are subject to CGT in the United Kingdom to the extent they can be matched with the trust's "Stockpiled Gains" in terms of section 87 of the Taxation of Chargeable Gains Act, 1992. Stockpiled Gains can be referred to as a pool of the trust's accumulated historical capital gains. The pool is reduced by capital distributions to United Kingdom resident beneficiaries, but not by distributions to non-United Kingdom resident beneficiaries. These matching rules do not apply to specific gains in a relevant year, rather, the trust gains are matched to capital payments to beneficiaries. In most cases, therefore, it would be impossible to "match" specific gains that accrued to the trustees to capital distributions made to the relevant United Kingdom beneficiary in terms of United Kingdom domestic legislation. The gains accruing to trustees and the section 87 "fictional" gains are two distinct amounts that are regarded as two separate sources and are not the "same profits" eligible for the DTA relief set out in section 21(2)(a) of the SA-UK DTA. Kessler (2024: 104) provides the following reasons for this position:

(1) The wording of s.87 suggests that the s.87 gains and the trust gains are distinct.

(2) If the trust gains exceed the capital payment, it would not be clear which trust gains were charged. Although there are matching rules, these rules only match capital payments to trust gains of a year; they do not match capital payments to specific gains within the year.

(3) For the purposes of the CGT remittance basis, the s.87 gain is treated as accruing on the disposal of a foreign situate asset, even if trust gains of the trustees accrue on the disposal of a UK situate asset.

The result is that relief with respect to South African tax paid by ABC Trust for amounts distributed as a capital distribution to Mr A will not be available in terms of the SA-UK DTA, read with United Kingdom domestic law. HMRC follows this approach, and it is HMRC's view that the beneficiary is not entitled to a credit for tax paid by the trust against the CGT they pay on the capital distribution, on the basis that the same gain is not being taxed as follows (HMRC: 2016**)**:

> **CG38790 - Double Taxation Relief**
>
> It is very unlikely that a beneficiary will be able to claim tax credit relief against the Capital Gains Tax due on a section 87 gain. This is because relief is given for foreign tax charged on the <u>same gain</u>. This applies whether the relief is given under the credit Article in a double taxation agreement, TIOPA10/S18(1), or unilaterally under TIOPA10/S9(2).

> Because of the pooling of trustees' section 2(2) amounts and the matching and possible apportionment of capital payments, it is not possible to identify the gain assessable on the beneficiary with the gain that accrued to the beneficiary (Own emphasis).

In scenario 1, the capital distribution of £76,511(= R1,738,879 / R22.73; **Item 10** of Table 4.4 below) resulting from a capital gain that was taxed in the hands of ABC Trust, net of CGT amounting to R1,080,000 paid by the trust, and disallowed expenses attributable to foreign dividend income, will be subject to CGT in the United Kingdom.

Mr A will be entitled to an "annual exempt amount" of £3,000 in terms of section 1K(2) of the Taxation of Chargeable Gains Act, 1992; **Item 11**).

This results in a chargeable gain of £73,511 ( = £76,511 minus £3,000; **Item 12**).

CGT will be levied on the chargeable gain of £73,511 at a rate of 24%, and CGT of £17,643 will be payable ( = £73,511 x 24%; **Item 13**).

The result is that tax amounting to £140,100 will be payable to HMRC (= £122,458 income tax + £17,643 CGT; **Item 14**), which amounts to R3,184,093 (= £140,100 x 22.73; **Item 15**). After taking the tax payable in South Africa into account, amounting to R1,754,810 (**Item 16**), the total economic tax payable by Mr A is R4,938,904 (**Item 17**) in Scenario 1. Therefore, the total economic tax paid by Mr A in Scenario 1 as a percentage of his portion of net income amounts to 44.10% (= R4 938 904 total tax / R11 200 000 net income multiplied by 100; **Item 18**).

On the basis that the United Kingdom will not grant a tax credit to Mr A in respect of CGT paid by ABC Trust and will levy CGT on the capital distribution received by Mr A, which included the capital gain subject to CGT in South Africa, Mr A will be subject to economic double taxation in respect of capital gain in question in the amount of £17,643, notwithstanding the provisions of Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument.

**Table 4.4: United Kingdom tax treatment of capital distributed to Mr A (Scenario 1)**

| ITEM | NARRATION | AMOUNT (£) |
|---|---|---|
| 10 | Capital distribution | 76 511 |
| 11 | Less: Annual exempt amount | (3 000) |
| 12 | Chargeable gain | 73 511 |
| 13 | CGT at 24% | 17 643 |
| 14 | **Total tax payable in the UK (122 458 + 17 463)** | **140 100** |
| | | **AMOUNT (R)** |
| 15 | Total taxation paid in the UK, in Rand | 3 184 093 |
| 16 | Total tax paid in SA | 1 754 810 |
| 17 | **Total tax paid by the UK beneficiary in Scenario 1** | **4 938 904** |
| 18 | Total economic tax paid by Mr A in Scenario 1, as a percentage of his portion of net income (R4 938 904 / R11 200 000) | **44.10%** |

Source: Own formulation

### 4.4.3 United Kingdom Tax Treatment of the Beneficiary: Scenario 2

In Scenario 2, which simulates a distribution after the amendment to section 25B of the South African Income Tax Act, the trustees of the ABC were not permitted to vest income in Mr A for tax purposes. As a result of this legislative restriction, Mr A received a capital distribution of R8,207,993 from ABC Trust, comprising of income and a capital gain that was subject to tax amounting to R2,992,007 in the hands of ABC Trust. Mr A's United Kingdom tax computation in respect of Scenario 2 is illustrated in Table 4.5 below.

Unlike the capital distribution in Scenario 1, which did not include any income, the capital distribution in Scenario 2 did include income on which ABC Trust had paid tax. As noted above, United Kingdom beneficiaries can be subject to income tax, or CGT, on capital distributions from non-United Kingdom resident trusts. In Scenario 1, all of the trust income was distributed as an income distribution. In Scenario 2 there were no income distributions as a result of the amendment to section 25B of the Income Tax Act. The rule that matches capital distributions with income must therefore be applied in this instance (refer to the "Available Relevant Income" matching rule discussed above). The income matching rule is, however, subject to a "Motive Defence" contemplated in section 742A of the Income Tax Act, 2007, which "turns off" rules in respect of "Available Relevant Income". The "Motive Defence" applies where there is no tax avoidance purpose. It is assumed that nothing in connection with the establishment or structuring of ABC Trust had a United Kingdom tax avoidance purpose. Therefore, the "Motive Defence" should be available to prevent the capital distribution from being subject to income tax in the United Kingdom. The "Motive Defence" will not be discussed in any further detail, as it has been assumed that ABC Trust was not set up for United Kingdom tax avoidance purposes (refer to the set of facts and assumptions discussed in Chapter 3).

Because the capital distribution will not be subject to income tax, as is the case in Scenario 1, the capital distribution will be subject to the "stockpiled gains" matching rule and will therefore be subject to CGT in its entirety, which will result in a much lower effective tax rate relative to the income tax rates. The capital distribution amounted to £361,152 ( = R8,207,993 / R22.73; **Item 1** of Table 4.5).

After the annual exempt amount of £3,000 was taken into account ( **Item 2**), the chargeable gain amounted to £358,152.

Unlike Scenario 1, because no income was included in Mr A's taxable income, CGT of £6,786 was levied at a rate of 18% on the first £37,700 of the chargeable gain (**Item 4**), as this amount was within the Basic Income Tax Band.

CGT of £76,908 was levied at a rate of 24% on the chargeable gain in excess of £37,700 (**Item 5**), which resulted in CGT of £83,694 ( = £6,786 + £76,908; **Item 6**).

The tax paid by ABC Trust in respect of the income and capital gains distributed amounted to £131,633 (= R2,992,007 / R22.73). As in Scenario 1, the tax paid by ABC Trust was not allowed as a tax credit. Accordingly, the tax liability in the United Kingdom amounting to £83,694 (**Item 7**) resulted in economic double taxation in the hands of Mr A.

Mr A was subject to slightly less total economic taxation in Scenario 2 (R4,894,153 or 43.70% of net income; **Item 13**) relative to Scenario 1 (R4,938,904 or 44.10%; **Item 20** of Table 4.4), notwithstanding the amendment to section 25B of the South African Income Tax Act. Given the relevant assumptions, Mr A actually paid less tax as a result of the amendment to section 25B and not more tax. It is submitted that, where ABC Trust had "Available Relevant Income" (unspent or undistributed income), or had a separate set of facts and assumptions been applied, there would possibly have been a different result.

Consequently, these findings indicate that the South African National Treasury's statement that Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument will grant the non-resident beneficiary (Mr A) relief from economic double taxation with reference to the South African tax paid by ABC Trust, was tested and found to be incorrect.

**Table 4.5: United Kingdom tax treatment of capital distributed to Mr A (Scenario 2)**

| ITEM | NARRATION | SUB-TOTAL (£) | % | TOTAL (£) |
|---|---|---|---|---|
| 1 | Capital distribution | 361 152 | | |
| 2 | Less: Annual exempt amount | (3 000) | | |
| 3 | Chargeable capital gain | | | 358 152 |
| 4 | Capital gains tax | 37 000 | 18 | 6 786 |
| 5 | Capital gains tax | 320 452 | 24 | 76 908 |
| | | 358 152 | | |
| 6 | Capital gains tax due | | | 83 694 |
| 7 | Total UK tax payable by Mr A (Scenario 2) | | | 83 694 |
| | | | | **R** |
| 10 | Total tax paid in the UK in Rand terms | | | 1 902 146 |
| 11 | Total tax paid in SA (Scenario 2) | | | 2 992 007 |
| 12 | Total tax paid by Mr A (Scenario 2) | | | 4 894 153 |
| 13 | Total economic taxation paid by Mr A in Scenario 2, as a percentage of his share of net income (R4 894 153/R11 200 000) | | **43.70** | |

Source: Own formulation

### 4.5 AUSTRALIAN TAX IMPLICATIONS

Section 97 of the Income Tax Assessment Act, 1936 ("the Income Tax Assessment Act of 1936"), includes amounts to which Australian resident beneficiaries are "presently entitled", in the resident's assessable income. A beneficiary will be "presently entitled" to the amounts distributed to them by a discretionary trust at the point in time that they have (at 37) "an interest in the income that is both vested in interest and vested in possession and an immediate present right to demand and receive payment of the income of the trust estate or a share of it" (*Harmer & Ors v FC of T,* 91 ATC 5000; *FC of T v Bamford,* 2010 ATC 20). On the basis that the trustees of ABC Trust vested and distributed both the income and capital gain, Ms B was presently entitled to the distributions.

### 4.5.1 Australian Tax Treatment of the Beneficiary: Scenario 1

The Australian tax computation of the tax treatment of Ms B in respect of Scenario 1 is illustrated in Table 4.6 below, which simulates a distribution taking effect on 29 February 2024 (the day before the amendment to section 25B of the Income Tax Act took effect).

**Australian tax treatment of the income distribution**

The income distribution amounting to R8,381,121 made to Ms B was included in her assessable income as "foreign source income" in terms of section 97 of the Income Tax Assessment Act of 1936, on the basis that she was presently entitled to her share of the amount from the net income of the trust estate (**Item 1** of Table 4.6). This resulted in an AUD 720,776 being included in Ms B's taxable income (= R8,381,121 / R11.63).

**Australian tax treatment of the capital distribution**

Ms B received a capital distribution of R1,738,879 from ABC Trust, which consisted of her portion of the capital gain of R1,827,216 (net of CGT of R1,080,000 paid by the trust), less disallowed expenditure of R88,338. Section 99B of the Income Tax Assessment Act of 1936 applies to trust property received by an Australian tax resident from the trustees of a foreign trust, that was not previously subject to tax in Australia. Section 99B(1) of the Income Tax Assessment Act of 1936 provides that trust property, which includes money or any other asset that forms part of a trust estate, that is paid to an Australian resident as a distribution from the trustees of a foreign trust in relation to which the resident is a beneficiary, must be included in the assessable income of that beneficiary, subject to certain exceptions pursuant to section 99B(2) of the Income Tax Assessment Act of 1936. The exceptions generally cover circumstances including where (1) the amount is corpus of the trust estate (except to the extent it is attributable to amounts derived by the trust estate that, if they had been derived by an Australian resident taxpayer, would have been included in their assessable income), (2) if the amount was derived by a resident taxpayer, it would not have been included in their assessable income; or (3) the amount has previously been subject to Australian taxation in the hands of the trust or the beneficiary.

The trust *corpus* is generally the initial capital and any assets (including cash) that were transferred by way of a gift or equivalent into ABC Trust by its founder or any other party. Any amount attributable to an accumulation of income by the trustee is not corpus for the purpose of section 99B of the Income Tax Assessment Act of 1936.

The capital distribution amounting to R1,738,879 made to Ms B was included in her assessable income as an amount of "foreign source income" in terms of section 99B of the Income Tax Assessment Act of 1936 on the basis that it was "property of a trust estate, paid to, or applied for the benefit of" her and the amount did not meet any of the conditions for exclusion. This resulted in AUD 149,544 being included in Ms B's assessable income (AUD 149,544 = R1,738,879 / R11.63; **Item 2**).

In addition, the tax paid by ABC Trust amounting to R1,080,000 that will be claimed by Ms B as a foreign tax credit in respect of the capital distribution paid to Ms B was also included in her Australian assessable income in terms of section 99B, resulting in AUD 92,880 being included in her assessable income (AUD 92,880 = R1,080,000 / R11.63; **Item 3**). This resulted in a total assessable income of AUD 963,200 ( = 720,776 +149,544 + 92,880; **Item 4**).

Total assessable income of AUD 963,200 was subject to income tax of AUD 399,578 according to the tax tables (**Item 5**).

In addition, a Medicare Levy of AUD 19,264 (= 963,200 assessable income x 2% Medicare levy; **Item 6**) was payable, resulting in a total tax liability of AUD 418,842 (= AUD 399,578 + AUD 19,264; **Item 7**).

**Foreign Income Tax Offset**

It needs to be established whether the tax paid by Ms B ( R674,810 / R11.63 = AUD 58,034) and the tax paid by ABC Trust (R1,080,000 / R11.63 = AUD 92,880) will rank as a foreign tax credit in terms of Australian domestic law, and failing which, Article 23 of the SA-Australia DTA.

<u>Foreign Income Tax Offset (1) – Items 12 to 14 of Table 4.6</u>

Ms B paid tax amounting to R674,810 (R 674,810 / R11.63 = AUD 58,034; **Item 12**) in South Africa on the income distribution. In terms of section 770-10 of the Income Tax Assessment Act, 1997 ("the Income Tax Assessment Act of 1997"), because the income that was subject to tax in South Africa was also included in Ms B's taxable income in Australia, she will be entitled to a Foreign Income Tax Offset (being a foreign tax credit) in respect of the tax paid in South Africa, limited to the tax liability on the income in Australia. Australia levied a tax amount of AUD 304,903 on the income distribution, which is greater than the tax of AUD 58,034 paid on the income distribution in South Africa (**Item 13**). Therefore, Ms B will be entitled to a full Foreign Income Tax Offset amounting to the tax paid in South Africa (AUD 58,034; **Item 14**).

Foreign Income Tax Offset (2) – Items 15 to 17 of Table 4.6

ABC Trust paid tax in South Africa amounting to R1,080,000 (R1,080,000 / R11.63 = AUD 92,880; **Item 15**) that is directly attributable to the capital distribution made to Ms B. Section 770-30 of the Income Tax Assessment Act of 1997 deems tax "paid on the taxpayer's behalf" by another taxpayer under foreign tax law to be tax paid by the taxpayer for the purpose of claiming a Foreign Income Tax Offset, but only to the extent that the income subject to tax in the foreign country was assessable in Australia. This deeming provision includes the situation where a foreign trust, in relation to which the Australian resident beneficiary is a taxpayer, has paid tax in the foreign state. The beneficiary's assessable income in Australia is grossed up to include the tax paid by ABC Trust (**Item 3**). The words "in respect of" in section 770-30 of the Income Tax Assessment Act of 1997 indicate that there must be a distinct connection between the tax paid by the trust and the income assessable in the Australian resident's hands. In terms of section 770-30 of the Income Tax Assessment Act of 1997, because the capital gain that was subject to tax in South Africa was included in Ms B's taxable income in Australia, she will be entitled to a Foreign Income Tax Offset in respect of the CGT paid in South Africa by ABC Trust, limited to the tax payable on the income in Australia on the capital distribution. Because Australia levied AUD 113,939 tax on capital distributions (**Item 16**), which is greater than the CGT paid by ABC Trust in South Africa of AUD 92,880, Ms B will be entitled to a full Foreign Income Tax Offset in the amount of tax paid in South Africa in terms of section 770-30 of the Income Tax Assessment Act of 1997, amounting to AUD 92,880 (**Item 17**).

After the Foreign Income Tax Offsets amounting to AUD 150,914 were taken into account (**Item 18**), the net tax payable in Australia amounted to AUD 267,928 (AUD 267,928 x R11.63 = R3,115,446; **Item 9**). Therefore, in respect of Scenario 1, Ms B was not subject to any economic double taxation, as she was entitled, in terms of Australian domestic legislation, to a Foreign Income Tax Offset (1) in Australia in respect of income tax that she personally paid in South Africa, as well as a Foreign Income Tax Offset (2) in respect of CGT paid by ABC Trust in South Africa. Because unilateral relief was obtained through domestic Australian legislation, it was not necessary to seek bilateral relief in terms of Article 23 of the SA-Australia DTA.

**Table 4.6: Australian tax computation of Ms B (Scenario 1)**

| ITEM | NARRATION | SUB-TOTAL: SOUTH AFRICAN RAND | TOTAL: SOUTH AFRICAN RAND | AUSTRALIAN TAX ACT REFERENCE | AUD |
|---|---|---|---|---|---|
| 1 | Rental income: SA source | 1 922 680 | | | |
| | Dividend income: SA source | 2 882 216 | | | |
| | Dividend income: non-SA source | 2 250 000 | | | |
| | Interest income: SA source | 480 786 | | | |
| | Interest income: non-SA source | 845 438 | 8 381 121 | Section 97 | 720 776 |
| 2 | Capital distribution from ABC Trust | 1 738 879 | 1 738 879 | Section 99B | 149 544 |
| 3 | Total SA tax paid by ABC Trust | 1 080 000 | 1 080 000 | Section 99B – gross up | 92 880 |
| 4 | **Total assessable income** | | | | **963 200** |
| 5 | Income tax payable | | | | 399 578 |
| 6 | Medicare levy | | | | 19 264 |
| 7 | Total tax liability | | | | 418 842 |
| 8 | Less: Foreign Income Tax Offset ("FITO") | | | | 150 914 |
| 9 | **Net tax payable in Australia** | | | | **267 928** |
| 10 | **Tax paid in South Africa** | | | | 150 914 |
| 11 | Total Tax Worldwide | | | | **418 842** |
| | **Foreign tax paid** | | | | |
| 12 | Tax paid by beneficiary in SA | | | | 58 034 |
| 13 | Tax payable in Australia | | | | 304 903 |
| 14 | **FITO(1)** | | | | 58 034 |
| 15 | Tax paid by Trust in SA | | | | **92 880** |
| 16 | Tax payable in Australia | | | | 113 939 |
| 17 | **FITO(2)** | | | | 92 880 |
| 18 | **Total FITO** | | | | **150 914** |

Source: Own formulation

### 4.5.2 Australian Tax Treatment of the Beneficiary: Scenario 2

The Australian tax computation of Ms B in respect of Scenario 2 is illustrated in Table 4.7 below, which simulates a distribution taking effect on 1 March 2024 (the day the amendment to section 25B of the Income Tax Act took effect).

**Australian tax treatment of the capital distribution**

Ms B received a capital distribution of R8,207,993 from ABC Trust, which consisted of her portion (one-third) of the income and capital gain, net of tax paid by ABC Trust in South Africa, and net of disallowed expenditure. The Australian tax treatment of the capital distribution in Scenario 2 is the same in Scenario 1, where the capital distribution will be included in Ms B's assessable income in terms of section 99B of the Income Tax Assessment Act of 1936 as "foreign source income", on the basis that the amount was paid to, or applied for the her benefit as a beneficiary of the trust estate and none of the applicable exemptions applied. This resulted in AUD 705,887 being included in Ms B's assessable income (AUD 705,887 = R8,207,993 / R11.63; **Item 1** of Table 4.7).

In addition, Ms B's assessable income will be increased by the tax paid by ABC Trust amounting to R2,992,007, pursuant to section 99B of the Income Tax Assessment Act of 1936, which will be claimed by Ms B as a Foreign Income Tax Offset, resulting in an additional AUD 257,313 being included in her assessable income (AUD 257,313 = R2,992,007 / R11.63; **Item 2**).

This resulted in the same total assessable income of AUD 963,200 ( = 705,887 + 257,313; **Item 3**) as Scenario 1. Tax amounting to AUD 399,578 was levied on the total assessable income of AUD 963,200 (**Item 4**). In addition, a Medicare Levy of AUD 19,264 ( = 963,200 assessable income x 2% Medicare levy; **Item 5**) was payable, resulting in a total tax liability of AUD 418,842 (= AUD 399,578 + AUD 19,264; **Item 6**).

**Foreign Income Tax Offset**

Similar to the tax treatment of the capital distribution in Scenario 1 above, the tax paid by ABC Trust in South Africa that is attributable to the capital distribution made to Ms B in Scenario 2, amounting to R2,992,007 (AUD 257,313; **Item 2**) was allowed in full as a Foreign Income Tax Offset (2) pursuant to section 770-30 of the Income Tax Assessment Act of 1997 (**Items 14 to 17**).

After the Foreign Income Tax Offset (2) amounting to AUD 257,313 was taken into account, the net tax payable in Australia amounted to AUD 161,529 (AUD 161,529 x 11.63 = R1,878,587; **Item 8**). In respect of Scenario 2, therefore, Ms B was not subject to any economic double taxation as a result of the amendment to section 25B of the South African Income Tax

Act, as she was entitled to a full Foreign Income Tax Offset in Australia in respect of tax paid by ABC Trust in South Africa.

Although Ms B was subject to the same amount of tax worldwide in Scenario 1 and Scenario 2, of AUD 418,842 (AUD 418,842 x 11.63 = R4,870,256; **Item 11** of Table 4.6 and **Item 10** of Table 4.7), and is no worse off as a result of the amendment, the South African tax increased as a result of the amendment from R1,754,810 (Scenario 1) to R2,992,007 (Scenario 2). The Australian Tax Authority, as a result, collected R1,237,197 less in Scenario 2 relative to Scenario 1 and is worse off as a result of the amendment (R1,237,197 = R3,116,006 Australian tax collected in Scenario 1 less R1,878,587 Australian tax collected in Scenario 2).

It is apparent from the simulation that the amendment to section 25B of the Income Tax Act did not result in economic double taxation in the hands of the beneficiary, Ms B. Because unilateral relief was available to Ms B, it was not necessary to consider the SA-Australia DTA.

**Table 4.7: Australian tax computation of Ms B (Scenario 2)**

| ITEM | NARRATION | SUB-TOTAL: SOUTH AFRICAN RAND | TOTAL: SOUTH AFRICAN RAND | AUSTRALIAN TAX ACT REFERENCE | AUD |
|---|---|---|---|---|---|
| 1 | Rental income: SA source | 1 057 474 | | | |
| | Dividend income: SA source | 2 882 216 | | | |
| | Dividend income: non-SA source | 1 711 662 | | | |
| | Interest income: SA source | 264 432 | | | |
| | Interest income: non-SA source | 464 991 | | | |
| | Capital distribution from ABC Trust | 1 827 216 | 8 207 993 | Section 99B | 705 887 |
| 2 | Total SA tax paid by ABC Trust | 2 992 007 | 2 992 007 | Section 99B – gross up | 257 313 |
| 3 | **Total assessable income** | | | | **963 200** |
| 4 | Income tax payable | | | | 399 578 |
| 5 | Medicare levy | | | | 19 264 |
| 6 | Total tax liability | | | | **418 842** |
| 7 | Less: Foreign Income Tax Offset ("FITO") | | | | 257 313 |
| 8 | **Net tax payable in Australia** | | | | **161 529** |
| 9 | **Tax paid in South Africa** | | | | 257 313 |
| 10 | Total Tax Worldwide | | | | **418 842** |
| | **Foreign tax paid** | | | | |
| 11 | Tax paid by beneficiary in SA | | | | 0 |
| 12 | Tax payable in Australia | | | | 0 |
| 13 | **FITO(1)** | | | | 0 |
| 14 | Tax paid by Trust in SA | | | | **257 313** |
| 15 | Tax payable in Australia | | | | 336 205 |
| 16 | **FITO(2)** | | | | 257 313 |
| 17 | **Total FITO** | | | | **257 313** |

Source: Own formulation

## 4.6 DUTCH TAX TREATMENT OF BENEFICIARY: SCENARIO 1 AND 2

The Dutch legal system is based on a civil law system that does not recognise the trust entity. Furthermore, the Dutch civil code does not allow a trust to be formed under Dutch law (Article 84 of Section 3, Book 3 of Civil Code 1992). In terms of Article 11 of the Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition ("the Hague

Convention"), however, together with domestic Dutch legislation in the form of *Wet Conflictenrecht Trust*, Dutch Staatsblad 1995, the Netherlands is required to recognise a foreign trust entity established in terms of foreign trust law. Therefore, the Netherlands will be required to acknowledge ABC Trust when applying a DTA. Furthermore, the Netherlands is required to regard trust property held by a foreign trust as a separate trust fund in respect of assets held by the trust situated both in the Netherlands and outside the Netherlands.

Because the Netherlands does not have a definition of a "trust" in its domestic law, as well as the fact that the Netherlands is a signatory of the Hauge Convention and is thus required to recognise foreign trusts in terms of Article 11 of the Hague Convention, it needs to be established whether ABC Trust meets the definition of a trust for the purpose of the Hague Convention. Article 2 of the Hague Convention defines a trust as follows:

> Article 2
>
> For the purposes of this Convention, the term "trust" refers to the legal relationships created - *inter vivos* or on death - by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or a specified purpose.
>
> A trust has the following characteristics -
>
> a. the assets constitute a separate fund and are not a part of the trustee's own estate;
> b. title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
> c. the trustee has the power and the duty, in respect of which he is accountable, to manage, employ, or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.
>
> The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.

It is submitted that ABC Trust, a valid trust *inter vivos* established under South African law, meets the definition of a trust in the Hague Convention. Because ABC Trust meets the definition of a trust in terms of the Hague Convention, the Netherlands must recognise ABC Trust as a trust when applying domestic Duch legislation for income tax and gift or inheritance tax purposes.

After acceding to the Hague Convention, the Netherlands incorporated domestic tax legislation to deal with fiscally transparent entities like trusts in section 2.14a of the Income Tax Act, 2001, known as a "separate private fund" that refers to funds established for a "private purpose". A "separate private fund", by definition, includes entities such as irrevocable discretionary trusts (Auerbach: 2010). A "separate private fund" is not a separate legal entity, but can be regarded as a Dutch domestic tax arrangement that does not constitute a "body of persons" in terms of Dutch law (Auerbach: 2010). A "separate private fund" is therefore not a juristic person or a natural person. From a Dutch perspective, the discretionary trust will not be seen as a "body of persons" within the context of the OECD MTC, whilst the trustees of the trust may be considered as a "body of persons" for this purpose, although this has not been settled (Du Plessis: 2014).

On the basis that ABC Trust falls within the meaning of the term "separate private fund", all the income, expenditure, assets, and liabilities must be attributed to the "contributor" for income tax purposes in terms of paragraph 1 of section 2.14a of *Wet Inkomstenbelasting* 2001, which will be the settlor of the trust in the case of ABC Trust. During the lifetime of the settlor, ABC Trust will be treated as fully transparent for Dutch income tax purposes, and all the income, capital gains, and assets of ABC Trust will be attributable to its settlor and not Ms C (Du Plessis: 2014). On the settlor's death, from a Dutch perspective, the income arising in the trust is attributable to the settlor's heir(s) in proportion to each heir's entitlement to the trust fund as set out in the settlor's will, regardless of the discretionary nature of the interest inherited (Du Plessis: 2014).

As it has been assumed that none of the beneficiaries of ABC Trust were heirs to the settlor's estate, it is submitted that the income distribution (refer to Scenario 1) and the capital distributions (refer to Scenario 1 and Scenario 2) will be not attributable to Ms C for Dutch income tax purposes, and the distributions will be treated as a "gift" of a capital nature that will not be subject to income tax in the Netherlands (Du Plessis: 2014). The settlor did not include his grandchildren as heirs of his personal estate on the basis that he had established ABC Trust as an irrevocable discretionary trust to benefit his grandchildren as part of his legacy, which is often the case with South African discretionary trusts.

It would then need to be determined whether any of the distributions paid to Ms C by ABC Trust will be subject to gift or inheritance tax by the Dutch Tax Authority, which is levied on the recipient (Ms C). Where the settlor or decedent is not a Duch resident or a deemed Dutch resident, and Ms C was not an heir of the decedent, no gift tax or inheritance tax will be payable in the Netherlands on distributions made by ABC Trust to Ms C (Lor: 2024).

As the distributions in Scenario 1 and Scenario 2 will not be taxed in terms of Dutch domestic legalisation, it will not be necessary to determine whether Ms C is entitled to any unilateral or bilateral (treaty) relief in respect of tax levied in South Africa.

**4.7 CONCLUSION**

This chapter discussed the tax treatment of the simulated distributions in Scenario 1 and Scenario 2 in each of the three resident states, Mr A in the United Kingdom, Ms B in Australia, and Ms C in the Netherlands, to determine whether the South African tax paid by each beneficiary and ABC Trust would rank as a tax credit or tax deduction in these jurisdictions. The chapter aimed to test the South African National Treasury's claim that Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument would provide relief from economic double taxation in relation to the South African tax paid by ABC Trust.

In the case of Mr A, who was tax resident in the United Kingdom, the income distribution (Scenario 1) and the capital distributions (Scenario 1 and Scenario 2) were subject to income tax and CGT respectively in terms of United Kingdom domestic legislation. It was questioned whether Mr A would be entitled to a foreign tax credit in respect of income tax and CGT paid in South Africa by ABC Trust. On the facts, however, it was determined that the South African tax paid by ABC Trust in respect of capital distributions would not rank as a foreign tax credit in Mr A's United Kingdom tax computations, notwithstanding Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument. This was as a result of the United Kingdom treating the capital distributions as a new source of gain unrelated to the income and capital gain on which ABC Trust had paid South African tax. The result was that Mr A was subject to economic double taxation in respect of the capital distributions he received from ABC Trust, due to not being provided relief in respect of the South African tax paid by ABC Trust. The claim by the South African National Treasury was found not to be correct.

In the case of Ms B, who was tax resident in Australia, the income distribution (Scenario 1) and the capital distributions (Scenario 1 and Scenario 2) were subject to income tax in terms of Australia's domestic legislation. It was found that Ms B would be entitled to unilateral relief in the form of a full Foreign Income Tax Offset (1) in respect of income tax paid in South Africa, and a Full Foreign Income Tax Offset (2) in respect of the income tax and CGT paid by ABC Trust in South Africa. It was not necessary, therefore, to determine whether bilateral relief in the form of Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument was available. Australia serves as an example of a jurisdiction that has favourable domestic legislation in the context of the case study in question, where unilateral relief was available for capital distributions made by South African resident trusts.

In the case of Ms C, who was tax resident in the Netherlands, the income distribution (Scenario 1) and the capital distributions (Scenario 1 and Scenario 2) were not subject to income tax in the Netherlands as a result of the specific set of facts and assumptions set out in the simulation discussed in Chapter 3. It was, therefore, not necessary to determine whether unilateral or bilateral relief from economic double taxation was available in respect of the South African tax paid by ABC Trust. The Netherlands serves as another example of a jurisdiction that has favourable domestic legislation in respect of capital distributions made by South African resident trusts.

In the following concluding chapter, the research findings will be summarised in relation to the goals of the research.

# CHAPTER 5: CONCLUSION

## 5.1 INTRODUCTION

The first chapter of the thesis commenced by describing the background to the research, and the recent amendment to section 25B of the Income Tax Act that resulted in, *inter alia*, trustees of South African resident trusts no longer being permitted to vest income in non-resident beneficiaries for tax purposes. The result of the amendment was that, with effect from 1 March 2024, any income distributed by the trustees of a South African resident trust to a non-resident beneficiary would be taxed in the hands of the trust, and potentially again by the non-resident beneficiary's resident state. This could result in the imposition of double taxation on the same income. The introduction of the first chapter focused on the public comment on the amendment to section 25B of the Income Tax Act, which asserted that the amendment could lead to economic double taxation. The South African National Treasury's response on 2 February 2024 to the public comment, was that the effect of Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument would be that the non-resident beneficiary would receive relief from economic double taxation in relation to the South African tax paid by ABC Trust.

Thereafter the chapter described the effect of Article 1(2) of the OECD MTC. It was stated that, to test the validity of the South African National Treasury's response, a simulation would be used that involved a South African resident discretionary trust making fictional income and capital distributions to three non-resident natural person beneficiaries, before the amendment took effect (Scenario 1) and after the amendment took effect (Scenario 2), to test whether the amendment resulted in economic double taxation. The decision to use the United Kingdom (Mr A), Australia (Ms B), and the Netherlands (Ms C) as the resident states of the three natural person non-resident beneficiaries was briefly motivated. The research methodology was described as falling within the interpretivist research paradigm, with a doctrinal methodology. The method used involved a hypothetical case study and a qualitative and comparative data analysis.

Chapter 1 outlined the primary goal of the research, which was to critically evaluate whether, as claimed by the South African National Treasury, Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument would address the potential burden of economic double taxation payable by non-resident beneficiaries of South African resident trusts in the selected countries, as a result of the amendment to section 25B of the Income Tax Act. The sub-goals that addressed the primary goal were then expressed as follows:

(a) describing the nature of how South African resident trusts and persons subject to South African resident trusts are taxed in South Africa;
(b) discussing the South African tax implications of the amendment; and
(c) discussing the foreign tax implications of the amendment.

## 5.2 RESEARCH FINDINGS

The research findings were set out in chapters 2 to 4, each of which dealt with a particular sub-goal of the research.

### 5.2.1 Tax Treatment of South African Trusts and Parties to South African Trusts

In addressing the first sub-goal of the research, Chapter 2 began by describing the basic concept of the South African trust entity for tax purposes in the historical context in which trust law has developed in South Africa. Thereafter, the general tax principles that relate to trusts were described in detail in the context of the present research. As South Africa utilises a residence-based system of taxation, the importance of establishing the tax residence status of trusts, funders of trusts, as well as beneficiaries of trusts, was discussed, in view of the fact that the amendment to section 25B of the Income Tax Act has resulted in the conduit pipe (flow-through) principle only applying to resident beneficiaries of South African resident trusts. Thereafter, the taxation of parties to a trust was described in detail with regard to the tax treatment of income and, to a lesser extent, the capital gains of a South African resident trust. Finally, the chapter described the tax treatment of income and capital gains received by or accrued to a South African resident discretionary trust in the hands of a) beneficiaries of the trust in the context of the conduit pipe principle, before and after the amendment to section 25B of the Income Tax Act; b) the trust in the context of undistributed income and capital gains; c) the funder/s of trusts in the context of the attribution rules in section 7 of the Income Tax Act and Part X of the Eighth Schedule to the Income Tax Act; and finally, d) the personal tax liability of trustees as representative taxpayers of trusts.

### 5.2.2 The South African Economic Impact of the Amendment

Chapter 3 addressed the second sub-goal of the research by illustrating the South African economic impact of the amendment to section 25B of the Income Tax Act on South African resident trusts and non-resident natural person beneficiaries of South African resident trusts. This was achieved through the use of simulated distributions made by the trustees of a fictional South African resident trust to three natural person beneficiaries tax resident in the United Kingdom, Australia, and the Netherlands before (Scenario 1) and after (Scenario 2) the amendment to section 25B of the Income Tax Act, which came into effect on 1 March 2024. In the case study, it was found that the amendment resulted in SARS collecting a significant amount more (around 70% more) tax in Scenario 2 relative to Scenario 1. Based on the case study, an analysis of the tax liability in South Africa before and after the amendment revealed two drivers for the increase in South African tax for each non-resident beneficiary. Firstly, foreign-source income that was vested in non-resident beneficiaries in Scenario 1 escaped taxation in South Africa in the hands of the non-resident beneficiaries, as non-residents are only taxable on South African source income. Foreign source income in Scenario 2 was taxed in the hands of ABC Trust as a tax resident, as the trustees were not permitted to vest income in the non-resident beneficiaries. Secondly, the local source income that was distributed to the beneficiaries and included in their gross income in Scenario 1, was subject to tax in terms of the South African tax tables applicable to individuals that currently range between 18% - 45%. ABC Trust was subject to a flat tax rate of 45% in Scenario 2 after taking the relevant deductions, allowances, exemptions and exclusions into account. For example, the beneficiaries paid income tax of R674,810 on the rental income in Scenario 1. The ABC Trust paid income tax of R865,206 per beneficiary on the same rental income; significantly more income tax relative to Scenario 1.

In addition to SARS collecting considerably more tax for the fiscus after the amendment to section 25B of the Income Tax Act, from an administrative perspective, Scenario 2 will be easier for SARS to administer relative to Scenario 1. By taxing ABC Trust on the income on a single tax return in Scenario 2, SARS will not need to consider the legal nature of the non-resident beneficiary, the jurisdiction of the ultimate non-resident beneficial owner, the complexities of applying one or more DTAs to the trust income, or the merits of withholding tax credits. The non-resident beneficiaries will also benefit from not having to submit South African income tax returns as a result of not earning any gross income (the distributions in Scenario 2 were of a capital nature). This will relieve SARS' administrative burden further, as SARS will need to process and verify fewer income tax returns relating to non-resident beneficiaries of South African trusts. Scenario 2 illustrated that tax compliance relating to non-resident beneficiaries of South African resident trusts will become far less cumbersome due to the amendment to section 25B of the Income Tax Act.

### 5.2.3 The Impact of the Amendment in the Resident States

Chapter 4 addressed the third sub-goal of the research by discussing the tax treatment of the simulated distributions in Scenario 1 and Scenario 2 in the resident states of Mr A (United Kingdom), Ms B (Australia), and Ms C (the Netherlands) to determine whether the South African tax paid by each beneficiary and ABC Trust would rank as a tax credit or tax deduction. The goal of the chapter was also the primary goal of the research, which was to test the South African National Treasury's claim that Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument would provide relief from economic double taxation with reference to the South African tax paid by ABC Trust.

In the case of Mr A, who was a tax resident in the United Kingdom, income distributions from ABC Trust were subject to income tax in the United Kingdom, and the capital distributions were subject to CGT in the United Kingdom. The United Kingdom tax computations in respect of Mr A before and after the amendment were discussed in detail, including whether Mr A was entitled to any unilateral or bilateral relief in respect of the South African tax paid by ABC Trust. The findings revealed that the South African tax paid by ABC Trust on the capital distributions did not rank as a foreign tax credit in both of Mr A's United Kingdom tax computations before and after the amendment, notwithstanding Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument. This was a result of the United Kingdom treating the capital distributions as a new source of gain unrelated to the income and capital gain on which ABC Trust paid tax in South Africa. This result illustrated that, contrary to the South African National Treasury's claim that Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument would provide relief from economic double taxation, Mr A was subject to economic double taxation in respect of the capital distributions he received from ABC Trust. He received a lower capital distribution as it was net of the South African tax paid by ABC Trust, and was taxed on the amount in the United Kingdom, whilst not being provided relief in the United Kingdom for the South African tax paid by ABC Trust.

In the case of Ms B, who was a tax resident in Australia, the income distribution (Scenario 1) and the capital distributions (Scenario 1 and Scenario 2) were subject to income tax in Australia in terms of Australia's domestic legislation. It was found that Ms B would be entitled to unilateral relief in the form of a full Foreign Income Tax Offset (1) in respect of income tax paid in South Africa, and a full Foreign Income Tax Offset (2) in respect of South African CGT paid by ABC Trust. It was therefore not necessary to determine whether bilateral relief was available in the form of Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument. Australia served as an example of a jurisdiction that, in certain instances, has favourable domestic legislation that provides unilateral relief for capital distributions made by South African resident trusts.

In the case of Ms C, who was tax resident in the Netherlands, the income distribution (Scenario 1) and the capital distributions (Scenario 1 and Scenario 2) were not subject to income tax in the Netherlands as a result of the specific set of facts and assumptions set out in the simulation. It was not necessary to determine whether unilateral or bilateral relief from economic double taxation was available in respect of the South African tax paid by ABC Trust. The Netherlands serves as another example of a jurisdiction that has favourable domestic legislation in respect of capital distributions made by South African resident trusts.

The research findings demonstrated that Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument cannot be relied on in all circumstances to provide relief from economic double taxation, having regard to the domestic law of the resident state of the beneficiary.

## 5.3 LIMITATIONS OF SCOPE

The research only focused on natural person non-resident beneficiaries of South African resident trusts and did not extend to other types of non-resident beneficiaries, such as trusts or companies.

In addition, the unique set of facts and assumptions on which the simulation was based, which were outlined in Chapter 3, limited the scope of the research regarding the application of the foreign legislation and relevant DTAs to the amounts distributed by the trust.

Lastly, the findings of the research were limited to the unique simulation that applied to only three jurisdictions, and the assumptions that underpinned the simulation. Due to the detailed information, descriptions and discussions of the process, this research will, however, be able to be replicated by other researchers using the same methodology and techniques, but different jurisdictions and different assumptions.

## 5.4 SUGGESTION FOR FUTURE RESEARCH

A suggestion for future research could include limiting or extending the assumptions listed in Chapter 3 to broaden the scope of the research. For example, an opportunity for further research could include an alternative Dutch scenario where the beneficiary is an heir in respect of the deceased contributor of the relevant South African resident trust. In this scenario, the income and capital gains attributable to the beneficiary would have been subject to tax in the Netherlands (section 2.14a of *Wet Inkomstenbelasting*, 2001; Du Plessis: 2014). The question would be whether the Dutch beneficiary would be entitled to a tax credit in respect of:

a. tax paid by the beneficiary in South Africa on the income distribution in Scenario 1; and
b. tax paid by the trust attributable to the capital distributions made to the beneficiary in Scenarios 1 and 2.

In addition, the sample of foreign jurisdictions could be extended to include an in-depth theoretical analysis of the impact of the amendment on non-resident beneficiaries resident in other jurisdictions, including civil law jurisdictions, for example, France, Germany, Spain, and Portugal.

## 5.5 CONCLUDING COMMENTS

As stated in the introduction of this Chapter, the primary goal of the research was to critically evaluate whether, as claimed by the South African National Treasury on 2 February 2024, the effect of Article 1(2) of the OECD MTC and Article 3(1) of the Multilateral Instrument would be that "the resident is allowed relief from economic double taxation with reference to the South African tax paid by the trust", and this will prevent economic double taxation in the context of the amendment to section 25B of the Income Tax Act. Through the use of a simulation involving three jurisdictions, this research has demonstrated that this claim on the part of the South African National Treasury was not correct in all circumstances, particularly in the case of a United Kingdom resident natural person beneficiary of a South African resident trust. As a result, with effect from 1 March 2024, trustees of South African resident trusts that have one or more non-resident beneficiaries will need to carefully evaluate the impact that the amendment to section 25B of the Income Tax Act will have with respect to each non-resident beneficiary, on a case by case basis.

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