

DRAFT INTERPRETATION NOTE

DATE:

ACT : INCOME TAX ACT 58 OF 1962
SECTION : SECTIONS 25B(1) and 7(8)
SUBJECT : VESTING OF INCOME IN A RESIDENT BENEFICIARY BY A NON-RESIDENT TRUST: INTERACTION BETWEEN SECTION 25B(1) AND SECTION 7(8)

Preamble

In this Note unless the context indicates otherwise –

- “**donor**” means a resident who makes a donation, settlement or other disposition to a non-resident trust;
- “**income**” means any amount received by or accrued to a non-resident trust that would have constituted income as defined in section 1(1) had the trust been a resident;
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

All guides referred to in this Note are available on the SARS website at www.sars.gov.za. Unless indicated otherwise, the latest issues of these documents should be consulted.

1. Purpose

This Note provides clarity on the interpretation and application of the words “subject to the provisions of section 7” in section 25B(1) and, more specifically, whether section 7(8) or section 25B(1) applies when income received by or accrued to a non-resident trust by reason of or in consequence of a donation, settlement or other disposition¹ by a resident, is vested in a resident beneficiary by the trustees of the non-resident trust.

2. Background

Under section 25B(1) if any amount² is received by or accrues to a trust during a year of assessment, and during the same year of assessment the amount –

- does not vest in a beneficiary, it is deemed to accrue to the trust; and

¹ Other than a donation, settlement or other disposition to an entity, which is not a resident and which is similar to a public benefit organisation contemplated in section 30.

² The reference to “any amount” does not extend to amounts of a capital nature that are not deemed to be gross income. See *Comprehensive Guide to Capital Gains Tax* in 14.11.1.

- vests in a beneficiary, it is deemed to accrue to that beneficiary.

Section 25B(1) overrides the principle that income cannot be disposed of after accrual.³ For example, if income accrues to a trust on 1 July of year 1, and the trustees vest the income in a beneficiary on 30 November of year 1, under common law principles the income would accrue to the trust, but under section 25B(1) it is deemed to accrue to the beneficiary.

Both the outcomes described in the above bullet points are “subject to the provisions of section 7”. This Note considers the implications of this “subject to” clause in relation to section 7(8).

The *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004* states the following on the rationale for the introduction of section 7(8):

“Foreign trusts have been a focus of concern for quite some time. South African taxpayers continue to artificially shift assets offshore via foreign trusts, thereby excluding income from the South African tax net. In 2001 and 2002 (as part of the shift to worldwide taxation), Government enacted further anti-avoidance measures to prevent this form of artificial exclusion from the South African tax net. Section 7(8) is a key anti-avoidance measure in this regard”.

3. The law

Section 25B(1)

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

Section 7(8)(a)

(8)(a) Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition.

4. Application of the law

4.1 Meaning of “donation, settlement or other disposition” in section 7(8)

The expression “donation, settlement or other disposition” used in section 7(8) has received judicial consideration in a number of South African court decisions. It includes a donation, being a disposition motivated by pure liberality or disinterested benevolence and not by self-interest or the expectation of a *quid pro quo* of some kind

³ The principle was confirmed in *CIR v Witwatersrand Association of Racing Clubs* 1960 (3) SA 291 (A), 23 SATC 380.

from whatever source it may come.⁴ It also includes a disposal of property under a settlement or other disposition for a consideration in which there is an appreciable element of gratuitousness and liberality or generosity.⁵ For example, it includes a loan on which interest is charged at a rate that is significantly below an arm's length rate of interest.

To the extent that income has been received by or accrued to a non-resident by reason of or in consequence of such a donation, settlement or other disposition by a donor, it must be included in that donor's income under section 7(8).

4.2 Meaning of "subject to" and the order in which section 25B(1) and section 7(8) must be applied

In *Premier, Eastern Cape, & another v Sekeleni Farlam JA* stated on the meaning of "subject to" that –⁶

"the expression 'subject to' has no *a priori* meaning⁷ (see *Pangbourne Properties Ltd v Gill & Ramsden (Pty) Ltd* 1996 (1) SA 1182 (A) at 1187J - 1188A). While it is often used in statutory contexts to establish what is dominant and what is subservient its meaning in a statutory context is not confined thereto and it frequently means no more than that a qualification or limitation is introduced so that it can be read as meaning 'except as curtailed by' (cf *Hawkins v Administration of South West Africa* 1924 SWA 57 and *Crook and Another v Minister of Home Affairs and Another* 2000 (2) SA 385 (T) at 389A - D)."

In *Sentra-Oes Koöperatief Bpk v KBI Nicholas AJA* cited the following cases with approval on the meaning of "subject to":⁸

"In the majority judgment in *S v Marwane* 1982(3) SA 717(A) at 747H-748B, Miller JA explained that the purpose of the phrase 'subject to' when used in a legislative provision, is –

' . . . to establish what is dominant and what subordinate or subservient; that to which a provision is "subject", is dominant – in case of conflict it prevails over that which is subject to it. Certainly, in the field of legislation, the phrase has this clear and accepted connotation. When the legislator wishes to convey that that which is now being enacted is not to prevail in circumstances where it conflicts, or is inconsistent or incompatible, with a specified other enactment, it very frequently, if not almost invariably, qualifies such enactment by the method of declaring it to be "subject to" the other specified one. As Megarry J observed in *C and J Clark v Inland Revenue Commissioners* [1973] 2 All ER 513 at 520:

'In my judgment, the phrase 'subject to' is a simple provision which merely subjects the provisions of the subject subsections to the provisions of the master subsections. When there is no clash, the phrase does nothing: if there is collision, the phrase shows what is to prevail.'

But when the intention is that that which is now being enacted shall prevail over other laws or provisions which may be in conflict with it, it is almost invariably prefaced by a

⁴ *Welch's Estate v C: SARS* 2005 (4) SA 173 (SCA), 66 SATC 303 at 314.

⁵ *Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55 at 76. In *C: SARS v Woulidge* 2002 (1) SA 68 (SCA), 63 SATC 483 at 489 the court described the failure by a parent to charge interest on a loan to a trust created for the benefit of his minor children as a gratuitous disposition.

⁶ 2003 (4) SA 369 (SCA) at 375.

⁷ Involving deductive reasoning from a general principle to a necessary effect; not supported by fact.

⁸ (1995) 57 SATC 109 (A) at 115.

phrase such as ‘notwithstanding any contrary provision . . .’ or words to similar effect . . .’“

Based on the above, the effect of the words, “subject to the provisions of section 7” in section 25B(1) is that if there is a conflict, inconsistency or incompatibility between section 25B(1) and section 7(8), section 7(8) is given dominance and will prevail.

4.3 Assessing whether there is a conflict, inconsistency or incompatibility

The starting point in determining whether the “subject to” clause in section 25B(1) has an effect is to establish whether there is a conflict between section 7(8) and section 25B(1).

When a non-resident trust derives income in consequence of a donation, settlement or other disposition by a donor and the trust vests that income, or a portion of it, in a resident beneficiary, a conflict arises because the amount is potentially economically taxed twice given that –

- section 25B(1) deems the amount vested in the beneficiary to have accrued to the resident beneficiary and therefore it would be included in the resident beneficiary’s gross income; and
- section 7(8) requires that any income received by or accrued to the non-resident trust be included in the donor’s income. Section 7(8) is not influenced by how the trustees dispose of the income after its receipt or accrual.

As indicated in **4.2**, in these circumstances section 7(8) must be applied in the first instance. In other words, section 25B(1) is disregarded to the extent that the amount is attributable to a donation, settlement or other disposition and is included in the donor’s income despite the fact that it may, subsequent to its receipt or accrual, have been vested in a resident beneficiary in the same year of assessment in which it was received by or accrued to the non-resident trust.

To the extent that there is no conflict, that is, when the amount derived by the trust is not attributable to a donation, settlement or other disposition, such remaining income must be dealt with under section 25B(1).

No economic double taxation arises under the interpretation adopted in this Note in the event that the trust has vested the relevant income in a resident beneficiary, because to the extent that section 7(8) applies, section 25B(1) does not apply. In other words, to the extent that the income has been attributed to the donor, it is not taken into account by a resident beneficiary in whom it has been vested.

Example – Income vested in a resident beneficiary by a non-resident trust derived in consequence of a donation, settlement or other disposition

Facts:

X, a resident individual, lent R1 million to a non-resident trust interest free at the beginning of the year of assessment. Had the trust borrowed the funds from a financial institution, it would have paid interest at a market-related rate of 10% a year. The trust used the funds to invest in a foreign bond, which produced an interest return of 12% a year during the same year of assessment. Before the end of the year of assessment, the trustees took the decision to vest the full income of R120 000 in Y, a resident beneficiary.

Result

The total income received by or accrued to the trust was R120 000 (R1 million × 12%). Of this amount, R100 000 (R1 million × 10%) was derived in consequence of the interest-free loan by X to the trust. Under section 7(8) R100 000 is deemed to be received by or accrued to X, while under section 25B(1) the balance of R20 000 is deemed to accrue to Y. Despite Y receiving R120 000, only R20 000 of that amount will comprise income in the hands of Y.

5. Conclusion

In applying section 7(8), the words “subject to the provisions of section 7” in section 25B(1) must be interpreted to mean that to the extent that both section 7(8) and section 25B(1) potentially apply, only section 7(8) must be applied. Section 25B(1) will apply to the balance of any income not derived in consequence of a donation, settlement or other disposition.

SOUTH AFRICAN REVENUE SERVICE