

## INTERPRETATION NOTE 114

DATE: 2 March 2021

**ACT : INCOME TAX ACT 58 OF 1962**  
**SECTION : SECTIONS 25B(1) AND 7(8)**  
**SUBJECT : INTERACTION BETWEEN SECTION 25B(1) AND SECTION 7(8) IN CASE OF CONFLICT, INCONSISTENCY OR INCOMPATIBILITY**

### *Preamble*

In this Note unless the context indicates otherwise –

- “**donor**” means a resident who makes a donation, settlement or other disposition;
- “**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.

### 1. Purpose

This Note provides clarity on only 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 if there is a conflict, inconsistency or incompatibility between the sections. This may occur when an amount received by or accrued to a non-resident discretionary trust by reason of or in consequence of a donation, settlement or other disposition<sup>1</sup> by a resident, which would have constituted income if the non-resident were a resident, is vested in a resident beneficiary by the trustees of the non-resident discretionary trust.

Consideration of other sections in the Act that may apply to the vesting of an amount in a resident beneficiary by the trustees of the non-resident discretionary trust is beyond the scope of this Note.

### 2. Background

Sections 25B and 7(8) are applied inconsistently by taxpayers. The interaction of these two sections therefore needs to be considered and analysed.

Under section 25B(1) if any amount<sup>2</sup> 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

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<sup>1</sup> 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.

<sup>2</sup> The reference to “any amount” does not extend to an amount of a capital nature which is not included in gross income or an amount contemplated in paragraph 3B of the Second Schedule.

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

Generally, once an amount has been received by or accrued to a person, that receipt or accrual is not undone by giving the right to that amount to someone else.<sup>3</sup> If applicable, however, section 25B(1) and 25B(2) will result in a different outcome because the amount is deemed to have been received by or accrued to the second person and not the first. For example, if an amount, which constitutes income, accrues to a discretionary trust on 1 July of year 1, and the trustees vest the amount in a beneficiary on 30 November of year 1, under normal receipt and accrual principles, taking into account that the trust is a separate person for income tax purposes, the amount would *prima facie* have accrued to the trust on 1 July of year 1, but under section 25B(1) and 25B(2) it is deemed to accrue to the beneficiary, not the trust.

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. 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 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.

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

## 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 from whatever source it may come.<sup>4</sup> 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.<sup>5</sup> For example, it would include a loan on which interest was charged at the rate of 2% when the arm’s length rate of interest was 12%.

To the extent that an amount, which would have constituted income had the non-resident been a resident, 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 –<sup>6</sup>

“the expression 'subject to' has no *a priori* meaning<sup>7</sup> (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”:<sup>8</sup>

“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:

<sup>4</sup> *Welch’s Estate v C: SARS* 2005 (4) SA 173 (SCA), 66 SATC 303 at 314.

<sup>5</sup> *Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55 at 76. In *C: SARS v Woullidge* 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.

<sup>6</sup> 2003 (4) SA 369 (SCA) at 375.

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

<sup>8</sup> (1995) 57 SATC 109 (A) at 115.

“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 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).

To illustrate the issue, assume that a resident provided an interest-free loan to a non-resident discretionary trust. The trust invested the loan amount and derived interest income from its investment. Three months later, in the same year of assessment, the trust vested the interest in a resident beneficiary. The trust is a separate person for income tax purposes and a determination needs to be made whether the interest derived by the trust is taxable in South Africa. Assume the interest derived by the trust is fully attributable to the interest-free loan. Relevant to the subject matter of this note, consideration must be given to whether section 7(8) and section 25B apply. Both sections potentially apply because for purposes of –

- section 7(8), an amount has, by reason of or in consequence of a donation, settlement or other disposition by a donor, been received by a non-resident and had that non-resident been a resident the amount of interest would have constituted income as defined, and
- section 25B, an amount has been received by a trust, which section 25B(1) potentially deems to accrue to the trust or to a beneficiary.

A conflict arises in this example because both sections potentially apply and, if both sections are applied, the amount is potentially economically taxed twice given that –

- section 7(8) requires that any amount received by or accrued to the non-resident discretionary trust, which would have constituted income had the non-resident been resident, be included in the donor’s income, and
- 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.

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 discretionary trust.

It is incorrect in the example above to apply section 25B and say that because the amount is deemed to accrue to the resident beneficiary, section 7(8) does not apply because, after applying section 25B, no amount has been received by or accrued to the trust. This approach is incorrect as it gives preference to section 25B and applies it to the actual receipt by the trust in preference to section 7(8) which also applies to the actual receipt by the trust (before applying section 25B). The potential operation of section 25B(1) is made "subject to the provisions of section 7" in the preamble of that section and, as indicated above, this means that section 7(8) prevails.

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 amount 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 amount of 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 amount of income has been attributed to the donor, it is not taken into account by a resident beneficiary in whom it has been vested.

**Example 1 – Income vested in a resident beneficiary by a non-resident discretionary trust derived in consequence of a donation, settlement or other disposition**

*Facts:*

X, a resident individual, lent R1 million to a non-resident discretionary 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 for the trust 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 amount of the interest derived from the bond of R120 000 in Y, a resident beneficiary.

The official rate of interest is 4,5%. X is a connected person to the non-resident discretionary trust.

*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. The amount would have constituted income as defined in section 1(1) had the trust been a resident. Under section 7(8), which is triggered before section 25B when the amount is initially received by or accrued to the trust, 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.

The loan by X to the non-resident discretionary trust is potentially an affected transaction for purposes of section 31(1). Section 7(8) applies first and if the amount attributed under section 7(8) is less than the arm's length return which is required for purposes of section 31, the difference between the two amounts will be included in X's taxable income calculation under section 31(2). In this example, the amount included in X's income under section 7(8) is R100 000 (see above). This amount represents an arm's length return on the loan which has been taken into account in determining X's taxable income under section 7(8), and consequently no additional adjustment will be required under section 31.

X must also consider the possible application of section 7C and donations tax. Section 7C(3)(a) stipulates that if a trust incurs no interest in respect of a loan, advance or credit referred to in section 7C(1) or (1A) (whether this is the case will depend on the facts of the case, facts not given in this example to make that determination), an amount equal to the difference between –

- the amount incurred by that trust during a year of assessment as interest in respect of that loan, advance or credit (nil in this example as the loan was interest-free); and
- the amount that would have been incurred by that trust at the official rate of interest (4,5% in this example)

must, for purposes of donations tax, be treated as a donation [R1 million × (4,5% – 0%) = R45 000] made to that trust by the person referred to in section 7C(1)(a) or (1A) (namely, X if the criteria in those sections are met) on the last day of that year of assessment of that trust.

**Example 2 – Income vested in a resident discretionary beneficiary by a non-resident discretionary trust derived in consequence of a donation, settlement or other disposition**

*Facts:*

X, a resident individual, donated R1 million to a non-resident discretionary trust at the beginning of the year of assessment. The trust used the funds to invest in a foreign bond, which produced an interest return for the trust 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 amount of the interest derived from the bond 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%) and was derived in consequence of the donation of R1 million by X to the trust. The amount would have constituted income as defined in section 1(1) had the trust been a resident. Under section 7(8) R120 000 is deemed to be received by or accrued to X. Despite Y receiving R120 000, the full amount of income is deemed to accrue to X under section 7(8) and therefore nothing is deemed to accrue to Y under section 25B(1).

The donation of R1 million by X to the non-resident discretionary trust is potentially subject to donations tax.

**Example 3 – Income vested in a non-resident beneficiary by a resident discretionary trust derived in consequence of a donation, settlement or other disposition**

*Facts:*

X, a resident individual, donated R1 million to a resident discretionary trust at the beginning of the year of assessment. The trust used the funds to invest in a foreign bond, which produced an interest return for the trust 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 amount of the interest derived from the bond of R120 000 in Y, a non-resident beneficiary.

*Result:*

The total income received by or accrued to the trust was R120 000 (R1 million × 12%) and was derived in consequence of the donation of R1 million by X to the trust. Although section 7(8) is not triggered before applying section 25B, after applying section 25B(1) and (2), R120 000 is deemed to be received by or accrued to Y which triggers section 7(8). The amount would have constituted income as defined in section 1(1) had Y been a resident. This outcome means that despite Y receiving R120 000, the full amount of income is deemed to have accrued to X under section 7(8).

The donation of R1 million by X to the resident discretionary trust is potentially subject to donations tax.

**Example 4 – Vested interest of a non-resident beneficiary derived in consequence of a donation, settlement or other disposition**

*Facts:*

A South African-registered and resident trust has one beneficiary, Y who is a resident of Country Z. Y has a vested right to the trust's capital and income.

X, a resident individual, donated R1 million to the trust at the beginning of the year of assessment. The trust used the funds to invest in a foreign bond, which produced an interest return for the trust of 12% a year during the same year of assessment.

*Result:*

Given that Y has a vested right to the interest, the trust is merely acting as a conduit in receiving the interest on behalf of Y, who is a non-resident. The total income of R120 000 (R1 million × 12%) derived in consequence of the donation of R1 million by X to the trust is therefore received by or accrued to Y as the non-resident vested beneficiary. The amount would have constituted income as defined in section 1(1) had Y been a resident. Under section 7(8) R120 000 is deemed to be received by or accrued to X. Despite R120 000 having been actually received by or accrued to Y, the full amount of income is deemed to have accrued to X under section 7(8) and therefore nothing is treated as having been received by or accrued to Y. If Y had been a resident, section 7(8) would not have applied.

The donation of R1 million by X to the non-resident trust is potentially subject to donations tax.

**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.

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