

Tax

Income earned by a minor – a case study

RONEL WILLIAMS

Mr X decides to provide financial assistance to his 16 year old daughter, G, to enable her to enter into the housing construction business. He makes an interest-free loan of R2 million to her, repayable in 10 years' time. He then helps her to construct a flat in Soweto from which she earns R300 000 as rental income.

Q: Is there any tax implication for Mr X?

The general rule when a minor child (an unmarried person under 18) receives income or when income accrues to him/her, is that the income is taxed in his/her own hands.

There are, however, circumstances where the income of the minor will be deemed to be income of his parent:

- s7(3) of the Income Tax Act¹ provides that, where a minor child receives income or income accrues to him "by reason of any donation, settlement or other disposition" made by the parent of the child, the income will be deemed to have been received by the parent.
- s7(4) provides that, where a minor child receives income or income accrues to him "by reason of any donation, settlement or other disposition" made by any other person, it will be deemed to be the income of the parent of the child if the parent or his or her spouse made a donation, settlement or other disposition or have given some other consideration directly or indirectly in favour of the said other person or his or her family.

The question whether G's rental income should be deemed to be that of Mr X is one of fact. It is necessary to look at the intention of Mr X when he made the loan – from the facts it appears that it was done to enable G to enter into the construction business. It is, however, also necessary to see if the donation made by Mr X was the effective cause of the accrued income. If it was, then the income is deemed to have been received by him, irrespective of whether or not the income was received from the original donation or from a subsequent re-investment of the income.

"Donation, settlement or other disposition"

It is evident when reading s7(3) that the phrase "donation, settlement or other disposition" forms the crux of any decision as to whether or not income of a minor child is deemed to be that of a parent. While the exact meaning of the words "donation" and "settlement" seem to have been settled, the words "or other disposition" have been the subject of extensive examination by our courts and for a long time there was uncertainty as to the exact meaning and scope.

In *CIR v Berold*² the court was faced with a situation where the taxpayer had sold some of his income-producing assets to a private company on credit

with no interest payable on the outstanding purchase price. The shares in the company (for clarity referred to as "company 1") were held by another private company ("company 2") and the shares in the latter company were held by the trusts created by the taxpayer for his children. Company 1 declared a dividend which was paid to company 2, which then in turn paid dividend to the trusts. The Court held that as long as the taxpayer did not insist on company 1 repaying the purchase price, there was a continuous donation to the company and this "donation" enabled it to declare dividends to company 2, which ultimately flowed to the trusts. It held that, since the income was derived from the donation, it was deemed to have been received by the taxpayer in terms of s7(3).

In *Joss v SIR*³ the taxpayer sold shares to a company that produced dividends. Some of the shares in the company were held by his minor daughter. In return he received a loan on which the company initially paid no interest. The Court held that the making of the interest-free loan constituted a disposition in terms of s7(3) as it enabled the company to declare dividends. If interest had been charged on the loan, the dividends would have been smaller. The Court accordingly held that the disposition was one not for full value and instructed the Commissioner to revise the assessment for the years in which no interest was paid and to include as income of the taxpayer the portion of the dividends that would not have been paid had interest been charged.

Though the outcome of these two cases was the same, the inclusion of the amounts in the taxpayers' income in the respective cases was done for very different reasons and for some time there was uncertainty as to the exact meaning of the phrase "donation, settlement or other disposition".

Finally, in 1980, the Appellate Division was asked to rule on the meaning. In *Ovenstone v SIR*⁴ the taxpayer lent money to his children to enable them to obtain shares in a company. The loans were not interest-free and he charged his children the same rate of interest his bank would charge him to lend money. The children earned dividends on the shares. The Secretary applied s7(3) and taxed the taxpayer on the dividends earned by the children less the amount of interest paid by them on the loans. The taxpayer objected and claimed that the section did not apply because there was no "donation, settlement or other disposition" that caused the dividends to accrue to the children. The Special Court dismissed the objection and the taxpayer appealed to the Appeal Court.

The Appeal Court found that the word "disposition" generally has a very wide meaning and meant any parting with property or transferring thereof



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