Trusts, tax and tomatoes

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It is a daily occurrence that funds are loaned to a trust in order for the trust to acquire assets. A loan account is created for the loaner of the funds and often this loan does not bear any interest and often income is distributed to beneficiaries and the income is then taxed at the beneficiaries' personal tax bracket. Although this is currently accepted practice, it is very important in these circumstances not to oversee the anti-avoidance provisions of the Income Tax Act 58 of 1962, ("the Act"), as explained in the example below.

Lucas, a vegetable farmer, is farming with tomatoes in the Lowveld. Since he started farming he has never considered using a structure such as a close corporation or company as he wanted to keep his farming enterprise as simple as possible. The reality is that he has had a very fruitful tomato crop in the current financial year. With all the income being paid into his personal farming account, he will currently pay income tax at the maximum rate of 40%. Needless to say that Lucas is not very pleased with this. He has heard from a friend that he needs to consider better possibilities for his farming and the use of a trust was mentioned as he could apparently save on income tax by using a trust and distributing income to his children. Lucas does not know anything about distributions, save for distributing chores to the labour on the farm and therefore consulted his adviser. After a discussion with his adviser Lucas now considers selling his farm to a trust of which he, his wife and their three minor children will be the beneficiaries. He then wants to split the income as far as possible to the minor children to avoid income tax to a certain extent. The purchase price paid for the farm will be owed by the trust to Lucas on loan account bearing no interest.

Notwithstanding the fact that a trust should never be considered for the sole purpose of avoiding income tax, there are other important factors to consider in this instance.
Section 25B of the Act prescribes how income tax is apportioned in respect of income that has accrued to a trust during any year of assessment. Section 25B(1) permits two apportionment possibilities. First, any amount received by or accrued to or in favour of the trustee of a trust shall, subject to the provisions of section 7 of the Act, be deemed an amount that has accrued to an ascertained beneficiary with a vested right to that amount insofar as that amount has been derived for the immediate or future benefit of that beneficiary. It is therefore clear that a beneficiary can indeed be taxed on the income received by the trust. Secondly, to the extent that the amount is not derived for the benefit of a beneficiary, it will be deemed to have accrued to the trust.

However, although the above are basic guidelines for the taxation of income of a trust, Section 7 of the Act was included to ensure that the trust is not utilised to avoid tax. The importance of Section 7 should not be overlooked and should be taken into consideration when considering the tax implications of a trust. Section 7 of the Act is essentially an anti-avoidance provision and regulates when income is deemed to have accrued or to have been received.

Section 7(3) is aimed at preventing income-splitting between parents and minor children in an attempt by the parents to take advantage of the children's lower tax rate. The subsection deals with the situation where the parent of a minor child has made a donation, settlement or other disposition to that child. If, as a result of such donation, settlement or other disposition, income has been received by or has accrued to or in favour of that child, or has been expended for the maintenance, education or benefit of that child, or has been accumulated for the benefit of that child, such income will be deemed to have been received by the donor parent of that child.

It was decided by the court in *Armstrong v CIR* 1938 AD and *SIR v Rosen* 1971 1 SA 172 (A) that income passing through a trust retains its identity and the trust acts merely as a conduit pipe through which the income flows. Although this implies that income can be distributed to the beneficiaries and each beneficiary is then taxed in their personal tax brackets, it is important to determine how the income producing asset came to be held in trust. A non-interest bearing loan account is seen as a disposition in this regard.

Therefore when an asset is sold to a trust on loan account and the loan account does not bear interest, section 7(3) will apply and the seller will be taxed on the income received by a beneficiary.

It was furthermore proposed in the 2013 National Budget speech that discretionary trusts should no longer act as flow-through vehicles and that taxable income and loss should be fully calculated at trust level with distributions acting as deductible payments to the extent of current taxable income.

It is therefore important for Lucas to take note that the current income splitting in trusts might not be available in future and should not be his focus point of registering a trust. If he wants to split the income received from selling his tomatoes to the beneficiaries of the trust while this practice is still accepted by SARS, then a loan account bearing market-related interest should be recorded in his accounting books. A holistic estate plan of his business is recommended to determine whether a trust will be the best solution for him.

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