The court decision in the case of Woulidge – A practical application

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Abstract
This article comprises an attempt to find a practical method of applying the decision in the case of the Commissioner for the South African Revenue Service v Woulidge (63 SATC 483) (‘Woulidge’) to limit the application of section 7(3) of the Income Tax Act (‘the Act’). It is proposed in this article that Woulidge would also apply to the provisions of section 7(5) and paragraphs 69 and 70 of the Eighth Schedule to the Act. The approach proposed is illustrated by means of examples. The approach adopted by the Commissioner for the South African Revenue Service is also discussed. A conclusion is drawn regarding the practicality of applying Woulidge in the light of the examples.

Key words
Woulidge Joss
Ovenstone s 7(3)
s 7(5) s 25B(1)
para 69 para 70
limits trusts
estate planning interest-free loans
attribution distribution
capital gains tax anti-avoidance

1 Introduction
The purpose of this article is to find a practical method of applying the decision in the case of the Commissioner for the South African Revenue Service v Woulidge (63 SATC 483) (‘Woulidge’) to limit the application of section 7(3) of the Income Tax Act (‘the Act’) and, it is submitted, section 7(5) to the extent of the gratuitous element of the disposition. To do this, the provisions of sections

1 Act 58 of 1962.
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7(3) and 7(5) as well as paragraphs 69 and 70 of the Eighth Schedule to the Act are examined in the light of the Woulidge judgment and applied to the scenarios contained in examples (see part 4).

In order to execute the above, certain assumptions have been made and precepts accepted from the judgments in Joss v Secretary for Inland Revenue (41 SATC 206) (‘Joss’) and Ovenstone v Secretary for Inland Revenue (42 SATC 55) (‘Ovenstone’) and, as such, only a brief discussion thereof is included in part 2 of this article. The following are the assumptions and precepts that are pivotal to this article:

- It is only the gratuitous element of the donation, settlement or other disposition (‘disposition’) that is included in the scope of the relevant paragraphs of section 7 (and paragraphs 69 and 70 of the Eighth Schedule);

- The income that accrues by reason of the disposition (that is, a causal link must exist) should be apportioned between the gratuitous and non-gratuitous elements (if the apportionment can be proved by the taxpayer in terms of the onus placed upon the taxpayer by the provisions of section 82 and as shown in Joss (SATC 1979:215)).

This article mainly considers sales to a trust on a loan account, because this is the most frequently used method of disposing of assets in terms of an estate plan. In addition, only trusts and persons that are residents, as defined, are considered.

2 Sections 7(3) and 7(5) and paragraphs 69 and 70 of the eighth schedule

The anti-avoidance provisions of section 7(3) and 7(5) were included in the Act, in the first instance, to prevent parents from diverting their income to their minor children and, in the second instance, to prevent taxpayers from diverting their income to separate legal entities. The successful splitting of income that was earned by one taxpayer between multiple taxpayers results in less taxable income being attributed to each individual taxpayer and, as a result of the lower tax rates applicable to natural persons that have low taxable incomes, the net effect is that less tax in total is paid.

Section 82 provides the following: ‘The burden of proof that any amount is:

a) exempt from or not liable to any tax chargeable under this Act; or
b) subject to any deduction, abatement or set-off in terms of this Act; or
c) to be disregarded or excluded in terms of the Eighth Schedule, shall be upon the person claiming such exemption, non-liability, deduction, abatement or set-off, or that such amount must be disregarded or excluded, and upon the hearing of any appeal from any decision of the Commissioner, the decision shall not be reversed or altered unless it is shown by the appellant that the decision is wrong.’

Failure to discharge the onus placed on the taxpayer is demonstrated in Ovenstone.
Section 7(3) provides the following:
‘Income shall be deemed to have been received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child -
• it has been received by or accrued to or in favour of that child, or has been expended for the maintenance, education or benefit of that child; or
• it has been accumulated for the benefit of that child.’

The courts have found the critical interpretative phrases of this section to be ‘by reason of’ and ‘donation, settlement or other disposition’.

The due consideration of the courts regarding the phrase ‘by reason of’ has resulted in the interpretation that a causal link should exist between the income received by the minor child and the ‘donation, settlement or other disposition’ (hereafter ‘disposition’), originally made by the parent, for section 7(3) to be applicable. In contrast, section 7(5) does not contain the words ‘by reason of’, but it appears from the section that these words are implied (refer to the discussion below).

Section 7(5) provides the following:
‘If any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or a portion of the income there under until the happening of some event whether fixed or contingent, so much of any income as would, but for the stipulation or condition, in consequence of the donation, settlement or other disposition be received by or accrue to or in favour of the beneficiaries, shall, until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person.’ [Emphasis added].

It is submitted that section 7(5) can be interpreted similarly to section 7(3) by virtue of the phrase ‘in consequence of’. Income accrued in consequence of the disposition and not distributed to beneficiaries as a result of any condition, for example the discretion of the trustees, is taxed in the hands of the donor. Therefore, similarly to section 7(3), a causal link should exist between the original disposition and the income sought to be taxed in terms of the provisions of section 7(5). Therefore both section 7(3) and section 7(5) consider the taxation of any income that arises, irrespective of whether it is distributed to beneficiaries, to be a result of a disposition.

It has furthermore been established by the courts that the phrase ‘by reason of’ does indicate that apportionment should be considered when the income is received or accrued as a result of elements of both full consideration and

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4 Refer to Kohler v Commissioner for Inland Revenue (16 SATC 312 at 316 to 317), Commissioner for Inland Revenue v Widan (19 SATC 341 at 350), Commissioner for Inland Revenue v Berold (24 SATC 729 at 738). This phrase was also discussed in the judgements of Joss v Secretary for Inland Revenue (41 SATC 206), Ovenstone v Secretary for Inland Revenue (42 SATC 55) as well as in Commissioner for South African Revenue Services v Woulidge (63 SATC 483).

5 Refer specifically to the judgements of Joss v Secretary for Inland Revenue (41 SATC 206 at 214) and Ovenstone v Secretary for Inland Revenue (42 SATC 55 at 74).
gratuitousness\textsuperscript{6}. For the purposes of this article it has therefore been accepted that only income accrued as a result of the gratuitous element of the disposition should be considered in terms of the provisions of sections 7(3) and 7(5). It is accepted though that the apportionment of the income between the full consideration and the gratuitous element would have to be proved by the taxpayer and that when the taxpayer fails to discharge the \textit{onus}, all the income, rather than merely a portion of the income, would be allocated to the gratuitous element (SATC 1980:77).

The remaining critical phrase, namely ‘donation, settlement or other disposition’, is common to both sections 7(3) and 7(5). Following the judgments of \textit{Joss} and \textit{Ovenstone}, it is submitted that there is now sufficient clarity on these terms. Essentially, the term ‘disposition’ has been interpreted \textit{ejusdem generis} with the terms ‘donation’ and ‘settlement’ (SATC 1980:74). Therefore, for the provisions of section 7 to apply, there should be an appreciable element of gratuity (SATC 1980:74).

The gratuitous element should be appreciable, because all transactions will contain an element of gratuity as a result of the skill of the negotiator, leaving some parties enriched and others impoverished. It is submitted that the extent of the gratuitous element should therefore be determined – this determination would be subjective - and would be required to be proved to the Commissioner. Ultimately, it is submitted that transactions proved by the taxpayer in terms of section 82 to the satisfaction of the Commissioner, or failing that to the courts, to be sufficiently close to full money’s worth (‘market value’) should be excluded from the scope of section 7.

The \textit{Woulidge} decision (discussed in detail in part 3), firstly resulted in the acceptance of the principle stated in \textit{Joss} and \textit{Ovenstone} that the income that accrues to a minor child should, provided the taxpayer discharges his \textit{onus}, be apportioned between the gratuitous and non-gratuitous elements of the disposition (SATC 2001:488). Secondly, \textit{Woulidge} applied a limit to the extent that the income may be attributed to the gratuitous element (SATC 2001:489). In \textit{Woulidge}, the sales to a trust by the parent were for full consideration on an interest-free loan. The gratuitous element was considered to be the continuing

\textsuperscript{6} \textit{Ovenstone} at 77 states: ‘Now where the consideration, while not being due consideration, is nevertheless appreciable, it will mean that the income in question under s 7(3) will usually have accrued or been received ‘by reason of’ both elements of gratuitousness and consideration. I see no reason why in those circumstances the income should not then be apportioned between the two elements. The words ‘by reason of’, themselves suggest some apportionment in order to give proper effect to the real cause of the accrual or receipt of the income. (\textit{Cf. Joss v SIR} [at 216 to 217]) If such apportionment is not possible, or if insufficient evidence is adduced to enable the court to effect it (the burden of proof being on the taxpayer under s 82), the composite disposal will usually, because of its appreciable element of bounty, be then simply treated as a gratuitous settlement or disposition, as the case may be, that falls within the scope of the critical phrase’ of donation, settlement or other disposition.
donation of the interest that was not charged. The limitation imposed by the court was the extent to which the income could be attributed to this gratuitous portion to a market-related notional interest rate, that is the income to be attributed to the parent in terms of section 7(3) was limited to the interest that could have been earned if a market-related interest rate had been charged on the loan. Because Woulidge only considers the treatment of interest-free loans, the treatment of donations and sales at less than full consideration should necessarily also be discussed.

As determined above, the application of section 7 in terms of Woulidge should be limited to the extent of the gratuitous element of the disposition. It is submitted that when an asset is donated to a trust, there is no basis for the application of a notional interest rate to the value of the asset donated, because the capital asset as a whole has not been replaced by another capital asset, namely an interest-bearing investment. This results in the entire disposition being considered to be gratuitous and, as such, it is submitted that no apportionment or limit is applicable and all the income arising in the trust from the asset would be attributable in terms of section 7. This aspect, discussed at length in Woulidge, is discussed in some detail in part 3. Because no limit is considered to be applicable to donations, these transactions are not considered for the purposes of this article.

Assets sold for less than full consideration give rise to more complex transactions in terms of Woulidge. Should the consideration charged be payable on an interest-free loan account, a notional interest rate can certainly be applied to the outstanding balance of the loan. However, this would provide an inappropriate limit for the income to be attributed in terms of section 7, because it would ignore a significant gratuitous element of the transaction, namely the difference between the market value of the asset disposed of and the inadequate consideration. It is submitted that the attribution in terms of section 7 should not only be limited by the determination of notional interest on the outstanding loan balance, but a portion of the income, i.e. the ratio of the difference between the market value and the inadequate consideration to the market value, should be calculated and attributed to the donor in each year of assessment and the remaining income applied to the notional interest ‘limit’. This ratio of automatically attributed income can be represented mathematically as follows:

\[ A = \frac{(M - C)}{M} \times I \]

where:

- \( A \) is the initial attribution before a limit for the remaining income to be attributed is determined
- \( M \) is the market value on the date that the asset was sold
- \( C \) is the inadequate consideration on the date of sale
- \( I \) is the income that arises from the asset in the current year
The above approach has been demonstrated in example 4 (see part 4). If the inadequate consideration had been settled, it is submitted that the only income to be attributed would be the income ratio as discussed above. The notional interest is nil, because no balance remains outstanding on the loan. However, a gratuitous element remains, namely the difference between the market value on the date of the sale and the inadequate consideration on that date.

Similar wording to that contained in sections 7(3) and 7(5) is contained in the Eighth Schedule to the Act, in paragraphs 69 and 70. As with sections 7(3) and 7(5), the purpose is to prevent one taxpayer from splitting capital gains between multiple taxpayers to take advantage of lower tax rates (refer to the preceding discussion).

Paragraph 69 provides the following:

‘Where a minor child’s capital gain or a capital gain that has vested in or is treated as having vested in or that has been used for the benefit of that child during the year of assessment in which it arose can be attributed wholly or partly to any donation, settlement or other disposition -

- made by a parent of that child; or
- made by another person in return for any donation, settlement or other disposition or some other consideration made or given by a parent of that child in favour directly or indirectly of that person or his or her family,

so much of that gain as can be so attributed must be disregarded when determining that child’s aggregate capital gain or aggregate capital loss and must be taken into account in determining the aggregate capital gain or aggregate capital loss of that parent.’

The wording of paragraph 69 is very clear: it is ‘so much of the [capital] gain as can be so attributed’ to the disposition that is included in the taxable income of the parent. This is very similar to the requirement in section 7(3) that income should be included in the taxable income of the parent to the extent that the income distributed to the minor child arises by reason of the disposition. It is submitted therefore the decision in Woulidge would also apply to capital distributed, for example a discretionary trust that distributes in the current year the income that was retained in the trust from the previous year of assessment, i.e. making a capital distribution and thereby vesting capital in the beneficiary.

Paragraph 70 of the Eighth Schedule provides as follows:

‘Where -

- a person has made a donation, settlement or other disposition that is subject to a stipulation or condition imposed by that person or anyone else in terms of which a capital gain or a portion of any capital gain attributable to that donation, settlement or other disposition shall not vest in the beneficiaries of that donation, settlement or other disposition or some of those beneficiaries until the happening of some fixed or contingent event;
- a capital gain that is attributable to that donation, settlement or other disposition has arisen during a year of assessment throughout which the person who made that donation, settlement or other disposition has been a resident; and
- that capital gain or a portion thereof has not vested during that year in any beneficiary who is a resident,
that capital gain or that portion thereof must be taken into account in determining the aggregate capital gain or aggregate capital loss of the person who made that donation, settlement or other disposition and disregarded when determining the aggregate capital gain or aggregate capital loss of any other person.'

To the extent that the capital gain arises from the disposition, the amount does not vest in the beneficiary and will be included in the aggregate capital gain of the person that made the disposition. It is submitted that Woulidge also holds implications for these Eighth Schedule paragraphs.

Paragraph 73 of the Eighth Schedule is applicable to both paragraphs 69 and 70. For the purposes of the examples (in part 4), the provisions of paragraph 73 have been applied in terms of an understanding of the Woulidge decision. In the authors’ opinion, the interpretation applied is contentious and falls within the scope of another article.

3 The Woulidge decision

The recent decision in Commissioner for the South African Revenue Service v Woulidge (63 SATC 483) (‘Woulidge’) must necessarily be examined. The objective of this article leads to focus being placed on the judgment only as it relates to section 7(3). The article does not give attention to the in duplum rule considerations of the courts (refer to the discussions below).

3.1 The facts of the case in brief

Woulidge had set up two trusts (one for each of his children). The shares in four companies were sold to these trusts for full consideration on a loan account. In terms of the sale agreement, the seller (Woulidge) could, if he so chose, charge interest on the loan capital that did not exceed the bank prime rate. In the years of assessment under consideration, and in the preceding years of assessment, no interest was charged on the outstanding balance of the loan. The terms of repayment of the outstanding capital sum were not fixed.

After a company (‘C’), that was not a connected person with respect to Woulidge or his children, had become interested in the four companies held by

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Paragraph 73 of the Eighth Schedule provides the following: ‘Where both an amount of income and a capital gain are derived by reason of or are attributable to a donation, settlement or other disposition, the total amount of that income and gain-

a) that is deemed in terms of section 7 to be that of a person other than the one to whom it accrues or by whom it is received or for whose benefit it is expended or accumulated; and

b) that is attributed in terms of this Part to a person other than the one in whom it vests, shall not exceed the amount of the benefit derived from that donation, settlement or other disposition.

(2) For the purposes of this paragraph, the benefit derived from a donation, settlement or other disposition means the amount by which the person to whom that donation, settlement or other disposition was made, has benefited from the fact that it was made for no or an inadequate consideration, including consideration in the form of interest.’
the trusts, restructuring took place. The new group structure comprised a
holding company that was installed between the holdings in the four companies
and the trusts. Each trust then sold 50% of its holding to C for a sum which each
trust used to repay the outstanding loan that was owing to Woulidge and to make
loans and other investments. Income accrued as a result of these investments
and the loans made by the trust; some of the income was distributed to the
beneficiaries of the trusts (i.e. Woulidge’s children). The Commissioner sought
to attribute the income from these investments to Woulidge.

3.2 The arguments

Woulidge contended that the income should only be attributed to him to the
extent that interest was not charged on the outstanding balance of the loans to
the trusts. He furthermore contended that it should be limited to the capital
amount of the loans in terms of the in duplum rule, thereby conceding that the
interest not charged fell within the provisions of section 7(3). The fact that the
sale had taken place at full consideration was not disputed in the lower courts
and, as such, was not considered by the Supreme Court of Appeal.

The Commissioner sought to argue that the entire scheme contained an
appreciable element of gratuitousness and, as such, all the income was by reason
of the sale of the shares by Woulidge and that it should be taxed in his hands.
Alternatively, it was submitted by the Commissioner that Woulidge had not
discharged the onus of apportioning the elements of gratuitousness and full
consideration.

3.3 The ruling

The court did not address the issue regarding whether the entire scheme
represents a sham or a simulation, because this argument had not been addressed
previously and, in the interests of fairness, could not be raised in the Supreme
Court of Appeal. The Commissioner had previously attempted to treat the sale
of the shares for full consideration as the causal link to the income and, as a
result thereof, to subject Woulidge to tax on that income. However, Davis J in
the judgment of the Cape High Court stated:

‘The transactions in question constituted an element of an estate planning exercise similar
in nature to those featured in Joss and Ovenstone (supra). In both cases, the courts had no
difficulty in classifying such a transaction as a genuine sale, a conclusion which is
reported accurately in appellant’s Income Tax Practice Manual at A – 166(1). In both Joss
and Ovenstone (supra) the court accepted a doctrine of apportionment based on a
distinction between two separate transactions, namely the disposition of shares at fair
value and a loan which is interest free’.

The Supreme Court of Appeal held further that Woulidge had discharged the
onus of demonstrating apportionment between the elements of gratuitousness
and consideration. Moreover, the degree of gratuity was limited to the forfeited

8 Commissioner for SARS v Woulidge (62 SATC 1 at 10).
interest and the sale at full consideration, and the subsequent repayment by the trust did not contain an appreciable element of gratuitousness.

As a result of the appreciable element of gratuitousness, it was held by the Supreme Court of Appeal that the *in duplum* rule could not apply, because its applicability was limited to real-world commercial and economic transactions, which the forfeited interest was not. For this reason, the *in duplum* rule is not considered further in this article.

### 3.4 The implications

Similarly to *Joss* and *Ovenstone*, two dispositions were considered. Firstly, the sale of the assets to the trusts on interest-free loans, and, secondly, the ‘continuing donation’ of the interest not charged on the loan. Only the loan itself was considered to contain the appreciable gratuitous element. It is submitted that the reasoning of the court, in simple terms, was that the sale of the asset represents the relinquishment of the return on that asset and the replacement of that return with interest on a loan account. The interest that was not charged, resulted in the interpretation that the creditor (the lender) was making a continuous donation to the debtor (the borrower) of the amount of interest that should have been charged. Therefore it was only the loan that contained the gratuitous element. This submission appears to be in line with the considerations of Trollip JA in *Ovenstone* where he stated (SATC 1980:72) that:

‘The transactions the legislature seems to have had in mind in enacting subsecs (3)-(6) are those in which a taxpayer seeks to achieve tax avoidance by donating, or disposing of income-producing property to or in favour of another under the therein specified conditions or circumstances, thereby diverting its income from himself without his replacing or being able to replace it (cf Estate Dempers vs SIR 1977(3) SA 410(A) at 421B-F44). But if he receives due consideration for the disposition, theoretically he is able to replace such income, and in practice he often does, by using or investing the consideration. In those circumstances no reason exists at all why the legislature should have wished to deem that income derived from the property disposed of should continue to be that of the disposer.’

Essentially, the above paragraph illustrates the principle arrived at in *Woulidge*, namely that the gratuitous disposition is the continuing donation of the interest on an interest-free loan and not the actual income received by or accrued to the new owner of the property (who has paid due consideration - submitted to be market value - for that property). The fact that the consideration that is paid is on a loan account merely implies that the seller has replaced the capital asset that produces income of whatever nature, for example, rent, with another, i.e. a capital investment that produces interest. Because the interest is not received or accrued (the loan being interest free), the taxpayer has not replaced the return and so falls within the scope of section 7 to the extent of the interest that is not charged.

Therefore the principle established by *Woulidge* is that the extent to which the income received by the minor is to be taxed in the parent’s hands is limited to the gratuitous portion of the disposition. It is therefore necessary for the
taxpayer to prove that the apportionment is appropriate, provide evidence on how to apportion the disposition into the gratuitous and full-consideration elements and also to prove the extent to which the income for the purposes of section 7(3) is to be limited.

It is submitted that the above principle is also applicable to section 7(5). The extent to which income is deemed to have accrued to the donor, depends on the extent of the gratuitous element of the disposition, applied to the income retained and not distributed to any beneficiary, based on a condition or stipulation in the trust deed.

While this principle appears to be simple, the ramifications for its practical application are vast and complex. The limit applied in *Woulidge* was the extent of the interest forfeited on the loan. What is not clear from the judgment, is how the Commissioner was to apply the decision. One of the difficulties in the application of a limit of this nature is highlighted in *Joss* in respect of which Coetzee J stated (SATC 1979:216):

'It is, however, illogical to suggest that only the interest which normally would have been paid in respect of the tax year in question affects the dividend. Obviously the interest-free loans during the preceding years also affect the quantum of the dividend received by Nicol and the trust in the tax years under discussion'.

In the case of *Woulidge* the above issue was not addressed, particularly with regard to the years in which no income accrued. In other words, was the notional interest that could have been charged, to be capitalised until such time as income arising in the trust could be applied to ‘settle’ the notional interest? From reading the above statement from *Joss* in isolation, it would appear that capitalisation of uncharged interest is implied. Firstly, this statement cannot be viewed in isolation and should be considered with regard to the facts of the case. Secondly, in terms of *Woulidge*, it is submitted that a capitalisation approach would not only be impractical, but also could never have been the intention of the decision. It appears that all that *Woulidge* sought to achieve, was to limit the amount to be attributed to a parent in terms of section 7(3) to a maximum of either market-related interest on the loan account or the actual income earned. Capitalisation of notional amounts would yield complex results. However, the judgement in *Woulidge* may have prevented this application by reverting to the taxpayer’s estimation of the extent to which the income to be attributed should be limited.

No attempt was made to apply the statement in *Joss* to that judgment. The court’s decision in *Joss* effectively applied the taxpayer’s estimate that the amount of the interest that should have been charged in each of the tax years in isolation was the amount included in his income in terms of the provisions of section 7(3). The tacit acceptance by the court of the taxpayer’s estimate in *Joss* may provide the point of departure for determining the extent of the disposition in the application of sections 7(3) and 7(5) (see example 1).

By limiting the application of section 7(3) to the extent of the disposition, the decision in *Woulidge* could result in a tax saving for the taxpayer that seeks to
divert his income to his minor children (refer to the examples in part 4). However, in doing so, this decision may have exposed the taxpayer to the application of section 103(1). In respect of the scenarios presented in the examples, it is submitted that a transaction, operation or scheme is in place, which has the effect of avoiding some income tax and estate duty. Two provisions of section 103(1) remain available to the taxpayer to avoid the application of the section to be established in terms of the section 82 onus, namely that the transactions entered into represent a normal approach to estate planning and, as such, the rights and obligations are normal in the context of the transactions and/or that the sole or main purpose was not to avoid income tax, but to invoke an estate plan. There is also merit in the argument that the application of the anti-avoidance provision (section 7) in terms of the legislation and associated case law could not result in the application of a further anti-avoidance provision, namely section 103(1). If these arguments are followed through to their logical conclusion, section 103(1) does not apply, because Woulidge merely results in the taxpayer that disposed of the asset being taxed to a maximum of the return that should be earned on the asset that replaced the asset that was disposed of.

The purpose of this article is not to discuss the implications of section 103(1), but rather to identify a practical method of applying the decision in Woulidge to

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9 Section 103(1) provides as follows: ‘Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property)-

a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and

b) having regard to the circumstances under which the transaction, operation or scheme

i was entered into or carried out -

ii in the case of a transaction, operation or scheme in the context of business, in a manner which would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit; and

iii in the case of any other transaction, operation or scheme, being a transaction, operation or scheme not falling within the provisions of item (aa), by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

iv has created rights or obligations which would not normally be created between persons dealing at an arm’s length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

c) was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit,

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.’
the provisions of section 7. The article assumes that section 103(1) would not apply. However, readers should be aware that certain other implications could result from the application of the *Woulidge* decision that is presented in the examples in part 4.

4 Examples

In order to adequately address the practical application of the principle established by *Woulidge*, scenarios have been constructed that illustrate growth from a basic model to more complex models.

4.1 Example 1

The following scenarios have been considered in this example:

- The beneficiaries have a vested right to the income of the trust in which:
  - there is only one beneficiary (a minor child, L) (see 4.1.1)
  - there are two beneficiaries (L and a major child, M) (see 4.1.2)
- The trustees have full discretion regarding the distribution of the income of the trust and there is only one beneficiary (a minor child, L) (see 4.1.3)
- The income retained in the trust in (b) above in reinvested and generates rental income (see 4.1.4)
- The income retained in the trust is used to repay the interest-free loan and the asset has a fluctuating return over a two-year period (see 4.1.5)

The following facts are common to all the above scenarios and the examples that follow:

P (the parent) sells a domestic interest-bearing investment on 1 March 2002 at the prevailing market value of R5 000 000 to a trust that is created for the benefit of his determined beneficiaries by way of an interest-free loan. On the date of the sale of the investment, the base cost equalled the proceeds and as a result there is no capital gains tax effect. The investment has an average return of 20 per cent per annum (altered in scenario (e)) and a market-related interest rate on the loan account (should interest be charged) would amount to an average of 18 per cent per annum. No amount distributed, is considered to be an annuity. The distribution from the trust represents L’s only income.

Should P never have sold the interest-bearing investment, the following would have occurred:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Addition to P’s taxable income (R5 000 000 x 20%)</td>
<td>1 000 000</td>
</tr>
<tr>
<td>Tax on the interest-bearing investment return(^{10})</td>
<td>400 000</td>
</tr>
</tbody>
</table>

\(^{10}\) It is assumed for all the examples that P has used all applicable exemptions provided for in the Act before the inclusions in terms of section 7 and is taxed at the highest marginal rate of 40%. For comparative purposes, the rebate granted in terms of section 6 of the Act is ignored.
4.1.1 Sole beneficiary is P’s minor child (L)

It is submitted that the effect of limiting the application of section 7(3) to the extent of the disposition would have the following effects:

Market-related interest on loan capital balance and therefore the limit for distributions and retentions (R5 000 000 x 18%) 900 000

Tax payable by P on the inclusion of the section 7(3) amount (R900 000 x 40%) 360 000

Tax payable by L on taxable income [(R100 000 - R6 000) - R80 000 x 30% + R17 200] 21 400

Resultant tax saving after the application of Woulidge (R1 000 000 x 40% - R381 400) 18 600

By limiting the amount attributed to P to the interest that should have been charged on the loan account, a tax saving has resulted, because the excess is taxed in L’s hands at a lower rate.

4.1.2 Two beneficiaries – one major (M) and one minor (L)

All income received or accrued to the trust is to be distributed to P’s children in equal proportions (that is, 50% each). Because some of the income is to be distributed to a major child, section 7(3) can have no application for that distribution. Section 7(5) does not apply either as no income is retained in the trust. The issue to be considered is the extent to which L’s distribution from the trust should be included in P’s income?

Because section 7(3) refers to the income received by the minor child by reason of the disposition, it is submitted that the major child has also benefited from the lack of interest charged against the income of the trust. The extent to which the income received by each child is affected by the disposition should mutatis mutandis be apportioned between the children. However, the portion of the limit to be allocated to the distribution received by the major child has no effect on either P or M, because section 7(3) does not apply to that distribution and, as such falls away. Only 50% of the notional market-related interest that is not charged by P should apply to the distribution received by L, the minor child.

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11 The difference between the actual investment income and the determined limit represents L’s gross income, that is R1 000 000 - R900 000 = R100 000

12 The R6 000 applied in this instance is the interest exemption in terms of the provisions of section 10(1)(i) for natural persons under the age of 65 as announced by the Minister of Finance in the budget presented to Parliament on 20 February 2002.

13 While the maximum marginal rate has been applied to the amounts attributed to P, the child’s tax has been based on the tax rate tables for the 2003 tax year of assessment and is the amount before any rebate is taken into account.
In addition to the generic facts above, the major child earns other taxable income that amounts to R170 000 per annum (that is, apart from the distribution received from the trust).

The effect is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market-related interest on loan capital balance and therefore the total limit for distributions and retentions (R5 000 000 x 18%)</td>
<td>900 000</td>
</tr>
<tr>
<td>Portion of the limit applicable to M’s distribution (50%)</td>
<td>450 000</td>
</tr>
<tr>
<td>Portion of the limit applicable to L’s distribution (50%) and therefore the limit for section 7(3)</td>
<td>450 000</td>
</tr>
<tr>
<td>Tax payable by P on the inclusion of the section 7(3) amount (R450 000 x 40%)</td>
<td>180 000</td>
</tr>
<tr>
<td>Tax payable by L on taxable income ([R44 000(^{14}) - R40 000] x 25% + R7 200)</td>
<td>8 200</td>
</tr>
<tr>
<td>Tax payable by M on distributed trust income ([R494 000(^{15}) - (R240 000 - R170 000) x 40% + (R240 000 - R170 000) x 38%](^{16}))</td>
<td>196 200</td>
</tr>
<tr>
<td>Resultant tax saving after the application of Woulidge (R1 000 000 x 40% - R384 400)</td>
<td>15 600</td>
</tr>
</tbody>
</table>

An alternative interpretation with regard to the limit to be applied to the distributions could be that the limit determined is only applicable to amounts that are subject to section 7. In terms of this interpretation, the fact is ignored that M has also benefited from the loan being interest free and, as such, receives a larger distribution. If the minor child receives only half of the income, that child cannot be said to have received the full benefit of the fact that the loan is interest free, but only benefits to the extent that the lack of interest matches the distribution (that is, in the same proportion). If the limit were not apportioned in the manner illustrated in the example above, the application of Woulidge in later examples would be further (and unnecessarily) complicated. Should the court not interpret the extent of the disposition to be limited in the manner presented above, with the effect that the full distribution to L is included in P’s taxable income in terms of section 7(3), the tax saving of having the return on the interest-bearing investment distributed to separate taxpayers is reduced by R11 800 to R3 800 (This saving is attributable to M being in a lower tax bracket before receiving the distribution).

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\(^{14}\) L’s taxable income consists of R500 000 (distribution) - R450 000 (§ 7(3)) - R6 000 (interest exemption)

\(^{15}\) M’s distribution of R500 000 is reduced by the R6 000 interest exemption.

\(^{16}\) M’s other taxable income has been applied to the tax rate tables first, resulting in the distribution from the trust being taxed at the applicable marginal rates. The tax effect of the R170 000 is therefore removed when comparing the total taxes payable on the total income that has arisen on the asset in the trust.
4.1.3 Discretionary trust with partial distribution – sole beneficiary – a minor child (L)

This is a discretionary trust and distributions in terms of this disposition are conditional on the trustees exercising their discretion. Therefore section 7(5) is applicable. It is submitted that, similar to the case of multiple beneficiaries, a portion of the notional interest limit should be applied to the retentions. If R400 000 of the R1 000 000 income that is earned by the trust were retained and the rest distributed to L (the minor child), the net effect on taxes payable (following the approach adopted for multiple beneficiaries) would be as follows:

- Tax payable on the inclusion of the section 7(3) amount (R540 000 x 40%) 216 000
- Tax payable on the inclusion of the section 7(5) amount (R360 000 x 40%) 144 000
- Tax payable by the minor on taxable income 17 10 700
- Tax payable by the trust on the excess above that which is subject to tax in terms of section 7(5) and section 25B(1) 18 [(R400 000 - R360 000) x 40%] 16 000

Resultant tax saving after the application of Woulidge (R1 000 000 x 40% - R386 700) 13 300

This saving is fully attributable to the fact that L is taxed at a lower rate than P.

If the income retained in the trust from the 2003 year of assessment were distributed in the 2004 year of assessment, that income could be said to have benefited from that fact that no interest had been charged on the loan for two years. However, it is submitted that the limit that applied to the income in the 2003 year attaches to the amount retained, and it is the ratio of that limit to the original amount retained that is applied when the retained income, or, if reinvested, the asset, is distributed to minor children (see examples 3 and 4).
The limits are therefore not capitalised and, as such, no notional interest rates apply to these capitalised limits.

Similarly, the interest not charged on the loan account is not capitalised at the end of the 2003 year of assessment. In the above scenarios, the income received by the trust exceeded the notional interest that would have been charged on the loan. However, even if the limit had exceeded the income, it is submitted that any remaining limit falls away (see scenario (c) below). The purpose of Woulidge, it is submitted, was merely to cap the amount that could be attributed to the parent, and not to create income where none existed. Therefore the limit to be applied is submitted as being the lower of the notional interest on the loan or the income received or accrued from the asset sold on a loan account or assets obtained through the reinvestment of previously retained income from the same asset. It would appear illogical to assume that the notional amount should also be considered to be reinvested by the holder of the loan (that is, a further injection of capital into the trust) as this would force an exponential growth to the limit, creating absurd results. The application of a limit that is the lower of the notional interest and the actual income provides a simpler method of accounting for the extent of the disposition with which to obtain a reasonable result for the taxpayer.

Note that, whereas there are capital gains tax implications for assets or capital gains distributed, if the retained income were held as cash and this cash distributed to the beneficiaries, no capital gains tax implications would arise. While the cash distributed is of a capital nature, paragraph 11 of the Eighth Schedule, which determines the actions that constitute disposals, provides the following in the preamble to subparagraph (1):

‘Subject to subparagraph (2), a disposal is any event, act, forbearance or operation of law which results in the creation, variation, transfer or extinction of an asset’ [italics added for emphasis].

The preamble to paragraph 11 refers to ‘an asset’. An asset is defined in the Eighth Schedule as including:

- ‘property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and
- a right or interest of whatever nature to or in such property’ [italics added for emphasis].

Therefore, while cash is held by the trust (representing the income retained from the preceding year and held as an asset by the trust), the disposal of this cash by the trust will not have implications for capital gains tax. For the implications of capital gains tax for the distribution or vesting of capital assets, refer to examples 3 and 4.

4.1.4 Reinvestment of income retained from a previous year of assessment

A critical issue with regard to the application of a limit to the amounts subject to section 7 is the extent to which the income that arises from reinvested income,
that was subjected to the limits imposed by *Woulidge* in the preceding year, should be considered to arise by reason of, in consequence of or to be attributable to the original gratuitous portion of the disposition.

An amount of income that is retained in the trust, having been subjected to tax in terms of section 7(5) of the Act up to the limit in terms of *Woulidge* and the excess in the hands of the trust, changes from a revenue to a capital nature. Should this retained amount then be reinvested in, for example, a rental-producing property, the question that remains is: to what extent does any limit in the current year of assessment that was determined for the original disposition relate to the income from the asset that is created from funds that have previously been subjected to a limit?

It is submitted that the total limit, i.e. the notional interest on the loan, should be applied to each income stream in the same ratio as each income stream bears to the total income received or accrued as a result of the disposition. This method of apportionment will result in realistic results, especially when the original asset has been sold and replaced by an asset that has a return that differs from the original. Furthermore, this approach will be far easier to apply in periods of fluctuating returns on the various assets. Moreover, when, unlike the scenarios presented in this article, distributions are made during the year of assessment, it is submitted that this method will result in the limits being attributed to the correct proportion of income. The net effect remains that P is never taxed on more than the notional interest, irrespective of the quantum of the income streams deemed to arise by reason of the original donation, settlement or other disposition.

This scenario illustrates the principle of amounts retained by the trust that are reinvested and the application of *Woulidge* to the income arising from the reinvested amounts.

Assume that the amount of R400 000, which is retained by the trust (from 4.1.3 above), is reinvested on 1 March 2003 in a property that has an average rental yield of 12% per annum. L remains the sole beneficiary of the trust and is still a minor child. The trustees exercise their discretion on 29 February 2004 to distribute 70% of the income from the interest-bearing investment and 40% of the rental produced by the property.

| Total return on the interest-bearing investment received by the trust | 1 000 000 |
| Rental produced (R400 000 x 12%) | 48 000 |

**Distributed to L:**

| From interest (700 000) |  |
| From rental (19 200) |  |
| Retained in the trust | 328 800 |

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21 Tax rates have been assumed to be unchanged from those applicable in the 2003 year of assessment.
Market-related interest on the loan capital balance and therefore the limit for distributions and retentions (R5 000 000 x 18%) 900 000

Portion of the limit applicable to the amount retained in the trust (section 7(5))

Applicable to interest\(^{22}\) 257 634
Applicable to rental\(^{23}\) 24 733

Portion of the limit applicable to L's distribution and therefore the limit for section 7(3)

Applicable to interest\(^{24}\) 601 145
Applicable to rental\(^{25}\) 16 489

Taxed in minor's hands\(^{26}\) 95 566

Tax payable by P on the inclusion of the section 7(3) amount\(^{27}\) 247 053
Tax payable by P on the inclusion of the section 7(5) amount\(^{28}\) 112 947
Tax payable by the minor on taxable income\(^{29}\) 21 870
Tax payable by the trust\(^{30}\) R 18 573

Resultant tax saving after the application of Woulidge\(^{31}\) 18 757

Whereas the total of taxes payable by all taxpayers is higher than the tax that would have been payable by P on the return from the interest-bearing investment only, additional income has also been created, inflating the taxes payable by the minor child and the trust and resulting in income being attributed in a different ratio. Because the highest marginal rate for individuals is the same as the flat rate for trusts (other than special trusts or testamentary trusts created for the benefit of a minor child), it would be more tax effective to distribute as much as possible of the income from the trust to the minor as all of the tax saving is attributable to the fact that L pays tax at a lower rate than P.

\(^{22}\) \(\frac{(R1 000 000 - R700 000)}{(R1 000 000 + R48 000)} \times R900 000\)
\(^{23}\) \(\frac{(R48 000 - R19 200)}{(R1 000 000 + R48 000)} \times R900 000\)
\(^{24}\) \(\frac{R700 000}{(R1 000 000 + R48 000)} \times R900 000\)
\(^{25}\) \(\frac{R19 200}{(R1 000 000 + R48 000)} \times R900 000\)
\(^{26}\) \((R700 000 + R19 200 - R601 145 - R16 489 - R6 000)\)
\(^{27}\) \(\frac{R601 145 + R16 489}{(R257 634 + R24 733)} \times 40\%\)
\(^{28}\) \(\frac{R257 634 + R24 733}{(R95 566 + R80 000)} \times 30\% + R17 200\)
\(^{29}\) \(\frac{R328 800}{(R257 634 + R24 733)} \times 40\%\)
\(^{30}\) \(\frac{R1 000 000 + R48 000}{(R328 800)} \times 40\% - R400 443\)
4.1.5 A single asset that has a fluctuating return is sold on a loan account for full consideration and the loan capital is partially repaid

This scenario illustrates the principle discussed earlier in the example in which the limit is not fully applied in a previous year of assessment. It is submitted that when the income earned, is less than the limit determined, the unapplied excess falls away and cannot be applied in the following year of assessment, i.e. the limit is the lower of the notional interest and the income actually earned from the assets received as a result of a donation, settlement or other disposition (refer to the earlier discussion). Furthermore, this scenario demonstrates the effect on the limit applied when the loan is repaid. To do this, the example spans two years of assessment and assumes that the tax rates remain unchanged.

Should the income that is earned from the investment that is held by the trust amount to only R600 000 in year one, of which R200 000 is distributed to the minor child (L) and R100 000 to the major child (M), R300 000 would be retained by the trust. If the income retained by the trust were used to reduce the loan after year one, the limit for year two would be reduced. As in the earlier scenario, assume that M has other taxable income of R170 000. The effect in year one would be as follows:

Because the loan account is reduced only at the end of the first year of assessment, the notional interest deemed to be incurred on the loan account for the purpose of identifying a limit amounts to R900 000 (R5 000 000 x 18%). It is submitted that in practical terms, the limit should be based on the average balance of the loan account to the date of distribution (when distributions are made during the year of assessment). An amount of R200 000 is applied to section 7(3) and R300 000 to section 7(5), i.e. the maximum of the limit applicable to the disposition or the actual income distributed from or retained by the trust. A total of R150 000 of the notional interest is deemed to apply to M’s distribution and, while inapplicable for the purposes of section 7, it can be deemed to have been further limited to the actual income of R100 000 distributed to M. Of the original notional interest of R900 000, R300 000 remains unused at the end of year one (representing the difference between the notional interest and the actual income of the trust). Because, as has been submitted, the purpose of Woulidge was merely to identify a limit, the excess of R300 000 falls away and the limit is determined afresh in the next year of assessment, without capitalising or in any other way referring to the previous year’s excess limit.

Assume that in year two, the trust earned income of R1 500 000 from the interest-bearing investment and at the end of the year distributed R450 000 to L and R375 000 to M. Of the current year’s income, R675 000 is retained by the trust. The loan account has an opening balance of R4 700 000 (R5 000 000 - R300 000), having been reduced because the trustees used the retained income to repay the loan account. Therefore year two has a revised limit that has the following effect:
Market-related interest on the loan capital balance and therefore the limit for distributions and retentions (R4 700 000 x 18%) = 846 000

Portion of the limit applicable to M’s distribution\(^{32}\) = 211 500

Portion of the limit applicable to L’s distribution and therefore the limit for section 7(3) = 253 800

Portion of the limit applicable to the amount retained (s 7(5)) = 380 700

Total taxes payable by all persons = 572 596

Resultant tax saving after the application of Woulidge (R1 500 000 x 40% - R572 596) = 27 404

The tax saving can be attributed to the amount of the notional interest that is applied to M’s distribution and M being in a lower tax bracket before the receipt of the distribution from the trust. Further savings result from the lower limit being applicable and L being taxed at a lower rate than P.

The repayment of a portion of the loan capital has provided P with the capital to reinvest elsewhere to his advantage (that is, it could be invested elsewhere to earn a return that would be included in P’s taxable income calculations). It is submitted that only the lower limits should be applicable to the trust and the beneficiaries of the trust, because the income is attributable to a lesser extent to the disposition and to a greater extent to the management of the assets.

\(4.2\) Example 2 – Multiple assets sold at full consideration on a loan account, some of which have a return less than the notional interest rate on the loan account

The previous example provides the basis for the application of a limit to the provisions of sections 7(3) and 7(5). However, those scenarios only consider the sale of a single asset on a loan account, of which the income earned on the asset exceeds the notional interest on the loan balance. It would certainly be considered to be a more frequent occurrence that multiple assets are sold on the same loan account. This example serves to illustrate a practical method of accounting for the disposition limit. It is submitted that it would be necessary to apportion the limit between the various assets that were sold as the trust deed may provide that certain beneficiaries are to receive income only, at the trustees’ discretion, from a particular asset. The limits should therefore be allocated to the various assets.

In addition to the domestic interest-bearing investment, P also sells to the trust a rental-producing property and shares in South African resident

\(^{32}\) R375 000 / R1 500 000 x R846 000
companies on 1 March 2002 at the prevailing market values of R5 000 000, R6 000 000 and R8 000 000 respectively. The investments have average returns of 25%, 17% and 16%\(^{33}\) per annum. Only L, the minor child, may participate in the income from the rental-producing property; only M, the major child, may participate in the dividends received on the shares; and both may participate in income from the interest-bearing investment.

Some issues that arise with regard to the above scenario require resolution. Firstly, how the notional interest limit should be apportioned between the income of the various assets and, secondly, how the limit should be applied when some assets produce income at a lower rate, other assets produce a higher yield than that of the notional interest on the loan, but all the assets were derived from the same disposition. These two issues are interrelated as alternative methods of apportionment could influence the extent of the tax saving.

Based on the facts of the above scenario, two alternative methods exist with regard to the apportionment of the notional interest: either the notional interest is apportioned on the basis of the market values at the date of the sale\(^{34}\) of the assets; or the notional interest is based on the determined or expected yield of the properties. A split of the limit that is based on the ratio of income earned from the various assets appears to be the simplest method of accounting for the limits, rather than basing the limits on fixed market values that may have no bearing on the return from the asset. The limits that are applied to each income stream will therefore differ each year, based on the income used for the distributions. This method should also prove to be a better alternative when distributions are made during the year of assessment rather than at the end of the year of assessment (as in this example). For the purpose of illustration, the income received on each asset will be adopted as the appropriate apportionment method. However, no apportionment method can be said to have blanket application, and it would have to be decided on the basis of the facts of each scenario. To illustrate the difference between the two methods of apportionment, both methods are applied below.

4.2.1 Split of the limit that is based on market values

The allocation of the limit (that is, the notional interest) would result in the following limits being applicable to the income earned from these assets:

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\(^{33}\) While it is noted that the dividend yield for the shares could be unrealistically high, the percentage has merely been selected for illustrative purposes.

\(^{34}\) It is submitted that the use of the market values of the investments at the end of each year of assessment would not result in an appropriate link between the income and the gratuitous element of the disposition. Furthermore, the changes in the market values are more closely linked to the determination of the capital gain or capital loss than to the income received.
As can be seen from the above table, if all the income from the rental-producing property and the shares were to be distributed to the minor child (assuming this was possible in terms of the trust deed), the limits that are based on the notional interest chargeable on the outstanding loan would exceed the income derived from that property. Therefore the full amounts of R1 020 000 and R1 280 000 would be subject to section 7(3).

If this method of apportionment were adopted, it is submitted that the apportioned limit would first apply to the asset to which it was allocated, then to any remaining assets that arise from the same disposition up to a maximum of the lesser of the notional interest and the income earned in total from the assets that arise from that disposition. In the above table, the total actual income from the assets amounts to R3 550 000 (R1 250 000 + R1 020 000 + R1 280 000), which in total is greater than a market-related interest rate on the loan balance. The maximum amount that can be attributed to P and taxed in his name is therefore R3 420 000.

The facts presented earlier are applied in the following example on the basis that L is to receive 70% of the interest income and 60% of the rental income and M is to receive 30% of the interest income and 50% of the dividend income. M has other taxable income of R170 000. It is assumed that both P and M have made full use of the interest exemption prior to any distributions being made from the trust.

<table>
<thead>
<tr>
<th>Income received by the trust</th>
<th>Interest</th>
<th>Rental</th>
<th>Dividends</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income received by the trust</td>
<td>1 250 000</td>
<td>1 020 000</td>
<td>1 280 000</td>
<td>3 550 000</td>
</tr>
<tr>
<td>Distributions to L</td>
<td>(875 000)</td>
<td>(612 000)</td>
<td></td>
<td>(1 487 000)</td>
</tr>
<tr>
<td>Distributions to M</td>
<td>(375 000)</td>
<td></td>
<td>(640 000)</td>
<td>(1 015 000)</td>
</tr>
<tr>
<td>Retained in the trust</td>
<td>0</td>
<td>408 000</td>
<td>640 000</td>
<td>1 048 000</td>
</tr>
</tbody>
</table>

The court decision in the case of Woulidge – A practical application
Market-related interest on loan capital balance and therefore the limit for distributions and retentions (R19 000 000 x 18%)\(^{35}\) 3 420 000

Because the limits for the rental income and dividend income exceed the actual income, all the income retained from these investments will be attributed to P in terms of section 7(5).

Portion of the limit applicable to L’s distribution and therefore the limit for section 7(3)

- Applicable to interest (R875 000 / R1 250 000 x R900 000) \(\) 630 000
- Applicable to rental (limit exceeds income and is therefore limited to income) \(\) 612 000
- Difference between notional interest on rental and actual income applied to interest distributed to L\(^{36}\) \(\) 60 000

Total taxes payable by all persons 1 392 820

Resultant tax saving after the application of Woulidge\(^{37}\) 27 180

The saving can be attributed to the fact that M is categorised in a lower tax bracket before the distribution is received and L is subject to a lower tax rate than P.

Note that the interest limit for L is limited, but that there is an excess attributable to the rental income. The limit for the rental income is first applied to that income and then applied to the other income amounts attributable to the original distribution (that is, the sale of the assets on the loan account).

From the perspective of estate planning, it would have been better for P to require in the trust deed that beneficiaries under the age of 21 may only participate in domestic dividend income and combined interest of not more than R6 000\(^{38}\), it being the interest exemption for natural persons under the age of 65 in terms of section 10(1)(i)(xv). Whatever amounts were then attributed to P in terms of section 7(3) would be exempt in terms of section 10(1)(k) and section 10(1)(i)(xv). The provisions of section 7(5) could have been avoided if all the other income were distributed to the beneficiaries over the age of 21 and only

\[^{35}\] R900 000 interest + R1 080 000 rental + R1 440 000 shares  
\[^{36}\] Because L cannot participate in the dividends distributed by the trust, it is submitted that the excess limit cannot be applied to the difference of the actual interest less the applicable limit.  
\[^{37}\] (R3 550 000 x 40% - R1 392 820)  
\[^{38}\] In his budget speech, presented to Parliament on 20 February 2002, the Minister of Finance announced an increase in the interest exemption for natural persons.
domestic dividend income retained in the trust, which, if attributed in terms of section 7(5), would be exempt in any event.

4.2.2 Split of the limit that is based on the income from the various assets

The allocation of the limit (that is, the notional interest) would result in the following limits being applicable to the income earned from these assets:

<table>
<thead>
<tr>
<th>Interest asset</th>
<th>Rental asset</th>
<th>Shares</th>
<th>Loan value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital sum</td>
<td>5 000 000</td>
<td>6 000 000</td>
<td>8 000 000</td>
</tr>
<tr>
<td>Return %</td>
<td>25%</td>
<td>17%</td>
<td>16%</td>
</tr>
<tr>
<td>Income earned</td>
<td>1 250 000</td>
<td>1 020 000</td>
<td>1 280 000</td>
</tr>
<tr>
<td>Limit apportioned</td>
<td>1 204 225</td>
<td>982 648</td>
<td>1 233 127</td>
</tr>
</tbody>
</table>

Note that none of the income streams have excess limits.

The income distributed in the same proportions as in 4.2.1 of this example results in the following tax effect:

| Market-related interest on loan capital balance and therefore the limit for distributions and retentions (R19 000 000 x 18%) | 3 420 000 |
| Portion of the limit applicable to the amount retained in the trust (section 7(5)) | |
| Applicable to interest (no income retained) | 0 |
| Applicable to rental | 393 059 |
| Applicable to dividends | 616 563 |
| Portion of the limit applicable to L’s distribution and therefore the limit for section 7(3) | |
| Applicable to interest | 842 958 |
| Applicable to rental | 589 589 |
| Applicable to dividends | 0 |
| Total taxes payable by all persons | 1 403 732 |
| Resultant tax saving after the application of Woulidge | 16 268 |

Whereas the above method of apportionment would result in a lower tax saving, it is submitted that it remains the more practical and accurate method of allocating the limit.

39 (R408 000 / R1 020 000 x R982 648)
40 (R640 000 / R1 280 000 x R1 233 127)
41 (R875 000 / R1 250 000 x R1 204 225)
42 (R612 000 / R1 020 000 x R982 648)
43 L cannot participate in the dividends and therefore the limit is inapplicable to section 7(3)
44 (R3 550 000 x 40% - R1 403 732)
4.3 Example 3 – Distribution of a capital asset that is obtained through the original disposition and a capital asset that is created from income that is retained in the trust

In the case of a distribution of a capital asset that is created by the original sale at full consideration on a loan, it is submitted that none of the capital gain should be attributed to the seller of the asset, because the trust has had no gratuitous benefit (it owes the full amount of the consideration). Therefore the attribution rules contained in part X of the Eighth Schedule should only be applied to assets that are not sold for full consideration, or donated, or to capital assets that are created out of income deemed to arise from the gratuitous element of the disposition.

It should be noted that, while in this example the trustees are given full discretion regarding the capital and income distributions, other trust deeds might limit capital distributions to or the vesting of capital gains in particular beneficiaries.

The example below necessarily spans two years. Year one is consistent across 4.3.1 and 4.3.2. Because the calculations for one year are similar to previous examples, but are merely changed in quantum, year one is not presented explicitly.

In 4.3.1, at the end of year two, the rental property acquired from reinvesting the income that is retained in year one is vested in the major child, M. The interest-bearing investment is retained in the trust.

In 4.3.2, at the end of year two, the rental property acquired from reinvesting the income that is retained in year one is distributed to the minor child, L. The interest-bearing investment is retained in the trust.

In addition to the facts stated in example 1, the following considerations apply:

- The interest-bearing investment has a return of R1 000 000 in the first year and R1 500 000 in the second year.
- In year one, R500 000 is distributed to L, R200 000 to M and R300 000 is used to purchase a rental property.
- The rental-producing property has an average return of 10% in year two.
- In year two, 40% of all the income earned is distributed to L, 50% to M and the rest is retained in the trust. In both years, M has other taxable income of R170 000.

4.3.1 Reinvested rental property that is vested in the major child (M)

The property is vested in M at the end of the second year when the market value of the property had risen to R450 000, but the property and gain were retained in the trust, that is, vested, but not distributed. The gain amounts to R150 000,
The court decision in the case of Woulidge – A practical application

which represents the difference between the market value on the date of vesting and the base cost of R300 000.

The limits to be applied are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Interest asset</th>
<th>Rental asset</th>
<th>Loan value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital sum</td>
<td>8 000 000</td>
<td>300 000</td>
<td>5 000 000</td>
</tr>
<tr>
<td>Capital limit</td>
<td>270 000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return %</td>
<td>20%</td>
<td>10%</td>
<td>18%</td>
</tr>
<tr>
<td>Income earned</td>
<td>1 500 000</td>
<td>30 000</td>
<td>1 530 000</td>
</tr>
<tr>
<td>Limit apportioned</td>
<td>882 353</td>
<td>17 647</td>
<td>900 000</td>
</tr>
</tbody>
</table>

The effects are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Interest</th>
<th>Rental</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income received by the trust</td>
<td>1 500 000</td>
<td>30 000</td>
<td>1 530 000</td>
</tr>
<tr>
<td>Distributions to L</td>
<td>(600 000)</td>
<td>(12 000)</td>
<td>(612 000)</td>
</tr>
<tr>
<td>Distributions to M</td>
<td>(750 000)</td>
<td>(12 000)</td>
<td>(762 000)</td>
</tr>
<tr>
<td>Retained in the trust</td>
<td>150 000</td>
<td>6 000</td>
<td>156 000</td>
</tr>
</tbody>
</table>

Market-related interest on loan capital balance and therefore the limit for the application of section 7 (R5 000 000 x 18%) 900 000

Portion of the limit applicable to the amount retained in trust (section 7(5))

Applicable to interest\(^{45}\) 88 235
Applicable to rental\(^{46}\) 3 529

Portion of the limit applicable to L’s distribution and therefore the limit for section 7(3)

Applicable to interest\(^{47}\) 352 941
Applicable to rental\(^{48}\) 7 059

Portion of the limit applicable to M’s distribution

Applicable to interest\(^{49}\) 441 176
Applicable to rental\(^{50}\) 7 059

\(^{45}\) R150 000 / R1 530 000 x R900 000
\(^{46}\) R6 000 / R1 530 000 x R900 000
\(^{47}\) R600 000 / R1 530 000 x R900 000
\(^{48}\) R12 000 / R1 530 000 x R900 000
\(^{49}\) R750 000 / R1 530 000 x R900 000
Gain attributed to P in terms of paragraph 70 51 135 000
Annual exclusion 52 (10 000)
Net capital gain 125 000
Taxable capital gain (R80 000 x 25%) 31 250

Gain attributed to M (R150 000 - R135 000) 15 000
Annual exclusion (10 000)
Net capital gain 5 000
Taxable capital gain (R80 000 x 25%) 1 250

Total taxes payable by all persons 596 600
Resultant tax saving after the application of Woulidge 53 27 900

4.3.2 Reinvested rental property that is distributed to the minor child (L)
The solution for this part of example 6 is almost identical to that of 4.3.1. The only change is the reference to paragraph 69 of the Eighth Schedule rather than to paragraph 70. Furthermore, the tax saving figure is not altered as L is already subject to the highest marginal tax rates and therefore the additional amount attributed to L is taxed at 40%, as is the portion attributed to P.

4.4 Example 4 – Multiple contributors, capital gains tax and sales for inadequate consideration
In each of the above examples, only one person (P) has contributed assets to the trust. This example illustrates (a) how to apply the principle in Woulidge in practical terms to multiple contributors; (b) the impact of a person selling an asset to a trust at less than full market value and (c) the sale of an asset to a trust on a low-interest loan. The example spans two years of assessment and includes the vesting of capital assets.

50 R12 000 / R1 530 000 x R900 000
51 It is submitted that the capital gain to be attributed to P relates directly to the extent of the gratuitous disposition that created the reinvestment, i.e. the ratio of the limit applicable to the retained income that is used to create the new asset. The ratio for this new asset is R270 000/R300 000 in this example. The gain attributed to P is therefore R270 000/R300 000 x R150 000
52 It is assumed for all taxpayers in this and the remaining examples that the capital gain as calculated above is the only gain for the year and, as such, the annual exclusion for natural persons is applicable.
53 (R1 530 000 + 25% x R135 000) x 40% - R596 600
While the implications of donations tax and capital gains tax for the selling of assets for less than full consideration have not been taken into account for the individual on the date of sale, the capital gains tax implications have been taken into consideration for the trust. As a result of the provisions of paragraph 38 of the Eighth Schedule, the base cost for the trust in the event of a sale to the trust for less than full consideration would be the market value.

The facts relating to P (the parent), the trust and the market-related interest rate are the same as in example 1. On the same date as P’s sale to the trust, G (the grandfather) sells a rental-producing property for R3 000 000 (the market value was R4 000 000) and Y (the grandmother) sells a patent (for the full market value of R2 000 000) on a loan account that bears interest of 9%. On the date of the sale of these assets, the base costs equalled the proceeds, with the result that there were no capital gains tax effects. These assets had returns of R1 000 000, R760 000 and R200 000 respectively in the first year; and R1 500 000, R900 000 and R500 000 respectively in the second year.

In year one, 50% of the income is distributed to L, 20% to M and the rest is retained and reinvested in a fixed deposit account (which earns R71 000 interest in year two). In year two, 40% of the income (other than the fixed deposit interest) is distributed to L, 60% to M, the rental-producing property is vested in L and the patent is vested in M, on which dates the market values were R5 000 000 and R2 500 000 respectively. In both years, M has other taxable income of R170 000 and the grandparents are both in the highest tax bracket.

<table>
<thead>
<tr>
<th>Interest asset</th>
<th>Rental asset</th>
<th>Patent (Y)</th>
<th>Loan value</th>
</tr>
</thead>
<tbody>
<tr>
<td>(P)</td>
<td>(G)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market value</td>
<td>5 000 000</td>
<td>4 000 000</td>
<td>2 000 000</td>
</tr>
<tr>
<td>Loan capital</td>
<td>5 000 000</td>
<td>3 000 000</td>
<td>2 000 000</td>
</tr>
<tr>
<td>Limit percentage</td>
<td>18%</td>
<td>18%</td>
<td>9%</td>
</tr>
<tr>
<td>Annual limit on uncharged interest</td>
<td>900 000</td>
<td>540 000</td>
<td>180 000</td>
</tr>
</tbody>
</table>

Paragraph 38 of the Eighth Schedule provides the following: ‘(1) Subject to subparagraph 2 and paragraph 67, where a person disposes of an asset by means of a donation or for a consideration not measurable in money or to a person who is a connected person in relation to that person for a consideration which does not reflect an arm’s length price,

a) the person who disposes of that asset must be treated as having disposed of that asset for proceeds equal to the market value of that asset as at the date of that disposal; and
b) the person who acquired that asset must be treated as having acquired that asset at a cost equal to that market value, which cost must be treated as an amount of expenditure actually incurred and paid for the purposes of paragraph 20(1)(a).

(2) Subparagraph (1) does not apply in respect of the disposal of,

a) a right contemplated in section 8A; or
b) an asset in the circumstances contemplated in section 10(1)(nE).’

This 9% is the difference between the market-related interest rate of 18% and the 9% being charged to the trust.
Additional limit on inadequate consideration 56

<table>
<thead>
<tr>
<th></th>
<th>P</th>
<th>G</th>
<th>Y</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income earned</td>
<td>1 000 000</td>
<td>760 000</td>
<td>200 000</td>
<td></td>
</tr>
<tr>
<td>Total limits applicable to income stream</td>
<td>900 000</td>
<td>730 000</td>
<td>180 000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest</th>
<th>Rental</th>
<th>Royalties</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income received by the trust</td>
<td>1 000 000</td>
<td>760 000</td>
<td>200 000</td>
</tr>
<tr>
<td>Distributions to L</td>
<td>(500 000)</td>
<td>(380 000)</td>
<td>(100 000)</td>
</tr>
<tr>
<td>Distributions to M</td>
<td>(200 000)</td>
<td>(152 000)</td>
<td>(40 000)</td>
</tr>
<tr>
<td>Retained in the trust</td>
<td>300 000</td>
<td>228 000</td>
<td>60 000</td>
</tr>
</tbody>
</table>

Market-related interest on the loan capital balance and additional limits that represent limits for distributions and retentions

<table>
<thead>
<tr>
<th></th>
<th>P</th>
<th>G</th>
<th>Y</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limits applicable to amounts retained in trust (section 7(5)) 57</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Applicable to interest</td>
<td>270 000</td>
<td></td>
<td></td>
<td>270 000</td>
</tr>
<tr>
<td>Applicable to rental 59</td>
<td>219 000</td>
<td></td>
<td></td>
<td>219 000</td>
</tr>
<tr>
<td>Applicable to royalties 60</td>
<td></td>
<td>54 000</td>
<td></td>
<td>54 000</td>
</tr>
<tr>
<td>Portion of the limit 61 applicable to L’s distribution and therefore the limit for section 7(3) 62</td>
<td></td>
<td></td>
<td></td>
<td>450 000</td>
</tr>
</tbody>
</table>

56 \(\frac{[R4 \,000 \,000 - R3 \,000 \,000]}{R4 \,000 \,000} \times R760 \,000\), that is 25% of the income is immediately attributable.

57 Because each income stream is greater than the applicable limit, no excess limit exists to apply to any other income stream.

58 \(\frac{R300 \,000}{R1 \,000 \,000} \times R900 \,000\)

59 \(\frac{R228 \,000}{R760 \,000} \times R730 \,000\)

60 \(\frac{R60 \,000}{R200 \,000} \times R180 \,000\)

61 \(\frac{R500 \,000}{R1 \,000 \,000} \times R900 \,000\)

62 Section 7(3) only applies to income that arises from dispositions from the parent. Therefore the remaining income sources are irrelevant.
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Tax payable by P on the inclusion of the section 7(3) amount\textsuperscript{63} 180 000

Tax payable on the inclusion of the section 7(5) amounts

\begin{tabular}{ccc}
& 108 000 & 87 600 & 21 600 & 217 200 \\
\end{tabular}

Tax payable by M\textsuperscript{64} 153 000

Tax payable by L on taxable income\textsuperscript{65} 187 400

Tax payable by the trust\textsuperscript{66} 18 000

\begin{tabular}{c}
755 600 \\
\end{tabular}

Resultant tax saving after the application of Woulidge\textsuperscript{67} 28 400

The limits applied above are specific to each person that made the disposition and, it is submitted, cannot be attributed to other persons. To do so would be inappropriate.

In year two, the tax effect is as follows:

<table>
<thead>
<tr>
<th>Interest asset (P)</th>
<th>Rental asset (G)</th>
<th>Patent (Y)</th>
<th>Fixed deposit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value</td>
<td>5 000 000</td>
<td>5 000 000</td>
<td>2 500 000</td>
</tr>
<tr>
<td>Loan capital</td>
<td>5 000 000</td>
<td>3 000 000</td>
<td>2 000 000</td>
</tr>
<tr>
<td>Limit percentage</td>
<td>18%</td>
<td>18%</td>
<td>9%</td>
</tr>
<tr>
<td>Annual limit on uncharged interest</td>
<td>900 000</td>
<td>540 000</td>
<td>180 000</td>
</tr>
<tr>
<td>Additional limit on inadequate consideration\textsuperscript{68}</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total limits for the current year's income</td>
<td>900 000</td>
<td>765 000</td>
<td>180 000</td>
</tr>
</tbody>
</table>

\textsuperscript{63} (R450 000 x 40\%)

\textsuperscript{64} \{(R392 000 - R6 000) - (R240 000 - R170 000)\} x 40\% + (R240 000 - R170 000) x 38\%

\textsuperscript{65} \{(R980 000 - R450 000 - R6 000) - R240 000\} x 40\% + R73 800

\textsuperscript{66} (R588 000 - R270 000 - R219 000 - R54 000) x 40\%

\textsuperscript{67} R1 960 000 x 40\% - R755 600

\textsuperscript{68} (R4 000 000 – R3 000 000) / R4 000 000) x R900 000, that is 25\% of the income earned on this asset in the current year of assessment.
### Income earned

<table>
<thead>
<tr>
<th></th>
<th>1 500 000</th>
<th>900 000</th>
<th>500 000</th>
<th>71 000</th>
</tr>
</thead>
</table>

### Fixed deposit income attributable to each income stream

<table>
<thead>
<tr>
<th></th>
<th>36 224</th>
<th>27 531</th>
<th>7 245</th>
</tr>
</thead>
</table>

### Total income to be applied to limits

<table>
<thead>
<tr>
<th></th>
<th>1 536 224</th>
<th>927 531</th>
<th>507 245</th>
</tr>
</thead>
</table>

### Income received by the trust

<table>
<thead>
<tr>
<th></th>
<th>1 500 000</th>
<th>900 000</th>
<th>500 000</th>
<th>2 900 000</th>
</tr>
</thead>
</table>

### Reinvestment interest

<table>
<thead>
<tr>
<th></th>
<th>36 224</th>
<th>27 531</th>
<th>7 245</th>
<th>71 000</th>
</tr>
</thead>
</table>

### Distributions to L

<table>
<thead>
<tr>
<th></th>
<th>(600 000)</th>
<th>(360 000)</th>
<th>(200 000)</th>
<th>(1 160 000)</th>
</tr>
</thead>
</table>

### Distributions to M

<table>
<thead>
<tr>
<th></th>
<th>(900 000)</th>
<th>(540 000)</th>
<th>(300 000)</th>
<th>(1 740 000)</th>
</tr>
</thead>
</table>

### Retained in the trust

<table>
<thead>
<tr>
<th></th>
<th>36 224</th>
<th>27 531</th>
<th>7 245</th>
<th>71 000</th>
</tr>
</thead>
</table>

### Market-related interest on the loan capital balance and additional limits representing limits for distributions and retentions

<table>
<thead>
<tr>
<th></th>
<th>900 000</th>
<th>765 000</th>
<th>180 000</th>
<th>1 845 000</th>
</tr>
</thead>
</table>

### Limits applicable to amounts retained in trust (section 7(5))

- Applicable to interest and attributable reinvestment income\(^{70}\) for P: 21 222
- Applicable to rental and attributable reinvestment income\(^{71}\) for G: 22 706
- Applicable to royalties and attributable reinvestment income\(^{72}\) for Y: 2 571

### Portion of limit\(^{73}\) applicable to L's distribution and therefore the limit for section 7(3)\(^{74}\): 351 511

\(\text{P} = \frac{R300 000}{R588 000} \times R71 000\)

\(\text{G} = \frac{R228 000}{R588 000} \times R71 000\)

\(\text{Y} = \frac{R60 000}{R588 000} \times R71 000\)

\(\text{R36 224 / R1 536 224 x R900 000}\)

\(\text{R27 531 / R927 531 x R765 000}\)

\(\text{R7 245 / R507 245 x R180 000}\)

\(\text{R600 000 / R1 536 224 x R900 000}\)

\(\text{Section 7(3) does not attribute the income of a minor to persons other than the parent}\)
Capital gain vested\textsuperscript{75} & L & M & 1 000 000 & 500 000 \\
Attributable to persons other than the beneficiary (gain retained in the trust after vesting)\textsuperscript{76} & & & 250 000 \\
Gain attributed to the person that made the disposition & & & 250 000 & 0 \\
Annual exclusion & & (10 000) & N/a \\
Net capital gain & & & 240 000 & 0 \\
Taxable capital gain (R240 000 x 25\%) & & & 60 000 \\
Gain attributed to beneficiary & & & 750 000 & 500 000 \\
Annual exclusion & & (10 000) & (10 000) \\
Net capital gain & & & 740 000 & 490 000 \\
Taxable capital gain (at 25\%) & & & 185 000 & 122 500 \\

\begin{tabular}{l l l l}
\hline
& P & G & Y & Totals \\
\hline
Tax payable by P on the inclusion of the section 7(3) amount\textsuperscript{77} & & & & 140 604 \\
Tax payable on the inclusion of the section 7(5) amounts\textsuperscript{78} & 8 489 & 9 083 & 1 028 & 18 600 \\
Tax payable on capital gain attributed to G in terms of paragraph 70 of the Eighth Schedule & & & & 24 000 \\
Tax payable by M (including taxable capital gain)\textsuperscript{79} & & & & 741 200 \\
\hline
\end{tabular}

\textsuperscript{75} L = R5 000 000 - R4 000 000 \ The R4 000 000 (i.e. the market value at the date of acquisition) is used in terms of paragraph 38 of the Eighth Schedule of the Act and not the inadequate consideration \\
M = R2 500 000 - R2 000 000, i.e. the market value at the date of vesting, less the full acquisition consideration \\

\textsuperscript{76} Because only 75\% of the market value was the consideration at the time of the acquisition, it is submitted that 25\% of the capital gain should be attributed to the original seller of the asset at an inadequate consideration. The asset that vests in M was sold to the trust for full consideration and therefore none of the gain has been attributed to the original seller of the asset. \\

\textsuperscript{77} (R351 511 x 40\%) \\
\textsuperscript{78} Each of the section 7(5) limits has been applied to the maximum marginal rate of tax. \\
\textsuperscript{79} \[(R1 740 000 + R122 500 - R6 000) - (R240 000 - R170 000)\] x 40\% + (R240 000 - R170 000 x 38\%)]
Tax payable by L on taxable income (including taxable capital gain)\textsuperscript{30} & 372 796  
Tax payable by the trust\textsuperscript{31} & 9 800  
\begin{tabular}{l}
Resultant tax saving after the application of Woulidge\textsuperscript{32} \\
\end{tabular} & \textbf{29 400}

\section{SARS' approach to Woulidge}

The Explanatory Memorandum to the Taxation Laws Amendment Act 5 of 2001 ('Explanatory Memorandum') provides examples of the application of the capital gains tax legislation to the attribution of capital gains. Included in part X of the Eighth Schedule are anti-avoidance provisions that are similar to those of section 7, namely paragraphs 69 and 70, which are discussed in the preceding sections of this article.

In one example that is presented in the Explanatory Memorandum (SARS 2001:109), assets are sold to a trust on an interest-free loan account. Income is earned from the assets in the trust, certain assets are vested and others distributed to beneficiaries of the trust. All the above occurs in the trust's first year of assessment. The example does not proceed to consider later years of assessment.

In the example, the income earned from the assets that are held in trust is less than market-related interest on the outstanding loan for the year. The income is distributed to a minor child. The notional interest that is determined in terms of Woulidge is, as is submitted to be correct, applied first to the provisions of section 7 in this example. However, the remaining limit is then applied to the capital gains that arise in the year of assessment, that is, capital gains are first attributed to the founder (the loan holder) before being attributed to the beneficiary or trust. This article does not treat the capital gains in this manner and therefore the approach adopted by SARS should be addressed.

In the examples in part 4 above, as in the example contained in the Explanatory Memorandum, the notional interest limit is first applied to the provisions of section 7, i.e. on the income that arises from the assets in the trust. However, in contrast to the example presented in the Explanatory Memorandum, any limit not used against the income earned from the assets in the trust is considered to be lost and is not applied to any capital gains that arise in the year of assessment.

As has been discussed in part 2 above, the provisions of section 7 apply only to the gratuitous element of the disposition, that is, the continuing donation of the interest not charged on the loan account. The interest not charged (i.e. the

\begin{align*}
\text{(R1 160 000 - R351 511 + R185 000 - R6 000 - R240 000) x 40\% + R73 800} & \\
\text{(R71 000 - R21 222 - R22 706 - R2 571) x 40\%} & \\
\text{(R2 971 000 + R185 000 + R60 000 + (R10 000 x 25\%) + R122 500) x 40\% - R1 307 000} & 
\end{align*}
The court decision in the case of Woulidge – A practical application

gratuitous element of the disposition) has a clear causal relationship with the income distributed or retained in the trust, that is, income would have to be first applied to the interest expense before any distribution may take place. However, the assets that generate the income were sold for full consideration on an interest-free loan account. It is submitted that there is no similar gratuitous element to the disposition that relates directly to the capital growth of the asset. Should interest have been charged on the loan, the growth in the value of the asset would have occurred in any event and, as such, no similar causal link exists between the interest not charged on the loan and the capital gain (this is clearly distinguishable from an asset sold at less than full consideration).

The argument for using the limit against capital gains would be that, should interest have been charged on the loan and the income of the trust have been insufficient to fund such interest expense, either the interest would be capitalised to the loan account or a capital asset would be sold to fund the interest expense. As discussed in a preceding section, the capitalisation of a limit would create absurd results and it is therefore dismissed. The sale of one or more assets would therefore be used to fund the excess interest expense and so allocation between all the assets of the excess notional interest does not appear to have merit.

The isolated nature of the example in the Explanatory Memorandum does not consider the following situation. A trust purchases an asset for full consideration, which is immediately settled. A further asset is acquired on an interest-free loan from the parent of the beneficiary (being a minor child). The income earned from the asset that is sold on a loan account is insufficient to cover the notional interest that should have been charged on the loan. No capital is vested in the minor child. In this situation, it would be accepted that the income that is earned from the asset that is sold on a loan account should be attributed to the parent of that minor child in terms of section 7(3) and that the remaining limit is lost, that is none of the income from the asset that is purchased by the trust for full consideration (and immediately settled) is attributable to the parent. However, in a real-world situation, the interest on the loan account (if charged) would have been settled by both sources of income. It would appear to be that, if income from other sources cannot be attributed in terms of sections 7(3) and 7(5), capital gains that are not associated with the gratuitous element of the disposition, i.e. the non-charging of interest, cannot be attributed in terms of paragraphs 69 and 70 (because these capital gains relate to the purchase price and not to the notional interest).

Furthermore, it could be inferred from the example in the Explanatory Memorandum that an implication of the approach adopted by SARS is that unused limits would have to be capitalised and applied to both income and capital gains until such time as these capitalised limits have been fully applied. Not only would an approach of this nature be complex to apply (a principle not demonstrated in the example in the Explanatory Memorandum as it only deals with one year of assessment), but in the application of capitalisation principles,
unused limits could grow exponentially. The result is that not only would all income that is either distributed to a minor child (section 7(3)) or retained in the trust (section 7(5)) be attributed to the founder/donor, but all capital gains would also be so attributed. A consequence of such an application is that the object of using a trust as an estate-planning vehicle would be defeated.

It is therefore submitted that the attribution rules in part X of the Eighth Schedule to the Act are not applicable to assets that are sold for full consideration. However, assets that are created from reinvested income that is derived by the trust or from assets that are donated or sold for less than full consideration would be subject to the attribution rules, as demonstrated in examples 3 and 4 in part 4 above.

6 Conclusions

Ultimately the question remains whether there is a simpler method of applying the court decision in Woulidge. As demonstrated in part 4, there certainly is a practical method of applying it, but this method is numerically complex, considers various values and requires constant reallocation of income-limit amounts.

The above examples illustrate that record-keeping for trusts is critical to the application of Woulidge and that the limits to be determined are moving targets that must necessarily be recalculated whenever a distribution is to be made (often resulting in different implications for the taxpayer). The only constant with regard to the approach taken in this article is that the amount to be attributed to the taxpayer should always be the lesser of the actual income earned from the asset and the determined limit. It is submitted that at least this constant is the ultimate intention of the courts in deciding on matters that relate to Woulidge.

While it has been demonstrated that a practical method of applying Woulidge exists, the viability of this approach remains in question. In all the examples presented, the resultant tax saving in relation to the income generated by the assets in the trust is minimal. The burden of record-keeping and numerical calculations that are involved in determining these limits may result in additional costs of administering the trust that outweigh the benefits to be obtained from the application of the limits. This situation may prevail in most cases and that the taxpayer should therefore accept the greater tax liability in terms of sections 7(3) and 7(5) in return for the reduced costs of administering the trust.

The authors hope that when trusts choose to apply Woulidge, the application of a logical approach (as is done in this article) will satisfy the Commissioner in respect of the onus imposed in terms of section 82 that the legislation and applicable case law have been correctly applied. Alternatively, the Commissioner should supply trustees with a detailed method that takes into
account the regular features of trusts, which, in his opinion, would be the appropriate application of the decision in Woulidge.

**Bibliography**


