Tax Planning for the South African Emigrant to the United States, having reference to proposed & actual legislative changes in 1987 - 1988

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INTRODUCTION

INTRODUCTION

That approximately 40 South African citizens per day are officially emigrating to various countries(1) is common knowledge to some and would be not surprising to many.

The reasons for what may appropriately be called this 'wave of emigration' are beyond the scope of this work. Certainly the decision of each individual or household to emigrate - whether for a few years or permanently, is a personal one, whether based on, inter alia political considerations or a desire to expand their experience or expertise.

Similarly, the proprietary and/or pecuniary consideration of each emigrant are personal. For prospective emigrants who have established themselves financially in South Africa, and who possibly support a family, the value of the South African Rand against other currencies is of grave concern. The prospective emigrant will invariably desire to channel the fruit of his labour to the place where he intends to take up residence - and so the prohibitive Exchange Control Regulations must be assimilated into his plan for emigration.

The multitude of countries to which a South African may (still) emigrate, and the complexity of financial situations which arise for consideration in each case, cannot, practically, be extensively covered in a dissertation of this nature.

The focus, accordingly, is on a protagonist, a South African, who desires to emigrate to the United States of America. What plan/arrangement of assets will result in the most tax-efficient flow of income to the foreign country?

Attention will be paid to the recommendations of the Margo Commission of Inquiry into the Tax Structure of the Republic of South Africa ("The Margo Commission"), and to legislative developments in both South Africa and in the United States in 1987-1988.

ASSUMPTIONS

Our protagonist (M) is married out of community of property;

M and her husband each own 25% of the share capital of a property holding company, Majic Holdings (Pty) Ltd, and a trading company, Majic Hotels (Pty) Limited, which carries on the business of hoteliers.

The other 50% shareholding is held by their two children in equal shares.

Both companies are registered and incorporated under the Company Laws of the Republic of South Africa.

M has invested in various quoted securities, and the family live in a house which is registered in M's name.

There are three motor vehicles in the family.

All the family members are directors of Majic Holdings (Pty) Limited and Majic Hotels (Pty) Limited, and each derives an annual salary and dividend from those companies.

The elder son has emigrated to the United States and is self-supporting. The remainder of the family consider joining him there permanently.

We shall concern ourselves with four types of income generated by the assets located in South Africa :

a. Dividend Income
b. Interest Income
c. Trade Income earned by Majic Hotels (Pty) Limited
d. Rental Income earned by Majic Holdings (Pty) Limited

CHAPTER I

BASES OF TAXATION IN SOUTH AFRICA AND THE UNITED STATES

CHAPTER 1.

BASES OF TAXATION IN SOUTH AFRICA AND THE UNITED STATES

1.1 SOUTH AFRICA

Taxpayers are annually assessed in South Africa for liability for tax on their taxable income, under the provisions of the Income Tax Act No. 58 of 1962, as amended ("the Act"). The Act provides for taxation of "income". Taxable income is determined by calculating the taxpayer's gross income and making certain permitted deductions therefrom. Gross income is defined in Section 1 of the Act as: "the total amount in cash or otherwise received by or accrued to or in favour of any person, during the year or period of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature ..."
(Certain inclusions being thereafter specified, without limiting the generality of the aforegoing definition.)

Tax systems can usually be classified as predominantly source-based or residence-based; alternatively, the system may levy taxes on a combination of these bases.

In South Africa, only receipts and accruals of income derived from a source within the Republic, are subject to tax in terms of the definition of gross income, save in specific limited circumstances. The nationality of the taxpayer, or his domicile or ordinary place of residence is thus of no consequence, save in those exceptional circumstances, in establishing his liability for tax. (The different considerations, which may apply to taxation in terms of a Double Tax Agreement, Non-Residents Shareholders' Tax (NRST) and the Non-Resident's Tax on Interest (NRTI) will be discussed below.)

Although South Africa keeps company with very few countries in having "source" as its base of taxation, the Margo Commission recommended that this base be restrained.

The word "source" is not defined in the Act and we are left to consider how this term has been interpreted by the South African Courts. In the leading case of The Commissioner for Inland Revenue v Lever Bros & Unilever Ltd(2), the Honourable Chief Justice Watermeyer stated (in one of the two majority judgements of the Appellate Division of the Supreme Court) that it is probably impossible to formulate a definition of the word "source" that would furnish a universal test for determining when an amount is received from a source within the Republic. It has been pointed out that this may be the very reason why the term was not defined in the Act.(3)

Nevertheless, Watermeyer C J considered various cases where the source of income had been determined, and drew the inference therefrom(4) that by "source" is meant the "originating cause". Once the originating cause has been identified, it follows that it must then be located geographically.

If more than one cause can be ascribed to the accrual or receipt of the income, and such causes arise in difference localities, the dominant, main or substantial cause must be sought.(5) Incidental causes are thus disregarded and the total income is attributed to the main cause.

If one of the multiplicity of causes cannot be identified as major or fundamental, logically an apportionment of the income between the causes arising in different localities, would follow. A firm statement on this issue has yet to emanate from our Courts. However, this appears to be the practise of the Revenue authorities.(6)

Lastly, Section 9 of the Act provides for certain circumstances where amounts shall be deemed to have accrued from sources within the Republic. The definition of "gross income" in Section 1 of the Act also makes special provision for dividends and recoupments which are deemed to be from a source within the Republic. In terms of paragraph (k) of that definition, dividends from sources outside the Republic received by or accrued to any person other than a company which is ordinarily resident in the Republic are deemed to have been received by or accrued to that person from a source within the Republic. This provision therefore does not apply to non-residents, even though they may be carrying on business in the Republic.

The meaning of the terms "ordinary resident" and "carrying on business" require definition. Section 42 of the Act, for example, provides that Non-Residents Shareholders Tax ("NRST") shall be paid in respect of the amount of any dividend which has been declared by any company, after the 13th June, 1962, if the shareholder to whom the dividend is paid or payable is a person other than a company not ordinarily resident nor carrying on business in the Republic.

Despite representations to the Margo Commission calling for the abolition of NRST, seen to be inhibiting foreign investment in South Africa, the Commission recommended that NRST be retained, even if, following another of its recommendations, normal tax on dividends received by South African residents is abolished.

However, one might note that the Margo Commission also recommended that the Non-Residents Tax on Interest ("NRTI") be retained, yet it was announced by the Minister of Finance in his Budget Speech on March 16, 1988 that legislation would be passed in the forthcoming parliamentary session to abolish NRTI, with effect from March 17, 1988. No similar announcement was made sounding the demise of NRST.

ORDINARY RESIDENT

These words are not defined in the Act and the rule of statutory interpretation - that a word be given its normal everyday meaning as is understood by the language of the time - does not resolve all questions that arise from the use of the term. As a result, the decisions of our Courts are looked to for clarification. It was authoritatively stated by the Honourable Justice of Appeal Schreiner, in the case of Cohen v CIR(7) that the question whether a person is "resident" or "ordinary resident" in a country is one of fact. It was also decided in that case that a person could be "resident" in more than one place at one time, but that the term "ordinary resident" implies one's most fixed or settled residence and thus it would not be logically permissible to hold that a person could be "ordinarily resident" in more than one country at the same time(8). He added, however, that he could see no reason why the types of evidence admitted to prove them should not be the same. Unlike the English Income Tax Act, the South African Act does not cater for temporary stays which constitute technical non-residence.

Residence in the case of a company includes the concepts of management and control. The rule which was established in the early case of Calcutta Jute Mills Co Ltd v Nicholson is that a company resides, for income tax purposes, where the powers of the company are exercised(11B). This view was followed in the South African case of De Beers Consolidated Mines Ltd v Howe (Surveyor of Taxes).(11C) In determining where the central management and control of the company is exercised, the residence of the directors is of little importance; rather the jurisdiction in which the directors habitually meet and conduct the company's business is looked to.

The United States and United Kingdom recognise dual resident companies - which are, for example, incorporated in the US and managed and controlled in the UK. However, this concept is not recognised for South African income tax purposes. (Following the 1988 Budget Speech in the United Kingdom, it is furthermore eminent that the use of United Kingdom non-resident companies will no longer be available.)

Physical presence is not necessarily required to provide ordinary residence,(9) and fictitious or artificial persons such as trusts and deceased estates are capable of having a residence and being resident.(10) The most usual factors considered to determine ordinary residence in South Africa are, inter alia :-

(a) duration and regularity of visits to South Africa
(b) whether there is a fixed abode in South Africa
(c) reasons for residence in South Africa
(d) are belongings stored in South Africa
(e) are assets administered/controlled in South Africa.(11)
(f) reasons for absence from South Africa; length of absence is not decisive.(11A)

CARRYING ON BUSINESS

The Act defines the term "trade" but offers no guidance on what acts constitute "trading" or "carrying on a business" in South Africa. "Trade" as defined in Section 1 includes every profession, trade, business, employment, calling, occupation or venture, the letting of property and the use of patents, trade marks and other similar property. An employee may be ""carrying on a trade" within the ambit of this definition when he is clearly not "carrying on a business" - thus the terms are not identical - the former encompassing a much wider scope of activities than the latter. As will be discussed (below, page ..), only if a taxpayer's trade excludes the carrying on of a business in the Republic will NRST be avoided.

In short, our Courts have held, following English decisions, that "business" is anything which occupies the time and attention and labours as a person; and while the objective of making a profit may assist in determining that a business is being conducted, such profit motive is not essential.(12) It has been stated that because the term is not statutorily defined, it should be given its ordinary meaning in the commercial or business sense - the question being one of fact.(12A) The inference that business is being carried on may be drawn more easily when the test is applied to a corporate taxpayer than to an individual.(13) Isolated profit-making transactions are, therefore, generally excluded.

The starting point for this distinction between companies and individuals was the old English case of Smith v Anderson(13A) where it was stated that, in the case of a company formed for a certain purpose, it could be said at once that it was carrying on business; it was formed for that purpose and for nothing else, and from the very nature of the association, the idea of continuity is inferred.

This statement was followed in the case of Platt v CIR,(13B) and in CIR v Stott,(13C) Wessels JA went even further, stating as follows :

> "If you are dealing with a company, one of whose objects is to buy and sell land, then the company might well be considered to be doing the business of buying and selling land, even though it carries out only a single transaction. ... Before an individual can be said to be carrying on a business there must be some proof of continuity"

This dictum was quoted by our Appellate Division in later cases, for example Yates Investments (Pty) Ltd v CIR.(13D) A person can carry on business through an employee; and an agent may carry on his own business of agency whilst carrying on business on behalf of a principal. There is clearly much scope for discussion of the meaning of these terms "ordinary resident" and "carrying on business" but this cannot be done without a lengthy excursus from the mainstream of the topic under discussion. The significance of their meaning will be emphasized when we discuss those instances where the place of residence or the place where business is carried on provides a specific exemption from, or liability for, tax in terms of the Act (for example NRST and NRTI). The place of residence also assumes importance regarding the application of the provisions of double tax agreements. Domicile is not the test.

1.2 UNITED STATES OF AMERICA

A non-United States citizen who enters the United States is classified as either a non-resident alien (NRA) or a resident alien (RA) and is consequently taxed on either United States source income or worldwide profits respectively. Consequently, the determination of a foreign national's residence is the first and most important evaluation to be made. The emigrant to the United States will be classified as a resident of either South Africa or the United States of America by four different sets of criteria, for four different purposes :-

a. For the purpose of levying donations tax,(14) NRST and NRTI - he/she will be classified as ordinarily resident in the Republic of South Africa or not, according to the criteria outlined above (1.1).

b. For South African exchange control purpose he/she will be identified as non-resident the moment his/her emigration documents are filed.

c. For the purposes of the erstwhile Double Tax Agreement (DTA) between South Africa and United States of America, or any other DTA that may be involved in the emigrant's scheme, the concept of "resident" is important for the application of the treaty, which is directed mainly at avoiding double taxation based on principles of source and residence. The only South African DTA which did not provide a definition of residence was that with the United States of America.(15) This DTA also lacked rules for the resolution of conflicts of dual residence, and there had accordingly to be provision for mutual agreement between the countries. The other treaties have adopted factual concepts, and the sequence of their application in solving conflicts of dual residence is also laid down.(15A)

d. For the purposes of levying United States taxation on the resident aliens' worldwide income and capital profits.

In South Africa there is no correlation (except by coincidence) between "residence" for the purposes of emigration/exchange control, and residence for income tax purposes. In the United States by comparison, a "resident alien" for taxation purposes is determined in some measure according to his Immigration Department status.

DEFINITION AND CONSEQUENCES OF UNITED STATES RESIDENCE

On the 18th July, 1984, the Tax Reform Act amended the United States Internal Revenue Code by inserting a definition of "Resident Alien" (RA) for the first time.

Significant consequences follow the classification of a taxpayer by the Internal Revenue Services (IRS) as an RA or an NRA :-

1. Under the Internal Revenue code of 1986, as amended ("the Code") an alien is subject to United States income tax while an NRA, on the following :-

   a. United States source fixed or determinable periodic income, not effectively connected with the conduct of a United States trade or business including interest, dividends, rents, salaries, wages, premiums, annuities and other fixed or determinable annual or periodic gains, profits and income,(16) at a flat rate of 30% (or such lower rate provided in terms of a DTA). Whether this income is from a source within the United States in determined by a set of technical rules.(17) For example, all interest in a United States banking branch of a foreign corporation; interest paid on accounts with mutual savings banks; domestic building and loan associations; and interest on amount held by insurance companies on deposit, are treated as foreign source income (unless effectively connected with a United States business) and are free of tax when paid to a non-resident alien or foreign corporation.

   b. All income which is effectively connected with the conduct of a trade or business in the United States. In making this determination, two factors are considered :-

i. whether the income is derived from assets used in, or held for use in, the conduct of a United States business;

ii. whether the activities of the United States business were a material factor in the realisation of the income.(18)

If periodic income falls within the effectively connected rules, the NRA is subject to tax at regular United States tax rates.

c. United States source capital gains of a NRA are taxed at regular United States capital gain rates, if effectively connected with a United States business. (The maximum rate of tax levied is 20%) Other capital gains escape tax unless the individual is present in the United States for at least 183 days during the taxable year.(19) A gain or loss from the disposition of United States real estate by a NRA or foreign corporation is treated as a gain or loss that is effectively connected with a United States trade or business.(20)

2. When a RA, the alien is subject to United States tax on :-

a. His worldwide income, wherever earned and whatever the source, both ordinary income and capital gain, to gift and estate taxes on all property, in a manner similar to that regime applicable to United States citizens.(21) Capital gains are taxed by reference to original cost regardless of how long the assets are held prior to obtaining US residence.

Consequently, a non-resident alien of the United States contemplating becoming a United States resident is well advised to review what steps might be taken to insulate his non-United States assets and income from United States taxation.

To illustrate one of the consequences under the code of the distinction between a RA and a NRA, consider the situation where a South African resident becomes a RA while owning shares in De Beers that were bought before becoming a RA. If the shares are sold at a profit he will be subject to tax under the code on the difference between the original purchase price and the selling price of the shares. No allowance will be made for the fact that capital gains are not taxable under the SA Act, and that the proceeds of the sale of the shares will be "blocked" by the South African Exchange Control Regulations. Neither does the Code provide for an adjustment of the purchase price to the value the shares had at the date when the taxpayer became a RA.(22) (On application, the Internal Revenue Service (IRS) may defer the capital gains until the blocked funds reflecting the gain are remitted).(23)

Other important consequences resulting from a change of status include the following :-

a. A resident is required to disclose any "signature" rights he has to foreign bank accounts;

b. In certain situations a resident will be subjected to tax on both the distributed an undistributed earnings of a non- United States corporation in which the resident owns shares.

c. If the nature of the residence in such as to constitute a change in domicile, the worldwide assets of the resident will be included in his estate on his death. (Domicile is established in the United States when an individual lives there with the intention of remaining indefinitely - so it is a subjective test of residence, which is established when either of two objective tests are satisfied. (See below))

d. Various requirements for reporting to the IRS.(24)

Since, for a South African emigrant, the retention of non-resident status will, as a general rule, be preferable to being classified as a resident under the Code (unless, for example, a person with $200 000 of taxable income from United States sources, and losses of $100 000 from foreign business operations could be taxed at a lower rate if classified as a United States resident), the critical question for the foreigner is to know when he will undergo the metamorphosis from NRA to RA status.

DEFINITION OF RA AND NRA (Since July 1984)

A. RESIDENT ALIEN

An alien individual shall be treated as a resident of the United States with respect to any calendar year if (and only if) such individual meets one of the following, objectively determined tests (added to the Code under the Deficit Reduction Act of 1984) :-

i. Such individual is a lawful permanent resident of the United States at any time during such taxable year. Lawful permanent residence constitutes holding a green card which has neither been revoked nor abandoned;

ii. Such individual meets the "substantial presence" test. An individual meets this test with respect to any calendar year if :-

a. the individual was present in the United States for at least 31 days during the calendar year, and

b. the sum of the number of days on which such individual was present in the United States during the current year and the two preceding calendar years (when multiplied by the applicable multiplier) is not less than 183 days.(26)

DAYS	APPLICABLE MULTIPLIER
Current year	1
1st preceding year	1/3
2nd preceding year	1/6

These objective tests are applied on a calendar year basis, regardless of whether the individual elects a calendar or fiscal year for tax purposes.(27) The individual is taxed as a RA for the portion of the year beginning on the day in that year when the individual satisfied (i) and (ii) above.(28) The emigrant might therefore achieve a reduction in tax liability by planning to attain RA status in the middle or towards the end of the tax year.

For the last year of residency, an individual is not treated as a resident during the portion of the calendar year which commences after the last day the individual was a lawful permanent resident or present, as the case may be, during which the individual had a closer connection to a county outside the United States, and is not a resident at any time during the next calendar year.

B. NON-RESIDENT ALIEN

An individual is a non-resident alien if such individual is neither a citizen of the United States, nor a resident of the United States (within the meaning of (A) above). It is clear from these rules that if an individual is present in the United States for 183 days in any one tax year, he is a resident - end of enquiry.

The cumulative three year test has, by comparison, two "escape routes".(28A)

a. The alien will not meet the substantial presence test if he is not in the United States for at least 31 days in the current year (notwithstanding that he may have exceeded the cumulative 183 day test in the two preceding years);

b. Even if the alien is in the United States for 183 days under the three year cumulative test, if he can establish that he has a "tax home" in a foreign country and has a closer connection to such country than to the United States, he will not be considered a RA.(28B) Factors that will establish the alien's "nexus" to the foreign country will be similar to those applied in the "nexus" or "gravity" test for establishing "residence" prior to 18th July, 1984 - inter alia - place of permanent residence; club memberships; location of family members; bank accounts; motor vehicle licences; reason for presence in United States - the leading case being Park v Commissioner.(29) This exception will not apply where the individual has taken steps to apply for status as a lawful permanent resident of the United States(30) (filing an application by relatives or other persons on one's behalf are not relevant). For individuals present in the United States before 1st January, 1985, when the amended provisions first applied, special transitional rules apply :-

(i) if an alien was not a resident of the United States at the end of the 1984 calendar year, only presence from the 1st January, 1985 will be taken into account for the substantial presence test;

(ii) if an alien was not considered resident at the end of the 1983 calendar year, but was resident at the end of the 1984 calendar year, the substantial presence test considers presence in the United States from 1st January, 1984 only.

Specific exemptions to the RA rules exist for foreign diplomats; teachers/trainees; students, commuters, transients and persons who were unable to leave the United States for medical reasons.(31)

One further noteworthy exception to the tax treatment of RAs relates to "foreign income" and "foreign housing costs" of a qualified individual taxpayer.

A United States RA may be a "qualified individual taxpayer" if he is present in one or more foreign country, for at least 330 days, during any consecutive period of 12 months, and earns income attributable to services performed in that country during the qualifying period.(32) The exclusion in respect of the foreign-earned income is limited to specified amounts, increased by $5 000 per annum to a maximum of $95 000 in 1990 and following taxable years.

A person is regarded as "present" in the United States on any day if physically present at any time during such day, unless commuting to employment from Canada or Mexico, or where in transit in the United States for less that 24 hours.(33) In addition, "nominal presence", that is presence for less than 10 days when an individual has a closer connection to a foreign country, is disregarded for the purposes of the "substantial presence test".(34)

The United States has adopted an aggressive approach in general for the prevention of tax avoidance through the use of "tax havens" and artificial constructions of the "substantial presence test". Individuals who meet the cumulative 183 day test are required to file annual statements setting forth the basis on which an exemption is claimed, and bear the onus of proving a "closer connection" is held to the foreign country; Section 7701(b)(a) of the Act provides an anti-avoidance rule : where an individual has been a RA for three years and is

thereafter absent from the United States for less than three years, such alien will be subject to United States tax during the period of non-residency.(35) The anti-avoidance provisions of DTA's will be dealt with in Chapter III.

Until the enactment of the new provisions for RAs and NRAs, an alien claiming to be a NRA under the former "objective intent" test did not file any document with the IRS, regardless of the number of days spent in the United States.

Additional means of government enforcement includes a variety of modern technological surveillance machines; inter alia, computers, airline reservation computers, telephone records and the traditional "neighbour and spurned employee/spouse/friend" source.(36)

With the certainty now afforded by Section 7701(b) of the Code, an alien can control his residency status from year to year under the substantial presence test - possibly choosing to become a United States resident for one year (to take advantage, perhaps, of foreign losses to offset United States gains) and a NRA the following year, to enjoy the favourable tax treatment for non-real estate capital gains.

If, however, an individual has been granted a "green card" (permit entitling the holder thereof to take up lawful permanent residence in the United States) and enters the United States on the basis thereof, but intends returning to South Africa, he will be deemed to have taken up residence in the United States and will be liable for United States tax as a resident from the first day of the calendar year in

which he is present in the United States.(37) It has been reported that the practise of the United States Immigration Department is to withdraw the "green card" from a holder thereof who fails to file a United States Income Tax Return. This practice has apparently induced green card holders from several countries to return these permits to avoid being subject to the United States tax system - the understanding being that green card holders are required to pay tax on their worldwide income, regardless of whether they have entered the United States.(38)

CHAPTER II

EXCHANGE CONTROL

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EXCHANGE CONTROL

South Africa has lived with Exchange Control for ±25 years and its demise in the foreseeable future does not appear imminent. The major step, allowing South African residents to freely import capital, seems unattainable. Certainly, the conditions which compelled the South African Government to impose Exchange Control in the first place, when it experienced the impact of a major capital outflow in 1960,(39) after Sharpeville - have remained remarkably unchanged.

Exchange Control (Excon) affects both income and capital remittances. Episodes which disturb confidence in the political and financial stability of South Africa and/or the current climax of sentiments in favour of sanctions on trade with, and disinvestment from, South Africa, are likely to continue to trigger sales of South African shares from abroad, which would normally result in outflows of short-term capital.

Similarly, were the Financial Rand to rise towards parity with the Commercial Rand, the consequence would be that the price of gold (and other) South African shares would fall for South African residents, and rise for non-residents, which would again result in a strong outflow of capital through the sale of quoted shared by the aggregate of non-residents to the aggregate of residents.

Naturally, if adverse political circumstances were to coincide with a major decline in the price of gold, the impact on the reserves would be severe (as witnessed after the "Soweto riots" in 1976).(40) To a limited extent, the losses which would be sustained on "bailing out" of investments cause this system to operate in an almost self-sealing manner.

The Financial Rand was reintroduced in South Africa with effect from the 2nd September, 1985, and at present the discount against the Commercial Rand is ±30%. Reasoning that a merger of the financial and commercial Rands ought to be preceded by a period during which the discount has been minimal, and given the implication to the Reserve Bank of the Financial Rand discount, the prospect of an early merger of the Financial and Commercial Rands would appear to be slim.

Following these hypotheses, who shall examine the Excon regulations which affect the remittance of capital and income of our emigrant to the Untied States with the expectation that these regulations will not be much changed in the foreseeable future. Upon emigration from South Africa, the following capital transfers are allowed by Excon. (It is noted that notwithstanding the 66% increase in travel allowance in 1987, the other allowances were not increased.)

1. A maximum of R100 000,00 per family unit - transferred through the Financial Rand medium;
2. Travel allowance of R10 000,00 for each member of the family unit, by way of Commercial Rand, if not already used during the six months prior to emigration;
3. Household effects to the value of R20 000,00;
4. A motor vehicle to the value of R20 000,00.

   NOTE: 3. and 4. are allowed, provided they have been owned by the emigrant for at least one year.
5. Inheritances up to R100 000,00 per beneficiary (if non-resident at the time of inheriting) through the medium of the Financial Rand. It is considered that Excon practise is to approve the remittance of the whole inheritance, to a non-resident, upon application.(41)

Provision must be made for all existing liabilities at the proposed date of emigration, and no resort to local borrowing may be had to make up the capital transfer allowance.

Any utilised portion of the allowance of a person who emigrated prior to September 2nd, 1985 may now only be transmitted through the medium of the Financial Rand.(42)

Assets which remain in South Africa are blocked and placed under the control of an authorised dealer (normally and authorised bank which processed the capital transfer application). Share certificates, title deeds and other documents of proof of title to unrealised blocked assets will be held by the dealer, and liquid funds may be invested on behalf of the emigrant in certain approved investments (any shares listed on the Johannesburg Stock Exchange; Government or Municipal stock), or to pay the premiums on approved life assurance policies.

All income from the blocked assets is transferable to the emigrant by way of Commercial Rand (after payment of the withholding taxes).

Director's fees in the sum of R4 000 per annum are remittable to the non-resident directors of a private company; and where the non-resident is a director of more than one such company (or is a member of a close corporation, which was formerly a private company from which he received director's fees) he may receive R4 000 per annum, per company. However, the Excon regulations provide that if the non-resident was an ex-South African resident, a single payment of R4 000 may be remitted per annum, irrespective of how many companies he is a director.

Although the form of the Excon regulations has hardly changed over the last ± 5 years (when the settling in allowance was increased from R30 000,00 per family unit to R100 000,00). It is generally recognised that the Excon system is now strictly policed.

Whether an emigrant's blocked assets are transferred to a holding/investment company; Close Corporation; Inter Vivos Trust, or into corporeal assets, would appear to be of little consequence to Excon. Income earned from these assets should, in principle, be freely transmissible to the non-resident owner or beneficiary.

NOTE : The interest income transmissible is limited to interest which could have been earned at the maximum ordinary banking or commercial rate at the time.

EXCON AND TRUSTS

There are distinct advantages to be gained from transferring a prospective emigrant's assets to an Inter Vivos Trust (see detailed discussion below, Chapter 4).

The advantages may be, inter alia :-

1. The growth of the assets in the settler's hands is pegged, resulting in the possibility of significant Estate Duty or Capital Transfer Tax savings.

2. The loan disposition of the Trust can earn interest income, which income can be invested or dealt with at the Trustee's discretion to maximise the profits which may be transmitted to the emigrant.

3. The flexibility of a discretionary Trust enables the Trustees to distribute the assets thereof among the designated class of beneficiaries, according to their circumstances at any particular time.

Excon is, however, notorious for its tough stance regarding transmissions of assets/income from Inter Vivos Trusts. When considering Excon's policy and practise in this regard, it would appear to be the very characteristic of flexibility and relative anonymity that causes Excon to single out Inter Vivos Trusts for obstructive treatment. As Excon is furthermore disinclined to make its policies known, this has caused great uncertainty for planners wishing to incorporate an Inter Vivos Trust into their scheme.

Bearing in mind that the policies of Excon may change at any time, the following appears to be the current practise of Excon when faced with an application for the remittance of income from an Inter Vivos Trust to a non-resident beneficiary thereof :-

1. The general principle is that income from an Inter Vivos Trust to a non-resident beneficiary may only be remitted through the Financial Rand mechanism (in contradiction of the general ruling that income may be transmitted through the Commercial Rand). In certain circumstances, Excon will make an exception and authorise the transmission of income through normal banking channels. This exception will generally be applied where Excon is satisfied, in their discretion, that the assets of the Trust are the "own assets" of the emigrant - that is, assets generated as a consequence of donations and/or loans by the emigrant, supplemented only by self-generated growth. If there is any indication of third party financing, the Trust will not be treated as an "own asset" Trust. The following are examples of third party financing :-

    a. A loan by a third party to the Trust which assisted in the financing of the acquisition of the assets thereof.

    b. The formation of a Company at the time of creation of the Trust, and financing introduced into the company by a third party (a loan, preference shares or otherwise) on the basis that the Trust subscribes for the growth shares at par, then the structure is considered to be financed by a third party.

A Trust established many years prior to the non-resident's emigration will diminish the presumption against the assets being "own assets" unless the assets are, notwithstanding the age of the Trust, clearly derived from third party financing.

If the Trust is financed by a prospective emigrant, and thereafter and prior to emigration, the settlor dies, a non-resident beneficiary of the Trust may receive the income if Excon is satisfied that the assets in the Trust, had they been in the Estate of the settler at the time of his death, would have devolved on the non-resident and would have become his "own assets".

BLOCKED ASSETS DERIVED FROM A TRUST

Excon will treat assets derived from a Trust and owned by a prospective emigrant in the same manner as if those assets were received by the emigrant from the Trust. In other words, had those assets still been in the Trust, whereof the non-resident would have been designated by the Trustee as a Third Party beneficiary, then Excon is concerned that the income should continue to be transferred through the mechanism of Financial Rands.

Initially, Excon endeavoured to control the situation by directing the authorised dealer to include in the emigration form a certificate to be signed by the emigrant that he was not a beneficiary of a Trust.

This method was easily foiled by terminating the Trust, distributing the capital to the emigrant prior to emigration, which then enabled the emigrant to certify that he "was not a beneficiary of a Trust". So the subsequent directive issued to the authorised dealers was to require the emigrant to certify that "no assets disclosed in the emigration form were derived from an Inter Vivos Trust during a five year period prior to emigration".(44)

The "five year rule" which was previously an informal "three year rule" was superceded by a new Excon ruling on the 1st September, 1986 - that all income to be transmitted from Inter Vivos Trusts required the permission of the Reserve Bank. Thus,, Trust Deeds are now lodged with the Reserve Bank, and each case is considered on its peculiar facts.(45)

Logically, the "age" of the Trust should be irrelevant in the case of "own asset" Trusts - given that income generated by the emigrant's blocked assets would in any event be transmissible through the medium of the commercial rand. If the earlier "five year rule" was a factor which was taken into account by Excon in exercising its discretion in favour of transmitting the Trust assets through the Commercial Rand, then presumably the Reserve Bank, on inspection of the Trust Deed, will be in a position to place the beneficiary of the "own assets" Trust in the same position as he would be were no Trust involved, without the application of any artificial measurement of time.(46)

The above appears to be the present policy of the Reserve Bank - which may make an emigrant inclined to transfer his assets to a "Blocked Asset Trust" to continue to enjoy the Estate Duty benefits from divestment of registered ownership of such assets. However, in the case of Blocked Assets Trusts and Third Party Trusts, there will be the continuing disadvantage of compulsory application for Excon approval to transmit the income on each occasion. In this regard, a directive has apparently been issued to authorised dealers that once approval has been granted for the transfer of income from a Trust, then the dealers are authorised to remit an equal amount of income each year thereafter without the necessity of reverting to Excon. Should the income increase above the amount previously approved, the the transferability of such excess will be subject to approval.(47) The Reserve Bank policy is, naturally, subject to any new directive that may be received from the Minister of Finance.

THIRD PARTY TRUSTS

Where a settlor has allowed his assets to devolve upon non-resident beneficiaries under a Trust, other than himself, Excon generally refuses to permit the transmission of the benefits to the non-resident third parties. The rationale of Excon practise appears to be that an emigrant may legitimately transmit the fruit of his own labour to a foreign country in the event of his emigration - however, where the settlor is not the party who emigrates, or will benefit from the transmission of assets from the Trust, this is a scheme to channel income out of the country to non-residents, and a practise which the Minister of Finance clearly considers undesirable.

Until approximately November 1985, a "three year rule" applied - namely, if the Inter Vivos Trust was established prior to February 1983, applications to remit income in accordance with the Trust Deeds were likely to be favourably considered.(48)

In contrast to this , the present position appears to be as follows :-

i. a "five year rule" in the case of "third party " asset Trusts will be strictly enforced, unless

ii. Excon denies remittability to third parties altogether

iii. Any permitted remittances will be restricted to the medium of Financial Rand.(49)

NOTE : Excon may be prepared to relax these rules upon receipt of an application where it is shown that the blocking of income is likely to cause unconscienable hardship, or where income has been committed to projects abroad.(50)

BEQUESTS TO TESTAMENTARY TRUSTS

There appears to be no objection on the part of Excon to the creation of an off-shore Trust by a Testator, to be nominated in his Will as heir, in substitution of a non-resident beneficiary. The permission to proceed with the creation of such Trusts must be granted by Excon in each particular case, and will necessitate an undertaking by the Testator that no funds will be credited to or transferred to the Trust prior to the death of the Testator, and furthermore that funds devolving on the Trust on the death of the Testator may only be transferred thereto with prior Excon permission.(51)

The validity of such bequests to Inter Vivos Trusts was clarified in the Appellate Division case of Braun v Blann NNO and Another.(52) The case concerned a Testatrix who had conferred on her Administrators, as Trustees, the power to select the income and capital beneficiaries of a Testamentary Trust from a designated group of persons. It was argued that the clause amounted to an unlawful delegation of Testamentary power and should accordingly be treated as pro non scripto.

The Honourable Justice Joubert JA considered at great length the development of the law of Trusts, as well as the nature of the proprietary relationship between the parties to a Trust. Joubert J A's conclusion - that the potestas eligendi out of a certum genus personarum which was an integral part of Roman and Roman Dutch Law of fideicommissa, which should be applied to our law of Trusts - is of considerable importance.(53) The Honourable Judge distinguished the situation where the power conferred on the Trustees is to select income and/or capital beneficiaries from a group of persons designated by the Testator,(54) from that situation where the Trustees have the power to create a new Trust on terms including the appointment of Trustees, left entirely within their discretion. The latter amounted to a delegation of the will-making power to create a new Trust, which the Testatrix should have exercised herself.(55)

Where Trustees of an Inter Vivos Trust are empowered by contract to select beneficiaries from a designated class of persons, such designation is unquestionably good in law. What then of a testamentary bequest to such Inter Vivos Trust? This issue was recently addressed in the case of Kohlberg v Burnett NO and Others.(56) The Testator in this case had bequeathed the residue of his estate to two named Inter Vivos Trusts. The Trusts were discretionary and the Trust Deeds were not attached to the Testator's Will. Such bequest was objected to on the ground that the intended beneficiaries had not been identified in the bequest.

The Honourable Chief Justice Rabie dismissed this objection - basing his finding on the fact that a Trust can receive benefits under a Will (via the Trustees who hold the property in their representative capacities). Thus, the ultimate beneficiaries are intended to, and surely will, benefit by virtue of the provisions of the Trust Deeds, not of the deceased's Will.(57)

The cumulative effect of the Kohlberg and Braun decisions may be of the utmost relevance to our planner, as Testatrix, who may herself be a beneficiary of a South African Inter Vivos Trust with vested rights to the income and/or capital thereof. She may validly bequeath those rights to an off-shore Inter Vivos Trust even if, were such Trust a Testamentary Trust, the bequest could be invalidated on the grounds that it involved a delegation of testamentary power.

OTHER RELEVANT EXCHANGE CONTROLS

Income which our planner may receive whilst a NRA (particularly as such income from a non-United States source may be received tax free) she may wish to invest in South Africa - thereby reaping the benefits of the Financial Rand. Prior to the "Rangle Amendments" of 1988 there were no exchange controls for United States RAs or NRAs, except to a limited number of countries (e.g. Vietnam, Cambodia, Cuba) of which South Africa was not one. However, SA has now been listed as one of these "proscribed" countries, in terms of Section 901(j) of the Code (See Chapter IV below).

The "Tax Haven" which our planner may incorporate into her scheme will, as is usually the case with "Tax Havens" be free of Exchange Control.

CHAPTER III

PLANNING FOR THE EMIGRANT

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The foundation of the emigrant's plan should, as far as possible, be laid before her emigration. Assuming that the emigrant will endeavour to retain NRA status for as long as possible in the United States, we shall first consider the emigrant's tax situation prior to becoming a United States RA. The special provisions which would apply to the emigrant once declared a RA will be discussed in Chapter IV.

The planner will apply to the Reserve Bank, via an authorised dealer, for the remission of the full settling in allowance, which is currently granted to a family unit :-

1. R100 000,00 from the combined cash on hand of the planner and her husband after deducting all liabilities and travel costs, plus R10 000,00 travel allowance for each member of the family;

2. A motor vehicle up to the value of R20 000,00;

3. Household goods and personal effects up to the value of R20 000,00.

Application to the Reserve Bank is required when the emigrant's assets exceed the settling-in allowance. Furthermore, as the planner is a shareholder in a South African company, application must be made to an authorised dealer for exemption from the restriction on local borrowings which applies to "affected persons", that is a legal person of which a 25% or greater interest is held by non-resident persons. The balance of the household furniture and effects, and the motor vehicles will be realised, and the proceeds thereof added to the planner's blocked assets which are held by the authorised dealer. The fundamental question therefore is - how best to deal with the blocked assets? Severe restrictions thereon are applied by Excon.

The well-recognised advantages of the Inter Vivos Trust have been briefly mentioned above, namely :-

i. to peg the growth in the planner's estate, for estate duty or capital transfer tax purposes; and

ii. the flexibility and ease of maintenance of the discretionary trust.

We shall therefore consider firstly the implication of incorporating an Inter Vivos Trust into the emigrant's plan.

THE INTER VIVOS TRUST

The South African Trust is an institution sui generis derived from the English law of trusts. The English conception of an equitable ownership distinct from, but co-existing with the legal ownership is, however, foreign to our law,(58) and the proprietary consequences of the Trust, (particularly the nature of the Trustees and the beneficiaries' rights over the assets forming part of the Trust) is still uncertain in our law(58A) notwithstanding that this matter was discussed at length in a recent Appellate Division case.

The duty to pronounce our law of trusts lies with the legislature, and not the judiciary. The Trust Property Control Bill was promulgated in February 1988 and provides in particular for the regulation and control of trust property : It also clearly provides that the trustee administers the property solely for the benefit of the beneficiary thereunder, and that the trust property shall not form part of the assets of the trustee unless he is a beneficiary thereunder. Until the Bill becomes law, the duties flowing from the trust will probably continue to be regarded as similar to those involved in the stipulatio alteri. The suggestion has been made that the South Africa law of Trusts might invest the trust beneficiary with a ius in re aliena, or a limited real right in the trust property, leaving the trustee with the correlative dominium minus plenum. The disparate proprietary interests vesting respectively in the trustee and trust beneficiary would thereby be identified and safeguarded.(59)

Without wishing to derogate from the issue at hand, it shall be accepted that once a planner validly settles his assets in a trust, he is thereby divested of ownership therein - and, failing adequate consideration therefor, would be liable for donations tax.

There are three essential requirements for a valid trust :

(i) certainty as to the settlor's intention to create a trust;

(ii) certainty of the subject matter of the trust;

(iii) certainty as to the beneficiaries for whom the trust is created.

The two planning trusts are the fixed interest trust and the discretionary trust. The fixed interest trust involves an express declaration for specified persons to have certain rights to part or all of the trust property. This type of trust is not suitable for arrangements that required a high degree of flexibility, but they are useful where there are tax or Excon disadvantages to making the trust discretionary, or where the use of a discretionary trust is unacceptable or inappropriate to the planner.

Assume that the planner realises and consolidates her blocked assets, and settles the blocked assets, save for the interest in the two companies, on an Inter Vivos Trust - The M Family Trust. The beneficiaries thereof will be M, her husband and their children. The Trustees will have the unfettered discretion to determine in what proportions the capital and income of the trust shall be distributed amongst the beneficiaries, and will decide how the blocked assets shall be dealt with (for example, the fixed property (the family residence) will be transferred into the name of "XYZ, the Trustee/s for the time being of the M Family Trust" and rental income may be earned therefrom. Alternatively, it may be realised and the proceeds invested to yield tax-free Escom or RSA stock - depending on the exigencies of the property and share markets.)

Should "M" decide to donate the blocked assets to the trust, then "M" will be liable for donations tax thereon, unless the donation only takes effect when "M" has relinquished her residency status in South Africa.(60) Whether the assets are donated to the trust or sold thereto, assuming that the assets will grow in value - an estate pegging exercise will have been successfully performed.

An advantage of donating the assets rather than selling them (the purchase price to be secured by way of a "loan note") might arise in the event of the insolvency of the planner (for example, where the planner has personally stood surety for the debts of Majic Hotels (Pty) Limited). In this event, should the donation of the Trust have been made for more than two years prior to the insolvency, then those assets will probably be protected against attachment by creditors. Where, however, the planner holds a loan note for the purchase price of the assets, such would constitute an asset in her hands, which might be attached on insolvency, and the loan recalled.

The planner who wishes to donate the assets to the trust when he is no longer resident in the Republic (to avoid liability for donations tax) must be careful to ensure that he has not been declared a RA for United States tax purposes before the donation is made, so that the rules relating to "Grantor Trusts" will not apply. The advantages to be gained by settling the assets on the Trust in return for a loan might be, inter alia :-

a. The loan could earn interest, which would be income that is remittable to the emigrant by way of the Commercial Rand. (The Margo Commission has recommended that interest-free loans should be subject to the newly introduced capital transfer tax.)
b. The Trust would pay the Non-Resident Tax on Interest on behalf of the shareholder - thereby whittling down the balance owning on the loan, and simultaneously the value of the emigrant's dutiable estate. However, in view of the Budget announcement of the Minister of Finance that NRTI will be abolished, this will no longer apply.

c. Should the assets in the Trust devalue, then the loan may be reduced commensurately, with no estate duty disadvantages.

d. The proceeds on the loan may be ceded to an off-shore Trust, which might re-invest same, tax free, and the asset will no longer meet the definition of "deemed property" for Estate Duty purposes (see further, below).

The viability of the Estate pegging exercise is, of course, subject to any amendments which may be made to the Estate Duty Act (No. 45 of 1955) and the possibility that this Act may yet be revoked in its entirety, and replaced by the Capital Transfer Tax - following the recommendations of the Margo Commission. While there is still an Estate Duty Act to contend with, the planner must be cautious not to be frustrated in her scheme by the deeming provisions of Section 3 thereof.

Sub-section 3(3)(d) of the Estate Duty Act provides as follows :- "Property which is deemed to be property of the deceased includes ... property (.....) of which the deceased was immediately prior to his death competent to dispose of for his own benefit or the benefit of his estate".

Sub-section 3(5) provides :- "For the purposes of paragraph (d) of sub-section (3) -

(a) the term "property" shall be deemed to include the profits of any property -

(b) a person shall be deemed to have been competent to dispose of any property -

(i) if he had such power as would have enabled him, if he was sui iuris, to appropriate or dispose of such property as he saw fit whether exercisable by will, power of appointment, or in any other manner;

(ii) if under any deed of donation, settlement, trust or other disposition made by him he retained the power to revoke or vary the provisions thereof relating to such property;

(c) the power to appropriate, dispose, revoke or vary contemplated in paragraph (d) shall be deemed to exist is the deceased could have obtained such power directly or indirectly by the exercise, with or without notice of power exercisable by him or with his consent. (My underlining).

With these provisions in mind, the planner may insert a clause such as the following into the Trust Deed to ensure the assets therein are not deemed to be property in her estate :-

"The provisions of this Trust Deed may be varied in writing by the Trustees and settlor (during her lifetime) acting jointly, and after the death of the settlor the provisions of this Trust Deed may be varied in writing by the Trustees, acting unanimously, provided that the Trustees and the settlor may not vary the provisions of this Trust Deed to benefit themselves or their estates."(61)

The planner will invariably be concerned by an outright divestment of her assets, over which she may no longer exercise control. However, it is submitted that the so-called "Dog-Collar" Trust where the planner retains the right to remove from office any Trustees, and replace them with such persons as she shall decide, notwithstanding the provision that there shall be at least three Trustees during the lifetime of the planner - does not adequately oust the planner's powers of control for the purposes of Section 3(5). It may well be argued that the two Trustees (besides the planner) are not legally bound to act according to her bidding.(62) Nevertheless, the mere fact that the planner retains the power to dismiss and replace Trustees leads to the almost inescapable inference that the planner retains the power of revocation because of her power over her co-Trustees. The inference would be strengthened, where the planner is also a beneficiary of the Trust, that the assets are being administered to benefit her or her estate.

Thus, a preferable construction may be :-

(a) not to appoint the planner as a Trustee, thereby giving the Trustees a totally unfettered discretion; or

(b) give the planner a power of veto over the appointment of the Trustees; or

(c) ensure that the planner, if a Trustee, can be ousted by a simple majority vote by the remaining Trustees; or

(d) appoint Majic Hotels (Pty) Limited as one of the Trustees, thereby providing another layer of protection to the planner. The planner, by holding preference shares in the Company, may effectively control the company, and the company as Trustee would probably survive the lifetime of the planner, so that the benefits of the creation of the Trust may endure.

There is unfortunately no South African case law to date on the application of the abovementioned deeming provisions of the Estate Duty Act. By way of illustration, we may consider the English case of In Re Penrose,(63) which considered the provisions of Section 2(1) of the English Finance Act, 1984 - which are substantially similar to the provisions of Section 3(3)(d) of the Estate Duty Act. The case involved a donee who retained the power of appointment over the assets in a fund. He was accordingly able to appoint the fund to himself and thereafter dispose of same as he saw fit. The purpose of that construction was clearly to appoint the fund for the objects he intended to benefit. The Court found that it made no difference to the factual situation if the donee could only achieve his object in two steps instead of one.

It might be expected that our Courts would adopt a similar approach - concerning itself with the "substance" above the "form" of the provision - in applying Section 3(5).

The planner's concern to exercise substantial control over her assets might rather be catered for in an informal manner. The following serve as suggestions therefor :-

a. The planner may address a "letter of intent" or "letter of wishes" to the Trustees. (64) Though couched in precatory terms, the letter has no formal binding power on the Trustees. The Trustees, on the other hand, might appreciate direction of this nature in the exercise of their discretion. It may be generally assumed that the planner will appoint Trustees who will "rubber-stamp" her wishes as and when formulated.

b. The "secret trust" is an institution which has been recognised by, inter alia, the English Courts, but which has not yet been presented for consideration by our Courts. A "secret trust" exists when four essential requirements are present :-

   i. the intention of the settlor to subject the "primary donee" (trustee) to an obligation in favour of the "secondary donee" (beneficiary);

   ii. communication of that intention to the primary donee;

   iii. acceptance of her obligation by the primary donee, either expressly or by acquiescence;(65)

   iv. the property, the subject of the Trust, must be certain.(66)

The English law has concerned itself mainly with Testamentary secret trusts. It is submitted, however, that where evidence has been admitted which contradicts the express provisions of the Will (which would usually signify a contravention of the Wills Act) then a fortiori with regard to an Inter Vivos Trust may evidence be led showing that the beneficiary nominated was not the beneficiary intended.

Smith, in an Introduction to the Canadian Law of Trusts,(67) states that "most ... true secret trusts involve testamentary or intestate situations." By implication, therefore, Inter Vivos Trusts may be involved.

In the British case of Ottoway v Norman,(68) the abovementioned four essential requirements were cited, and the Honourable Justice Brightman stated that clear evidence was required to show that the testator did not mean what was stated in his Will.

Further, in the Canadian case of Feltner v R,(69) it was held that an express or implied promise on the part of the donee-trustee to carry out the settlor's intention, is a further factor lending credence to the contention that the transaction is in fact one of trust.

Lastly, in the case of David v Skoze,(70) the Court enforced the secret trust against the donee-trustee, where it was found that both the donee-trustee and the settlor-beneficiary were in pari delicto.

It is patently clear that the "secret trust" institution would have the effect in South Africa of avoiding the restrictions of Excon, particularly where it is not disclosed that the ultimate beneficiaries of the Trust may be South African residents. It therefore remains to be considered whether the validity of such a trust will be upheld in our law :-(71)

Supposing that the primary donee (-trustee) is an off-shore trust (for example, a Guernsey Trust, where English law is generally applicable); the secondary beneficiaries are the settlor's children (South African and non-South African residents). There are a few alternatives as to which law will govern the terms of the Contract :

1. The lex loci contractus would be South African law. As the parties to the contract have the capacity to contract, such contract will be formally valid.
2. The intrinsic validity of the contract will be determined by the "proper law of contract" - that is, either -

(i) the system of law which the parties intended should govern the contract, provided there is some substantial connection with the contract, and/or

(ii) the law of the place where the administration of the trust is to take place.

Forsyth(72) indicates that the predominant view is that the terms of the administration should prevail; and Morris(73) is illustrative on the point where he submits that :

a. illegality by the lex loci contractus ought not to be fatal to the contract;

b. a contract which is illegal by its proper law cannot be enforced in England;

c. an English Court will not enforce a contract which is illegal under an English statute or which is contrary to public policy.

Thus, where the provisions of the secret trust are conveyed by the South African settlor to the primary donee (the off-shore trust) in Guernsey, and the trust is to be administered in Guernsey - Guernsey would appear to be the proper Law of Contract, and the transfer of assets from that donee to the intended beneficiaries may well take place; or at least be enforceable, albeit in breach of the Excon regulations.

3. A further controlling device in the hands of the planner is her ability to recall the loan account, should the Trustees at any stage prove to be recalcitrant.

The United States rules of practise regarding "Grantor Trusts" are a useful illustration of the notion of "control" over the Inter Vivos Trust, and shall be considered in greater detail below (Chapter IV).

Thus, were the planner to sell her rights against the trust for the repayment of the loan to an off-shore trust, her right to payment of the purchase price from the off-shore trust cannot be enforced in our Courts (as the contract was not concluded, and the parties are not resident, nor is performance required to be made in South Africa) and the purchase price of such loan account cannot therefore be included as "property" in the Estate. As there has been no agreement of "donation", neither does liability for donations tax arise.

NRST

We have thus dealt with the situation where the planner has settled growth assets on the trust, and wishes to avoid a construction where she can be deemed to control those assets, such that they may be included as deemed property in her Estate. What then of the situation where the trust fund does not consist mainly of growth assets but instead these funds have been applied to purchase shares with a high income yield, and the planner's primary objective is to receive as much income in her new country of residence as possible?

The provisions of Section 7 of the Act - which deem income to have accrued to or have been received by a taxpayer in certain circumstances, may have useful implications for the planner. (While there is no shortage of case law on the interpretation of the provisions of Section 7, and its provisions merit an entire report on their own, only certain of these will be discussed hereunder.)

Section 7(5) or 7(6) in conjunction with Section 10(1)(k)(ii) provide attractive tax-saving opportunities for the planner :-

Section 10(1)(k)(ii) provides that there shall be exempt from tax dividends received by or accrued to or in favour of any person (other than a company) <u>not ordinarily resident nor carrying on business in the Republic</u>.
(My underlining.)

Dividends sourced in South Africa do not escape the tax net altogether, however, as this section must be read together with Section 42(1) - the relevant portion thereof providing that : "Non-Resident Shareholders' Tax (at the flat rate of 15%, or such lower rate as may be provided in terms of a Double Tax Agreement) shall be paid in respect of the amount of any dividend (...) which has been declared by any company after the 30th June, 1982, if the shareholder to whom the dividend, or interim dividend, has been paid or is payable, is a person other than a company, not ordinarily resident nor carrying on business in the Republic ..."

It has been contended that in order to incur a liability for NRST a dividend, as defined, must have been declared, or an interim dividend must be approved by the directors, or a person acting under authority conferred by the Memorandum and Articles of Association. This would imply that deemed dividends, arising by virtue of the provisions of Sections 8B, 8C and 8D of the Act will not attract NRST. Accordingly, it is submitted that the exemption from NRST provided in Section 8B(3)(d) is superfluous.(73A)

Furthermore, although Section 42 does not refer to the source of the dividends in levying NRST, Section 46 of the Act makes it clear that NRST is payable on dividends, only to the extent that these are derived from Republic-sourced profits.

A "shareholder" is defined in Section 1 of the Act as :-

a. in relation to any company, the registered shareholder in respect of any share, or some other person who is entitled ....., by virtue of any agreement, contract or otherwise to all or part of the benefit of the rights of participation in the profits or income attaching to the shares so registered ..."
   (My underlining).

(The determination of the person who is the shareholder is made at the date when the dividend is declared or, when no formal declaration is made, at the date when the distribution is made and the shareholder is entitled thereto.)

b. .....

c. in relation to any Close Corporation, a member of such Close Corporation.

Thus, where the emigrant has settled shares in South African companies on a Republic discretionary trust - the trust is the registered shareholder in respect of those shares. Where, however, the Trustees have a discretion to distribute the income to the beneficiaries, but there is an additional stipulation by the planner which, were it not for the trustees' discretion aforesaid, would prevent the income from being received by the beneficiaries, then the provisions of Section 7(5) have been met,(74) and such dividend income as has not been paid by the Trustees to the beneficiaries is deemed to be the income of the planner. (The question whether a mere conferment of discretion on the Trustees, without any other stipulation, is sufficient to invoke the provisions of Section 7(5) is yet to be decided by our Courts. It is submitted that, along the lines of the argument for the taxpayers in Dempers'(75) case and in Berold's(76) case, that such provision would not amount to a "stipulation", and furthermore that Section 7(5) is limited in its application to the very narrow circumstances such as were present in Dempers' case.)

However, the planner is not the "registered shareholder" of the shares, neither, as the beneficiary of a discretionary trust, is she "entitled to" the benefits of the profits. Thus the non-resident planner cannot be liable for NRST in terms of Section 42(1). The trust, also, is not liable for income tax on the dividends since they are deemed, by Section 7(5) to be the income of the donor.(77) The dividends are thus earned by the Trust entirely free of tax. The provisions of sub-Section 7(5) only apply, however, where the income received by the trust is not distributed to the beneficiaries in the year of receipt.(77A)

Where the planner has reserved the right to revoke the conferment of income on a beneficiary of the trust, or to confer same on another (as contemplated by the provisions of Section 7(6)), the dividend income earned by the trust shall be deemed to be hers for as long as those powers are retained. The logic which applied to the arrangement with Section 7(5) above, will equally apply in this instance, save that the provisions of Section 7(6) apply where income is distributed to the beneficiary, and the planner will then fall within the exemption from income tax contained in Section 10(1)(k)(ii).

Dividend income of this nature should be remittable to the non-resident planner without any objection from Excon, and free of the "onus" of establishing that the income is derived from "own assets".

One might have expected that a similar scheme to those outlined above could be implemented by the use of the provisions of sub-Section 7(7) to avoid NRST. This sub-Section provides, in essence, that where a taxpayer has made a donation, settlement or other disposition whereby his right to receive income is ceded or otherwise made over for the benefit of a third party, and the cession is such that the taxpayer retains an interest in the property ceded, or is entitled to regain his interest therein, in circumstances where, but for the donation, settlement or other disposition the income would have been received by the taxpayer - such income shall nevertheless be taxable in his hands.

However, the use of this section in a NRST-avoidance scheme is specifically countered by the provisions of Section 43A of the Act, which provides as follows :-

> "if under the provisions of Section 7(7) any dividend is for normal tax purposes deemed to have accrued to any person, such person shall, for the purposes of this part be deemed to be the shareholder in respect of such dividend, and to be the person to whom, or in whose favour, the dividend accrues."

It is not entirely clear why the provisions of Section 43A stop short of deeming the donors in sub-Sections 7(5) and 7(6) to be the shareholder, in appropriate circumstances. However, the Margo Commission recommended that "schemes ... involving the use of trusts where dividend income is deemed to have accrued to non-residents in terms of Section 7 of the Income Tax Act be countered."(77B)

Revenue may seek to apply the provisions of Section 7(7) to the planner who has disposed of her blocked assets to a trust in return for a loan note. It might be argued that she is able to regain ownership of the settled property by calling up the loan. Where the loan is outstanding, however, and no fixed time for repayment thereof is stipulated, it is doubtful whether she is entitled to regain ownership in the property at a fixed or determinable time, as required by sub-Section 7(7).

It is contended that dividends earned by the trust will be taxed as dividends in the hands of the beneficiary thereof. This contention rests on the "conduit-pipe" principle laid down in the early Appellate Division case of Armstrong v CIR(79) where it was held that income, the subject of a trust, retains its identity until it reaches the parties in whose hands it is taxable. Thus, where dividend income is earned, the beneficiary is entitled to the percentage dividend deduction; if interest on government stocks is earned by the trust, and the beneficiary is not ordinarily resident nor carrying on business in the Republic, she may be exempt from normal tax thereon, in terms of Section 10(1)(h) (provided the other elements of that provision are satisfied).(80)

The subsequent case of SIR v Rosen(81) confirmed the rule outlined in Armstrong's case and tenuously added the proviso that the income earned must be paid to the beneficiaries in the same year of assessment as it accrued to the trust.(82)
It would follow that where the income is not actually paid but is deemed to be the income of the settlor, the benefit of the application of the conduit-pipe principle will still be enjoyed (notwithstanding that the income may have been reinvested by the Trustees on his behalf).

The practice of the Commissioner of Inland Revenue regarding the taxation of trusts is to tax, in the hands of the trust as such, income received and retained in the trust in the year of assessment. The trust is taxed at the rate applicable to an unmarried natural person. Where the trust is a vesting trust, the income is taxed in the hands of the beneficiaries, on whose behalf it is received and possibly invested by the trust. In the case of the discretionary Inter-Vivos trust, however, there has been no accrual to the beneficiaries of the trust until the trustees have exercised their discretion and distributed the income to them, or dealt therewith on their behalf.

Where the trustees of the discretionary trust retain the income in the year of receipt, and distribute same the following year, the Commissioner's practise is to tax the income in the hands of the trust in the first year. The receipt by the beneficiary in the second year will not be subject to further tax, as the inference against double taxation, referred to in the Delfos case, amongst others, will apply.

Whether this practise is strictly in accordance with the law of trusts or the Income Tax Act is still a matter of doubt. The definition of "representative taxpayer" in the Act refers to the person being represented, whereas a trust is not a recognised juristic person in our law.(84A)

It is submitted, however, that were income not capable of being taxed in a trust, then any subsequent distributions to the beneficiaries thereof would be taxable, the result whereof would be the eradication of the trust as a useful income-splitting device.

In any event, however, one might expect that this use for the trust will be laid to rest if the recommendations of the Margo Commission - to tax trusts at the flat rate applicable to companies, and to curb tax avoidance practices by the use of Inter Vivos trusts - are implemented.

To revert then to the case where the discretionary Inter Vivos trust is a registered shareholder, the provisions of Section 44(1)(b) which stipulates that agents receiving dividends "on behalf of a shareholder" must deduct NRST will not apply, as the trust, as shareholder, is the beneficial recipient of those dividends. Where the dividends are distributed from the trust to a non-resident beneficiary in the year that they are earned by the trust, NRST will not be deductible as the dividends as such were not payable to the non-resident, and hence the provisions of Section 42 of the Act will not apply. Neither will ordinary tax be payable by the trust, as the income was distributed in the year of receipt. Thus by interposing a trust between the beneficiary and the company one can avoid both normal tax and NRST, as the law currently stands.

Finally, it might be considered that where shares which have been held as an investment in the trust are realised, the profit on realisation would very likely be regarded by Revenue as a capital profit. As such, the profits would be added to the planner's blocked assets. Thus where the planner's concern is to receive as much income as possible in the new country of residence, the temptation to make a large capital profit on the sale of the shares should probably be resisted where the shares yield substantial dividends.

THE COMPANY AS A VEHICLE IN THE EMIGRANT'S PLAN

The companies Majic Holdings (Pty) Limited and Majic Hotels (Pty) Limited, the shares whereof are owned by the members of M's family, may be suitably advantageous vehicles by means of which the planner may retain those blocked assets.

For Estate Duty purposes the planner may reduce her shareholding to a relatively small percentage. The majority voting rights might attach to the preference shares retained by the planner, while the growth shares are held by the other members of her family whose estates may absorb same without incurring Estate Duty problems, particularly having regard to the proposals outlined by the Minister of Finance in his 1988 Budget Speech, to grant a primary rebate of R1 million for Estate Duty purposes The planner may, accordingly, donate part of her shareholding to her family once she has emigrated from South Africa, and before taking up residence in the United States. Alternatively, she may effect this disposition by means of an outstanding loan, which is relinquished to the extent of twenty thousand rand per annum, being the proposed annual exemption from donations tax.

The company as a vehicle also offers a fair amount of flexibility in that the shares of each shareholder may be held in a different class - such that dividend distributions may be varied between the classes of shares, to suit the circumstances. Furthermore, the point was upheld in the United States case of Byrum(84) that majority voting rights in a company do not automatically imply control over the company assets (as envisaged by Section 3(d) of the Estate Duty Act), as the Board of Directors of the company has a fiduciary duty to the minority shareholders. The same principle of fiduciary duties between shareholders would, it is submitted, apply to the fiduciary duties that exist between members of a Close Corporation.

In view of the opportunities outlined above for earning tax free dividend income in the Inter Vivos Trust, the planner may consider selling her shares in the companies to the Trust (again securing the purchase price thereof with an Acknowledgment of Debt or Loan Note) so that the dividends distributed by the company will be received in the Trust. Once again, any drop in the value of those shares can be reflected in a reduction of the balance due on the loan, so adverse Estate Duty or Capital Transfer Tax consequences are obviated.

Furthermore, having regard to the fact that the rental income earned by the property owning company - Majic Holdings (Pty) Ltd, is taxed at the higher corporate tax rate (currently 50%) and that dividends paid thereafter may, depending on the planner's emigration structure be subject to NRST, it may be preferable for the company to sell its property, and the funds which the shareholders receive by way of a liquidation dividend may be invested in a property unit trust. The rental income earned from the property owned by such trust is treated as a dividend when paid to the unit holders. Consequently, the emigrant would be liable only for NRST thereon rather than normal income tax at the corporate rate.

A further suggestion to the planner may be to incorporate a Dutch Company and to sell her shareholding in the Majic Companies to that Dutch Company - in order to benefit from the provisions of Article 10 of the DTA between South Africa and the Netherlands.

Article 10 provides that dividends paid by a resident company of one state to a resident of the other state may be taxed in "the other state". However, such dividends may also be taxed in the state of which the company paying the dividend is resident, but the tax shall not exceed 5% of the gross amount of the dividends if the recipient company controls, directly or indirectly, at least 15% of the entire voting power in the company paying the dividends. The Dutch authorities impose a nominal tax thereon, whereafter the funds may be transferred to their intended destinations, possibly a tax haven where they may be reinvested to yield tax-free earnings.

However, considering the fact that Majic Hotels (Pty) Limited is "carrying on a business" in the Republic (as defined in Chapter 1), significant tax advantages may be derived by converting the company to a close corporation, as explained below.

NRST AND CARRYING ON BUSINESS

Where dividends are distributed by a close corporation to South African resident members, they are received free of any liability for tax. However, no such exemption is made for non-resident members (Section 42(2) of the Act) who are accordingly liable for NRST on those dividends.

The specific exemption from NRST provided in Section 40B of the Act, in respect of dividends declared by a company in the course of winding up, which company could have been converted to a close corporation, has not been extended to the taxation of close corporations under Section 40A, giving rise to an anomalous situation.

The Margo Commission recommended that non-resident members of a close corporation remain liable for NRST, contending that the removal of such liability would enure mainly to the benefit of the foreign fiscus, when it was the practice of the foreign fisc to grant a credit for taxes paid in the country of origin of the income. As will be later discussed, the 1988 "Rangle Amendment" provides that the United States resident will no longer be entitled to a credit in respect of taxes paid on income sourced in South Africa.

The Margo Commission further recommended, however, that where no double taxation agreement exists, credit be given for the foreign tax against the South African tax liability, with a suitable limitation imposed on such relief. The Commission suggested that, in respect of dividends, the credit be limited to a maximum of 15% of the amount of the dividend, effectively reducing the South African tax thereon to nil.

However, as has been noted above (page) the imposition of NRST depends on whether the recipient of the dividend is, inter alia, a person other than a company not ordinarily resident nor carrying on business in the Republic.

So, if the emigrant continues to carry on business in the Republic, she shall still qualify for the exemption on dividends received by the close corporation (Section 10(1)(KA)) where no reference to "residence in South Africa" is made. The dividend will be received by the emigrant entirely tax-free as she no longer qualifies for NRST.

How does one "carry on business" in the Republic as an emigrant? Aside from the normal interpretation of what amounts to "carrying on business" (see Chapter 1 supra) it has been suggested that where a close corporation is an ordinary operating entity (as opposed to an investment company which probably requires little day to day administration of any kind), all the member need do to "carry on business" is appoint a South African resident as his employee, to administer the affairs of the close corporation.(85)

The Appellate Division in the case of Cohen v CIR(86) considered the situation where a director of a public company drew a director's fee and a salary from that company and other companies. He had gone to the United States to attend the business affairs of the group in the United States - where he was employed by a subsidiary company. The Provincial Division had found that, in the circumstances, Cohen did not carry on business in South Africa during his absence, and this view was not challenged in the Appellate Division.

However, in the case of Joel and Joel v CIR,(87) it was decided that where two taxpayers, carrying on business in a foreign country, were represented in South Africa by their "servant" (an "employee", as distinct from an "agent"), then the taxpayers themselves were carrying on business in South Africa.

The Appellate Division, in the 1975 case of SIR v Downing held that an emigrant was not carrying on business in South Africa where his agent was acting in the ordinary course of his own business as a broker.

The case of Joel and Joel distinguished between mere representation on a Board of Directors (whether or not a controlling interest is held therein) and "carrying on business". It is suggested that the position is different for members of a close corporation whose status under Section 42 of the Close Corporation Act No. 69 of 1984 (which establishes his fiduciary relationship to the close corporation) is unaffected by an Association Agreement and who continues his active involvement in the affairs of the close corporation through an employee. This fiduciary relationship of a member in relation to the close corporation usually exists between a company and its director. By virtue of this relationship the member becomes an "agent" of the close corporation, as opposed to an employee (compare the status of a company director) and in so doing he carries on his own business as an "agent".(88)

Pending the enactment of legislation to abolish NRTI, the advantage of possibly investing the trust income in Escom or RSA stock, the interest whereon is tax free for the non-resident, will not be lost as NRTI does not require that the taxpayer does not "carry on business" in South Africa (Section 64C).

The alternative arrangement of transferring the shareholder's interest to the Inter Vivos Trust will probably not, it is submitted, succeed with a close corporation. Section 29(1) of the Close Corporation Act, 1984, as amended, provides, inter alia, that only natural persons shall directly or indirectly (or whether through the instrumentality of a nominee or otherwise), hold a member's interest therein, save for a natural or juristic person, nomine officii, who is a trustee of a Testamentary Trust. Accordingly, the question whether a trustee of an Inter Vivos Trust can hold a member's interest in a close corporation in his capacity as trustee has been the subject of much debate. As the close corporation was specifically designed as a simple vehicle, for entities with less than ten members, it would appear to frustrate such purpose were a trustee, a representative of a potentially unlimited number of persons' interests, to be regarded as such a member. The Close Corporation Act was amended to specifically to provide for membership by

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Deceased Estates and Testamentary Trusts. One might argue that the rule of interpretation expressio unius exclusio alterius would therefore apply to exclude Inter Vivos Trusts from the ambit of the Act.

The argument was raised, however, that the trustee of an Inter Vivos Trust may be a member, as a nominee of the trust.(88B) The Founding Statement of the Close Corporation would reflect the trustee's name, and a separate agreement between the trustee and the trust beneficiaries would regulate his accountability to them for the profits and management of the close corporation. As trusts are not juristic persons (Commissioner for Inland Revenue v MacNeille's Estate 1961 (3) SA 833 (AD)) the trust is not prohibited, so the argument runs, by the provisions of Section 29(1) from holding a member's interest as nominee for an Inter Vivos Trust, or for any other natural person.

This view was tested and upheld in the unreported Transvaal Provincial decision of Jacobson and Others v Registrar of Companies on 5 November 1986.(88C) However, this was shortly followed by the press release statement by the Deputy Minister of Economic Affairs and Technology to the effect that it was clearly never intended that a trustee of an Inter Vivos Trust should be allowed to acquire membership in a close corporation, whether as trustee or nominee. He indicated his intention to obtain the necessary approval to draft legislation to give clear effect to that intention, with retrospective effect from the date of the announcement.

Lastly, it should be noted that where dividends accrue to a person while he is still a South African resident (in which event the exemption contained in Section 10(1)(k) will not apply) and the dividends become payable after that person's residence has terminated, then both normal tax and NRST are payable.

It is submitted that the "necessary inference against double taxation"(88A) referred to in Delfos' case would not apply, as the Act refers to two separate taxes, contained in

separate parts of the Act. Accordingly, where the ownership of the shares remain directly held by the planner, she should ensure that her emigration precedes the declaration of a dividend on the shares so that no amount accrues to her whilst still a resident of South Africa.

NRTI

The schemes that have been suggested thus far have not dealt with the emigrant's liability for Non-resident Tax on Interest on any interest income earned, for example, by the Trust and distributed to the beneficiary; any interest payable on the loan note; or any interest earned from debentures that may have been issued to the emigrant in the Majic Companies.

Subject to the enactment of legislation to abolish NRTI, following the pronouncements of the Minister of Finance in the Budget Speech on March 16, 1988, Section 64A of the Act provides that NRTI, at the rate of 10% shall be levied on any interest earned from a debtor, who is ordinarily resident or carries on business in South Africa, which accrues to any person, other than a company not ordinarily resident in the Republic.

As NRTI is levied on "any interest earned", it would appear that the source of the interest is immaterial, provided the debtor is ordinarily resident or carries on business in South Africa.

Where the interest is sourced in South Africa, ordinary tax thereon would also be levied. (In this respect NRTI may be distinguished from NRST.) NRTI is a minimum withholding tax - and to avoid double taxation, Section 6 of the Act provides for a rebate of NRTI paid against normal tax due.

The scheme suggested above, where a non-resident member of a close corporation carries on business in South Africa, and may accordingly earn wholly tax-free dividend income, would not apply to NRTI.

NRTI is payable within 14 days after the date of accrual of the interest, or such further period as the Commissioner may approve.

To minimise the taxation on interest income earned, the emigrant might consider ceding her right to interest income from the Inter Vivos Trust to a company or trust established in a foreign country, which has a favourable Double Tax Agreement (DTA) with South Africa. The DTA between South Africa and the United States made no specific provisions for the limitation of NRTI, and hence its demise does not affect any tried and tested scheme.

Article 11 of the Treaties with the Netherlands and Switzerland, for example, contain the following provision : interest arising in a contracting state, and paid to a resident of the other contracting state, may be taxed in that other state ... save for a withholding tax in South Africa of 10%. The NRTI will then be granted as a credit.

An agreement may be reached with the foreign company to cede all the income earned to an off-shore trust, subject to a minimal return,(89) for example 1%. (The Netherlands authorities insist on a minimal commercial return. The Netherlands does not, however, impose a withholding tax on interest,(90) unless a further company is interposed between the Netherlands company and the off-shore trust, in the Antilles - where a withholding tax of between 5% to 7,5% is imposed (since 1st January, 1986)).

In terms of Section 108 of the Act, DTAs may not impose liabilities on the taxpayer that go beyond the general scope of the Act. The DTA may, however, contain provisions contrary to the Act in order to achieve its objects, and subject to the proviso above, the provisions of the DTA will override those of the Act.(91)

In view of legislation intended to abolish NRTI, the planner might consider methods of converting equity into loan capital such that the dividend income due to the non-resident shareholders will be converted into interest income.

For example, the planner might sell her family's rights to dividend income to another South African company. The consideration therefor would remain an outstanding loan on which interest is charged. The "conduit" company would pay this interest from the dividend income earned.

It is considered, however, that the Reserve Bank would enquire as to the origin of the interest and restrict its flow. Furthermore, this information is transmissible to Inland Revenue which could well invoke the provisions of Section 103 of the Income Tax Act and assess to tax the dividend income "sold" in the hands of the planner.

Whilst considering "treaty-shopping" for the purpose of limiting the withholding taxes on dividend and interest income earned - one must bear in mind that the DTA provisions are subject to change at any time. An indication of the likely direction such change may take was given in a recent Netherlands Supreme Court ruling.

The ruling arose as a result of a case where dividends on a Netherlands company's shares were passed through an Antilles company, incorporated for the purpose of avoiding the 25% withholding tax of the Netherlands, as the DTA with the Netherlands and Antilles specified a zero rate of withholding tax at the time. The crucial question for decision was whether the "abuse of law" concept could be applied. The question was answered in the affirmative and the case was referred back to the lower Court of Amsterdam for further investigation.

It has been suggested that the case will be used with regard to Netherlands based holding companies to attack extreme cases of treaty shopping at the expense of the Netherlands tax administration.(92) This may also be an indication that other countries will follow suit and adopt a harsher stance where holding companies are placed in countries with an extensive favourable DTA network. The United States in particular has exerted pressure on countries with such networks, with mixed success - the Netherlands for example being content to be used on account of its extensive DTA network, as long as local taxes are not thereby avoided.(93)

In setting up an offshore structure involving the use of favourable DTA's, it is therefore important to plan for the easy collapse of the structure, and possibly provide for the removal of the seat of control of the ultimate holding trust or company to a favourable tax jurisdiction.

CHAPTER IV

LEGISLATIVE DEVELOPMENTS IN THE UNITED STATES IN 1987

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1987 proved to be a dramatic year insofar as anti-South African legislation was actively promulgated in the United States. With effect from July 1, 1987, the double tax treaty (DTT) between the USA and South Africa was cancelled, and in December the 1987 Revenue Act contained the so-called "Rangle amendment" abolishing foreign tax credits in the US on income earned from South African sources.

The overall impact of these amendments will not be discussed here, save insofar as they affect the potential taxation of the emigrant to the US, based on the facts and plans discussed thus far.

EFFECT OF CANCELLATION OF THE DTT

The treaty covered US Federal Income Tax, but did not extend to State taxation. The SA taxes affected thereby were normal income tax, NRST, NRTI and UPT.

South Africans who had US investments, such as were permitted by Excon, would not be affected by the cancellation of the DTT, since they enjoyed no benefits thereunder. On the contrary, the DTT contained a unique provision for the benefit of US investors in SA, in terms whereof the South African legislation as enforced on 1 July, 1946 was applied. Consequently, US investors were entitled to an exemption from South African NRTI and the withholding taxes on so-called "know-how royalties"received from South Africa. The

interest income was, theoretically, still subject to normal tax - a liability which was difficult to enforce on US investors with no other SA assets, but which posed little practical difficulties in respect of the SA emigrant whose assets, exceeding the settling-in allowance, are held in a blocked account.

The additional 10% NRTI for which the US investor found himself liable, as a result of the cancellation of the DTT was relieved in certain circumstances by the introduction of unilateral relief in the form of amendments to Section 64C of the South African Income Tax Act. The effect of these amendments is to place certain investors, namely those who invested in long term industrial or mining projects; specific community developments projects and investors who had granted loans to Republic residents prior to January 1, 1985, and were subject to the debt standstill.

The effect of the additional liability for NRTI on any other class of US resident investors will probably be removed once legislation intended to abolish NRTI is promulgated in South Africa - and which will probably be of retrospective effect to 17 March, 1988, in line with the Budget announcement of the Minister of Finance on 16 March, 1988.

There has been no similar unilateral relief from the additional 15% tax that must now be withheld on royalties accruing to US residents.

Until the enactment of the "Rangle amendments", the US resident was entitled to claim a credit for the South African taxes paid against the United States Federal Tax on that same income. (See below)

A further significant result of the cancellation of the DDT is that there no longer exists a provision for the exchange of information between the two administrations. Undoubtedly the United States is more severely prejudiced thereby, in view of its residence based tax system, as a result whereof it seeks to tax its citizens and residents on their world-wide profits. The exchange of information provision was one of its most

valuable weapons in achieving this objective.

AMENDMENTS INTRODUCED BY 1987 REVENUE ACT

The measure authorised by Congressman Charles Rangel and which was introduced into the 1988 US Budget at the eleventh hour, so to speak, relates to taxes paid and income earned in South Africa, South West Africa/Namibia and the TBVC Independent States. The legislation states that it will apply to income attributable to a period beginning on January 1, 1988, or alternatively to taxable years beginning after December 31, 1987. The uncertainty arising from these two potentially conflicting periods is still to be clarified by the Internal Revenue Service. The provision is scheduled to terminate when the US Secretary of State certifies that the SA Government has taken the steps set out in the comprehensive Anti-Apartheid Act of 1986 to reduce or eliminate apartheid.

The US Congress expressed the opinion that these amendments would serve purposes similar to those of the Comprehensive Anti-Apartheid Act, pursuant to which the US-SA DTT was terminated, and new US investment, as well as business transactions between US enterprises and the SA Government, prohibited.

The crux of the amendment is that South Africa has been added to the list of foreign countries in respect of which the foreign tax credit is denied, by the provisions of Section 901(j) of the US Code.

In particular, the 15% SA withholding tax on dividends and royalties as well as the 10% withholding tax on interest will not be creditable against the US Federal Tax on that same income; a tax credit which was formerly enjoyed by US citizens, US corporations or non-citizens resident in the US (RAs).

The SA income tax paid by companies on the profits out of which dividends are paid will also not be allowed as a credit against the US Federal Tax on the dividends. This credit for "deemed paid" foreign taxes was previously only available to US corporations which owned 10% or more of the voting shares of the SA company. Therefore, US RA's were not allowed this credit and will not be affected by this aspect of the amendment.

SA income taxes paid or accrued will, however, still be deductible by a US taxpayer for purposes of calculating his profits subject to US taxation - still a significant concession but considerably less than the former "credit" provisions.

The effect of adding South Africa to the countries listed in terms of Section 901(j) of the Code, extends to the US undistributed profits tax on sub-part F income (Code, Section 952(1)). In terms of this section, where a South African company is a controlled foreign corporation (CFC), the US corporate shareholder (individual or company) of that CFC will be taxed on the undistributed earnings, and profits of that CFC. The US shareholder, for these purposes, is a person who owns or is constructively deemed to own 10% or more of the total voting shares of the SA company, and a CFC means any foreign corporation of which more than 50% of either the company's voting power or the value of the corporation's shares is owned by US citizens or residents who each own at least 10% of the corporation's voting power on any day during the corporation's tax year. Shares owned indirectly through foreign corporations, partnerships or trusts are also taken into account, in addition to the rules of constructive ownership

The earnings or profits of a CFC which have already been included in the gross income of a US shareholder, are not taxed again when distributed to that shareholder. However, the 15% NRST will be levied at the time of payment, which may be claimed as a deduction against the US income.

Where the undistributed profits of the CFC may not be remitted from South Africa on the basis that they arose out of capital gains, or from trading income earned in previous years or where the company has exceeded its local borrowing limitations - Section 964(b) of the Code provides that the US tax on the undistributed earnings may be deferred so long as genuine Exchange Control restrictions exist. There has been no amendment to preclude this provision from applying to SA sourced income.

As will appear therefrom, the revocation of the DTT, coupled with the the Rangle amendment, has wrought crucial changes for the US taxpayers, who will now be liable for all taxes on income earned in South Africa. One consequence is that tax free investments, such as Escom stock, will become much more attractive.(93A)

CHAPTER V

TAXATION OF THE SOUTH AFRICAN EMIGRANT IN THE UNITED STATES

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As was noted (Chapter 1 above) once the South African emigrant becomes resident in the United States, for a sufficient period of time to be classified as a RA, she is liable for taxation on her worldwide income, and to gift and estate taxes on all property wheresoever situated.

We will assume that "M", the emigrant, before departing from South Africa, incorporated all her assets into a properly structured plan - possibly creating a discretionary "own assets" Inter Vivos Trust - with attendant Estate Duty and/or Income Tax advantages, such as were suggested in Chapter 111 (above).

The emigrant will thus have assured herself of a regular flow of income from South Africa to the country of her choice. This income will be particularly substantial should M's and her husband" major asset be sold - their shareholding in Majic Holdings (Pty) Limited and Majic Hotels (Pty) Limited (or their "members interests" if the private company was converted to a close corporation) which shareholding/interest may have been ceded/sold to the Trust.

Should the proceeds be invested in Escom, or other Government related stock, with a current yield of $\pm$ 15% per annum, the whole of which is currently remittable free of tax to non-residents,(94) notwithstanding the recommendations of the Margo Commission to subject all investments to normal tax, then the emigrant may expect to amass an estate off-shore, equivalent to that in South Africa, within six/seven years.

The favourable tax treatment for non-resident investors in Escom stock is, it is submitted, likely to continue in the foreseeable future, unless these endeavours are privatised, given the South African Government's not insignificant reliance on foreign investment in these corporations. One might be less confident of Excon's continued permission to allow an unlimited amount of income to be remitted from South Africa, through the medium of the Commercial Rand.

USE OF TAX HAVEN

While the opportunity exists to remit all income earned from South Africa, the planner must concern herself with limiting the tax payable thereon in the United States. The most obvious choice would be to invest the income, as much as exceeds what is required for the purpose of daily living, tax-free, and to this end the incorporation of a tax haven in the emigrant's plan has become popular.

The common advantages of a tax haven include :

a. Freedom from liability for tax

b. strict laws of secrecy for banking and commercial transactions; and

c. no exchange control.(95)

Not all tax havens are "pure"; that is, levy no taxes whatsoever. A country which levies tax based on source only will be a haven in respect of income derived from foreign sources. Similarly, a country whose tax base is restricted to its residents will be a haven in respect of local sourced income accruing to non-residents.

The disadvantages are usually that typical "tax havens" seldom enter into tax treaties with other countries, and the "aura of concealment" that surrounds them may cause the domestic tax authorities to monitor their taxpayers more closely. This has certainly been the trend with those havens in the Caribbean Basin, who have fairly recently concluded agreements with the United States to co-operate in tracing and eradicating United States tax evasion.

Tax havens are scattered around the world, and the better-known among them may be loosely grouped in the following areas :-

1.	The Caribbean area	Bahamas, Bermuda, Cayman Islands, British Virgin Islands, Netherlands, Antilles and Panama;
2.	The Mediterranean area	Gibraltar and Cyprus;
3.	The European area	Netherlands, Switzerland, Lichtenstein and Luxembourg;
4.	The Channel Islands area	Guernsey, Jersey and the Isle of Man;
5.	The Pacific area	Hong Kong, Nauru and Vanuatu.

The tax havens vary significantly in the tax-planning opportunities they offer, and the relevant factors for a company, trust or individual wishing to employ the same in their scheme must be carefully considered. The following are certain fundamental factors which might be considered :-

- geographical location;
- what share capital needs to be invested initially;
- the political and economic stability of the country;

- what taxes and duties are levied to finance the state;
- the tax treatment of non-resident and foreign income;
- what tax treaties have been concluded with other countries;
- any exchange controls and restrictions';
- business image of the haven;
- the costs of forming and administering entities such as companies and trusts;
- must there be a local office or employees;
- the adequacy of banking, professional, commercial, transportation and communication facilities;
- secrecy of information and the existence of bearer share companies;
- the flexibility of the laws concerning trusts and/or companies; and
- the existence of anti-tax avoidance legislation.(96)

The tax havens in the Caribbean area are conveniently close to the United Sates, physical proximity being an important factor where postal communications and bank transfers are carefully recorded and easily checked by the country of domestic residence.

Specific legislation has been passed in the Cayman Islands to encourage their employment as a tax haven - including the Companies Law; the Bank and Trust Companies (Regulations) Law; the Trust Law and the Insurance Law.

The Cayman Islands have no treaties or arrangements with other countries. However, no taxes are levied on income, profits, capital gains, sales, estates, gifts or inheritance - revenue being earned by means of an excise tax which is levied on most imports, together with licence fees.

The official language of the Islands is English and the currency is linked to the United States Dollar.

There are no exchange control regulations (such as existed were recently repealed); and all foreign currencies are freely convertible.

A sophisticated banking system is supplied by more than four hundred banks carrying on business in the Islands - with "secrecy laws" as comprehensive as would be expected in a tax haven.

Coupled with the banking system there are extensive communications and transportation facilities, to manage the inflow of off-shore funds, and experts are available who provide international financial services.

It is moreover possible to obtain a guaranteed exemption from any nature of taxes for twenty years where one creates an exempted company or exempted trust (that is, a company trust which declares that it will not engage in trade within the Cayman Islands).(97)

The attractions of this tax haven may be compared with those offered by any number of other popular havens. However, considering its proximity to the United States, and to avoid a lengthy exposition of the main features of each tax haven (which subject is discussed comprehensively in a number of works devoted thereto),(98) we shall accept the employment of the Cayman Islands into our planner's scheme.

As the United States Internal Revenue Service levies tax on a RA's worldwide income - the income earned from the assets invested in the tax haven, which typically has no DTA with the United States, will be taxed in the United States, unless those assets are separated from the ownership and/or control of the RA.

GRANTOR TRUSTS

The Inter Vivos Trust is recognised by the United States as an independent legal entity. As discussed (Chapter 111) the grantor/settlor divests himself of the assets which are donated to the Trust (a donation is probably less problematic than a sale to the Trust, where the settlor still has the right to the purchase price and is not entirely divested of his control). The Trustees will thereafter control the trust assets (possibly in conjunction with the "Protector" of the trust - who generally ensures that the intentions of the settlor are borne out by the trust.) The Trustees will, formally, have a totally unfettered discretion as to the choice of beneficiaries of the trust, and whether to distribute the income and/or capital of the Trust in the tax year in question.

As a result of the United States Supreme Court decision in the case of Helvering v Clifford,(99) the complex set of provisions generally referred to as the "grantor trust" rules were enacted (Sections 671 - 679 of the Code), which provide that in certain circumstances a trust will be ignored and another person (usually but not necessarily the grantor/donor of the trust) will be deemed to be the owner of the assets held by the trust for income tax purposes.

In the Clifford case, a trust was created by a husband for the benefit of his wife. The trust was to last for five years and at the end of that time was to revert to the husband/grantor if he survived. The husband, as trustee, had sole discretion as to amounts distributable to his wife, and otherwise retained wide powers of control over the trust.

The Supreme Court held that the income of the trust was taxable in the hands of the husband. The Court considered the solidarity of the family, the express reservation of powers and the fact that the income could be utilised for the grantor's benefit - and decided that in substance and effect the income was his.

In the domestic contract, a distribution from a "grantor trust" is treated as a gift to the beneficiary and not as income, and the beneficiary is therefore not taxed thereon.(100) This treatment might then be used to advantage in the international context; if a foreign trust is structured so that a person who is neither a United States citizen, nor resident, is considered the owner of the trust assets, distributions by the trust to a United States beneficiary should be considered to be gifts from that person. Such gifts would not be "income" in the hands of the beneficiary, and it would appear, need not be reported to the Internal Revenue Service.(101) The foreign "grantor/owner" is considered to have received the trust income, but as a non-resident alien will not be subject to United States tax as such income is not from United States sources.

TIMING

The language of the Code (Section 679) implies that a foreign trust with a United States beneficiary should not be a grantor trust if its transferror was not a "United States person" (citizen or RA) at the time of the transfer, without regard to whether he later becomes a United States person.(102A) Further, Section 6048 of the Code provides that :-

a. On or about the 90th day after -

   i. the creation of any foreign trust by a United States person, or

   ii. the transfer of any money or property to a foreign trust by a United States person, the grantor ... shall make a return in such form and shall furnish such information in respect of the foreign trust as the secretary may prescribe.(103)

By implication, therefore, if the grantor is not a United States person at the time of the "creation" or "transfer" no such information need be supplied.

Should the Internal Revenue Service regard the above as an artificial construction of the legislation, which too easily frustrates the intention of the Code, then the emigrant/grantor would need to be acquainted with the special "Grantor Trust Rules" contained in Sections 671 to 679 of the Code,(104) as she may be deemed to be such "Grantor" as soon as she becomes a United States RA.

Neither the provisions of the Code. nor the Regulations issued to interpret the Code, nor Rulings of the Internal Revenue Service, define the term "Grantor". The Federal Tax Laws that preceded the Code, extending back to the original enactment of the grantor trust provisions in Section 219(h) of the Revenue Act of 1924, likewise provide no definition of the term, nor does the legislative history of the law, as summarised by J S Seidman, Legislative History of the Federal Income Tax Laws, 1861-1938, a leading treatise, provide any assistance.

Consequently, one must refer to decided cases and subsequent treaties to determine the meaning of the term. In Buhl v Kavanagh(104A) the Court stated, in reference to several early Federal Tax Acts :

> "The word "grantor" is not defined in the statutes, and therefore is to be given its natural ordinary and familiar meaning ... Putting the word in its ordinary setting, it means the person who establishes the trust or its donor, creator or founder."

Similar definitions are found in later cases and treatises in the light whereof on must examine the "Grantor Trust" provisions of the Code :

Code Section 671 : This section contains general provisions relating to the whole sub-part E. If Code Sections 672 - 679 treat the grantor or another person as the "owner" of a trust, that person must include in his computation of liability all items of "income, deductions and credits against tax" which are attributable to the portion of the trust of which the individual is the "grantor". Any parties of a grantor trust which are not subject

to the grantor trust rules are taxed under the general rules of sub-parts A-D of sub-chapter J.

Code Section 672 : A grantor is taxed as the owner of any portion of a trust as to which either the grantor himself, or a "non adverse" party has a power of disposition, whether or not exercisable in conjunction with the grantor, unless it is exercisable only with the consent of any "adverse party". Since the Code and regulations define a non-adverse party as anyone who is not an adverse party, the latter definition is the more critical one. An "adverse party" is any person :-

(i) who has a beneficial interest in the trust in the present or in the future (including the power of appointment over the trust)

(ii) that is substantial (in relation to the total value of the property); and

(iii) which would be adversely affected by the exercise or non-exercise of the power held by the grantor or non-adverse party.

A trustee does not have a beneficial interest and cannot be an adverse party merely on the strength of being a trustee.(105) Family members, however, are not ipso facto precluded from being an adverse party. Spouses can be an adversary party (Laganas v Commissioner);(106) and the inference is certainly more easily drawn with ex-spouses.

Sections 673 to 677 define the circumstances whereunder trust income is taxed in the hands of a grantor. The circumstances, in general, are as follows :

1. If the grantor has retained a reversionary interest in the income or principal of the trust within specified time limits; (Section 673)

2. If the grantor or a non adverse party has certain powers over the beneficial enjoyment of the income of principal under the trust; (Section 674)

3. If certain administrative powers over the trust are retained under which the grantor can or does benefit; (Section 675)

4. If the grantor or non adverse party has the power to revoke the trust or return the principal to the grantor; (Section 676) or

5. If the grantor or a non adverse party has the power to distribute income to or for the benefit of the grantor, or the grantor's spouse. (Section 677) (In the case of Benson v Commissioner(107) the Tax Court held that a grantor owns that portion of the trust which, from the instrument and the facts and circumstances the grantor could borrow, rather than merely the amount the grantor did borrow. Indirect borrowing of trust funds would also result in the grantor's deemed ownership of the trust, unless adequate interest and security is provided. (Estate of Holden v Commissioner)(108)

From the aforegoing it will appear that only the actual creator of a trust, the donor of the funds establishing the trust, can be the grantor for the purposes of Sections 671 to 677 of the Code.

Code Section 678(a) : Trusts taxable to third person - In the case of Mallinickrodt Jr v Nunan,(109) the Court reasoned that if a grantor could be taxed as the owner of a trust over which he had certain broad powers, then a third person (not the grantor) could be taxed as its owner under similar provisions, provided that the actual grantor of the trust does not hold any of the proscribed powers of Sections 673-677 - the result being the enactment of this section.(110)

Section 678(a) has the effect therefore that someone other than the grantor will be taxed as the owner of the trust, or a portion of a trust as to which that individual, alone and without consent of any other person, has a power to vest the corpus or income in himself or herself or as to which the individual formerly had such a power, but disclaimed or renounced so much of it that the resultant power would, if held by a grantor, be sufficient to create a grantor trust under Sections 671 to 677 of the Code.

Accordingly, one may have the situation where the donor of the funds to the trust is considered to be the "grantor" by virtue of the provisions of Sections 673 to 677 of the Code; and a third party, by virtue of his power under Section 678 of the Code, would also be regarded as the owner of the trusts. The question which obviously arises, is which sections take precedence over the other?

Section 678(b) of the Code provides that Section 678(a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is otherwise treated as the owner under the provisions of Section 673 through 677 of the Code, other than Section 678. In other words, if both the grantor and a third person hold powers with respect to trust income, the grantor's power is considered to be superior.

Code Section 679 : The United States grantor of a foreign situs trust which has a United States beneficiary is taxed as the owner of that trust, since the taxable year commencing in January 1986.

These rules are replete with conditions and exceptions, and the above summary outlines only the broad principles thereof.

The Code circuitously defines a foreign trust as one that is taxed like a NRA.(111) Generally a trust is an "alien" if it is established abroad, and it is a non-resident of the United States if all of the relevant factors and circumstances demonstrate that it has no

significant United States contacts, inter alia :

- the law under which the trust was created
- the situs of its corpus
- the rationality and residence of the trustees
- the situs of the trust administration
- the nationality and residence of the grantor
- the nationality and residence of the beneficiaries.

A United States person is the "grantor" of a foreign trust if he makes any direct or indirect transfer, other than by reason of the death of the transferor, or a transfer by way of a sale (outright) or exchange, in certain circumstances.

The onus rests on the United States grantor to prove that there is no United States beneficiary who shall enjoy any portion of the trust.(113)

Notwithstanding the onerous provisions of sub-part E (the "grantor trust rules") there exists a further "anticipatory assignment of income" doctrine which may apply where the assignor has retained none of the controls mentioned in Sections 671 -677.(114) Consequently, one does not avoid tax on income by assigning the right to future income to a trust. This is often the basis for rejecting "garbage" grantor trusts, including "offshore estate trusts" and "foreign tax haven double trusts".(115)

In Revenue ruling 80-74,(115A) for example, the Service considered a transaction whereby a US resident set up foreign trust to which he contributed property, and named a foreign agent as "creator". A second foreign trust was set up by the creator in the foreign country of which the first trust was the trustee. Income of the first trust was distributed to the second trust, and the second trust made periodic distributions to the US resident and his family. The Service collapsed the two trusts and disregarded the foreign agent's status as the creator , treating the US resident as the grantor and taxing all income to him because of his dominion and control over the trust.

In the case of W E Gran v Commissioner(116) the Court of Appeal held that the taxpayer's attempt to shift the incidence of tax to a trust was not permitted where the property transferred was the product of their lifetime services and the evidence clearly supported the finding that none of the property transferred by the taxpayers to the trust had produced, or was intended to produce, income taxable to the taxpayers.

Further, in the case of Vnuk v Commissioner(117) it was held that income is taxed to the person who earned it, and attempting to deflect tax to another entity does not, in and of itself, shift the incidence of tax.

In Gran's case, the taxpayer tried to distinguish the facts from those in Vnuk's case, as the ownership of the goods was conveyed to the trust in the former case, not merely the use. The Court of Appeals dismissed this arguments as being without substance.

It might perhaps be argued that the assignment of the right to income can be separated from the assignment of the benefit which gives rise to that right to income. Similarly, one might distinguish a right to the dividends earned from certain shares, from a right to receive such shares. Thus, it is submitted, one might argue that where the emigrant, a beneficiary of a South African Inter Vivos Trust assigns outright her nomination as beneficiary of the trust to a Cayman Island trust, that assignment can be distinguished from an assignment merely of the income that is received by the emigrant, as and when it is received. By such arrangement the "anticipatory assignment of income" doctrine might be avoided. Excon furthermore would probably agree to the remittance of the income under these circumstances (and one need no longer caution for the unique agreement that existed between South Africa and the United States to assist each other with the prevention of tax avoidance in both countries, in terms of their DTA.)

We have thus considered the position of the emigrant in the event that the Code is given a broad interpretation, to give the fullest effect to what might have been the intention of the legislature in enacting those provisions. It is reiterated, however, that on a strict

interpretation of the Statute, an emigrant who orders her affairs prior to taking up residence in the United States, as a RA, should enjoy the benefits of a tax-free off-shore trust, and not be concerned with the provisions of the "grantor trust" rules or the "anticipatory assignment of income" doctrine. The planner should preferably complete her estate plan and divest herself of full formal ownership of her world-wide assets before entering the United States, when she might be obliged to render comprehensive information regarding those assets.

What may be adverse for a grantor who is a US resident or citizen, may prove beneficial to a NRA, as the grantor trust rules are not limited to US persons (RAs or citizens). A NRA can be the grantor of a grantor trust and thereby become subject to the grantor trust rules if a NRA (i) establishes a foreign trust for the benefit of a US beneficiary, (ii) retains any one or more grantor trust powers and, (iii) invests the trust assets in property producing income from foreign sources and not effectively connected with a US trade or business, the income derived by the trust would for US income tax purposes be treated as that of the foreign grantor and would not be subject to Federal Income Tax. The US beneficiary would not be subject to Federal Income Tax in respect of income distributions from the trust to him because such amounts would be treated as gifts for Federal Income Tax purposes.

This result applies irrespective of the fact that the foreign grantor is not subject to Federal Income Taxation under the Code on the foreign source income (not effectively connected with a US trade or business) attributable to him by reason of his grantor status. This result has been confirmed by the Internal Revenue Service.(117B)

Thus, although favourable US income tax consequences may result from the use of a foreign grantor trust - there may be adverse repercussions in the event that the foreign grantor becomes a US person. he will then be subject to Federal Income Taxation on the worldwide income of the trust and probably subject to Federal Gift Taxation on its distribution, while distributions to the US beneficiary will remain tax-free.

If the trust becomes irrevocable upon the death of the foreign grantor, there can be further adverse consequences to the US beneficiaries with respect to funds accumulated by the trust from the date of death of the grantor.

To avoid the situation where the benefits of the plan cease on the death of the foreign grantor, the planner may appoint a corporate body as grantor, which may extend the advantageous situation indefinitely; alternatively, a joint or substitute grantor who is a NRA may be appointed with the powers outlined under Section 678 (page above).

The use of a foreign corporation to perpetuate the foreign grantor trust status may not be a simple matter. Although it is clear that a corporation in the US can create a grantor trust for Federal Tax purposes,(117C) there is no authority to this effect in a foreign context. It is submitted that there should be no reason, in principle, to distinguish in this respect between the foreign and domestic context. If a foreign corporation is then used for this purpose it would be necessary to ensure that the law of the jurisdiction in which the company is incorporated authorises it to make gifts (contributions to the trust) and that the necessary corporate formalities are observed.

If gifts are not authorised, any distribution of income to the trust beneficiaries may be classified as dividends and result in taxation. Furthermore, if the corporation has only a nominal share capital, was established shortly before the creation of the trust, and carries on no independent business, it may be considered a share for Federal Tax purposes, in which case the beneficial owner of its shares would be deemed to be the grantor. These cautionary rules would apply similarly were the third party, who is deemed to be the power holder in terms of Section 678 of the Code, to be a corporate body. Treasury Regulation 1,671-2E specifically provides that the term "grantor", as used in the Code in Sections 671 to 678 includes a corporation.

Assets which might attract gift or estate tax liability on transfer to the United States beneficiary, might be held by an appropriate holding company, rather than held directly by the trust, and only the shares therein could be transferred to the beneficiaries.(118)

Thus, to suggest an effective tax structure for the would-be emigrant to the US, in view of the grantor trust provisions, a nominal grantor might create a foreign trust, with the family of the emigrant or discretionary beneficiaries. A corporate power holder might by formed, having the powers required by Section 678 to control the trust. One would take special care to ensure that none of the proscribed powers of Sections 673 through 677 appear in the deed and cancel the effect of Section 678.

It remains to briefly discuss the penalties that may be imposed if this structure is successfully attacked by the Internal Revenue Service.

Section 6661 if the Code provides that where there has been a "substantial understatement" of income for a taxable year, resulting from information not disclosed in the tax return or for which omission the taxpayer did not have "substantial authority", a penalty equal to 25% (twenty five percent) of the underpayment of tax resulting from the understatement is imposed. An understatement of tax is substantial under Section 6661(b) if it exceeds the greater of (a) 10% of the actual tax liability for the year of assessment, or (b) $5 000,00. The amount of the understatement can be reduced if part thereof is attributable to (i) the fact that there was substantial authority for this tax treatment, or (ii) the relevant facts affecting the item's tax treatment were adequately disclosed in the return.

Following Treasury Regulation 1.6661-3, what amounts to substantial authority depends upon the circumstances of the particular case, but one would have regard to, inter alia, court decisions, income tax regulation, revenue rulings, and revenue practices, as well as to legislative intent reflected in Congressional Committee Reports. The Regulations make it clear that the test for "substantial authority" is an objective one. The contention of the taxpayer must be stronger that one which is merely arguable, yet unlikely to prevail in Court.

For there to have been "adequate disclosure" in the return there must appear a statement setting forth the item, the amount involved, and the facts affecting the tax treatment of the item which reasonably may be expected to apprise the Internal revenue Service of the nature of the potential controversy concerning the treatment of the item. For example, the attachment to the tax return of the trust deed, without further explanation may not constitute adequate disclosure of the issues determining why the income of the trust has been excluded from the taxpayer's return.

As may appear therefrom, the would-be emigrant would generally prefer to rely on the "substantial authority" rather than the "adequate disclosure" test. It might finally be noted that the Service is authorised under Section 6661(c) of the Code to waive all or any part of the penalty if the taxpayer can establish that he acted in good faith, and that there was reasonable cause for the understatement.

From what has been described, there might appear to be a dichotomy between the provisions of Excon, which requires certainty as to the origin and destiny of South African assets, and the provisions of the United States Internal Revenue Code which are best avoided by structuring one's estate plan in as flexible a manner as possible, with the Trustees of the Inter Vivos Trust/s bestowed with an unfettered discretion to control those assets.

It is submitted that the dichotomy is not an irreconcilable one, with prognostic planning, and the proper representations to Excon.

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