

UNIVERSITY OF CAPE TOWN
INTERNATIONAL TAX OPINION

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MASTER OF PHILOSOPHY IN TAX LAW DEGREE

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To what extent can a South African Resident Donor's Offshore Investment Trust be arranged so as to avoid the following South African Taxes and Duty

Income Tax

Capital Gains Tax

Donations Tax and

Estate Duty

A discussion of the South African Tax impacts in a Trust situation. The possible avoidance of these impacts, including an assessment of the planning risks and how best to control them

CML638W - ADVANCED TAX LAW

SUPERVISOR – JUDGE D. DAVIS

Cape Town – 9 June 2004

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Research dissertation presented for the approval of Senate in fulfillment of part of the requirements for the Master of Philosophy (Tax Law) in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understand the regulations governing the submission of Master of Philosophy (Tax Law) dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to with those regulations.

My thanks to my supervisor, Judge Dennis Davis, for his relevant critical analysis of the shortcomings of the draft of this paper which have been noted by me and addressed.

SIGNED AT CAPE TOWN ON THIS 29th DAY OF OCTOBER 2004.

Signed by candidate

.....
CARL MAY

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PART A

A.1. WHAT REQUIRES CONSIDERATION HERE? – AN OUTLINE

This report will deal with a situation of the donor, commonly known as the settlor donating assets by way of an agreement to independent trustee/s located offshore for the benefit of various agreed beneficiaries; some, or more of them, being South African residents.

The report will also examine the ramifications for a South African donor and beneficiary from an income tax, capital gains tax, donations tax and estate duty point of view that will exclude a consideration of value added tax and regional services council levies on the basis that the offshore trusts being considered here, are not business or trading trusts in most instances.

The report will examine planning opportunities and the attendant risks of legal challenge currently presenting themselves.

PART B

B.1. BRIEFLY, WHAT IS A TRUST? – AN OUTLINE

1.1 A trust inter Vivos is a contract.¹

Honore is of the opinion that, to define a trust, one must distinguish between:

- (a) The process by which a trust is created;
- (b) The existence of an enforceable trust and
- (c) The administration of a trust

“One must distinguish, in South Africa as in any other country where English is spoken, between a wide and narrow sense of trust. In the wide sense, a trust exists whenever a person is bound to hold or administer property on behalf of another or for some impersonal object and not for his own benefit.² Such a person has the minimum of duty to keep the property he administers separate from his own and to avoid conflict between his own interest and that of the other person or object.”

Most offshore trusts are trusts in the strict sense, in which a trust exists when the creator of a trust whom we will call the founder³ has handed over or is bound to hand over to another the control of property which, or the proceeds of which, need to be administered or disposed of by the other (the trustee or administrator) for the benefit of some person other than the trustee as beneficiary, or for some impersonal object e.g. a charity.

A trust, in this sense creates a fiduciary obligation and is a species of the genus ‘trust’ in the wide sense. This definition confirms the determination of ‘trust’ in the Trust Property Control Act 1988.⁴

¹ SA Law of Trusts by A.M. Honore – chapters 1 to 10.

² Apart from statutory definition (Trustee) means “one who is entrusted with the affairs of another”: *Zinn No v Westminster Bank No 1936 AD 89 96, per Stratford JA*. For a Trustee (C Claassen’s Dictionary of Legal words and phrases)

³ In English Law usually called a settlor

⁴ Act 57 of 1988, S1 Trust

B.2 WHAT IS THE TRUE NATURE OF AN OFFSHORE TRUST?

A copy of a typical trust deed has been analysed setting out the contractual rights extended to the trustees and the trustees' obligations to the trust beneficiaries, as well as the confirmation and satisfaction of the donor's obligation to settle the trust assets.

In practice, in order to attract settlement of trust assets in trustees, trusts are commonly guided by way of letters of wishes. A typical letter of wishes has also been scrutinised. This letter does not, in any way, indicate a variation of the rights and obligations contained in the trust deed. The legality of offshore trusts have, have not been challenged in South African courts. It is submitted that the challenge in law would be based on the substance of the management of the trust assets by the trustees and not its legal form. In this, one would have to look at the actual management of the trust assets. If the trustees, at all times, acted on letters of wishes and did not exercise their discretion in relation to trust assets, it could be argued that the trust was not a true trust, but rather an agency in relation to the donor or settlor.

This was borne out in a 1990 Royal Court of Jersey case of *Rachman v Chase*⁵ in 1990; It was held that the settlement was void as the Settlor exercised control over the Trustees in the management and administration of the settlement, including the distributions to the Settlor and others as gifts. The settlor treated the trustees as agents or nominees. He delivered the assets to the trustees as nominees. He reserved the rights of disposition over them to get these back for himself. The securities custodian was instructed exclusively by the settlor.

⁵ *Rachman v Chase Rank Trust Company Ltd and others*, 1991. JLR 103

There is a practical difficulty in obtaining evidence, as rights to documents by beneficiaries are restricted in terms of the trust deeds between the settlor and the trustees.

An Australian court has held this view to be effective.

ALTERNATIVELY:

There is supporting evidence that the trustees at some of the larger trust companies do apply their discretion independently.

A review of correspondence between a major Jersey Trust Company and its client reveals a query of the source of funds to be devolved on the trust and thereafter distributed back to the settlor. This query is a result of anti-money laundering regulations in Guernsey. If a trust is held to be a sham in the nature indicated in the previous paragraph i.e. effectively an agency, this will be held to be effectively managed in the Republic and its income will be taxed as trust income in the Republic.

In this alternative situation, the trustees, further considered the best interests of the donor who is also a beneficiary in as far as the proposed further donation to the trust may have various tax impacts on him..

B.2.1 WHAT IS THE EFFECT OF LETTERS OF WISHES⁶ IN A TRUST SITUATION? AN EXERPT OF ESTATE PLANNING – SERVICE ISSUE 16 FEBRUARY 2004 – D DAVIS, C BENEKE, B JOOSTE

“Letters of wishes take various forms, designed to meet the particular circumstances of each case. Invariably, however, they stipulate that they are not

⁶ Estate Planning – service issue 16 February 2004 – D Davis, C Beneke, B Jooste

*binding on the trustees; that they are in no way to be construed as fettering the trustees' exercise of their powers and discretion conferred by the trust deed. Such a stipulation is aimed at countering any argument that the settlor is in fact in control of the trust*⁷. *If the trustees follow a detailed letter of wishes slavishly*

*there is the danger of the trust being set aside as a scam and the assets being regarded as still beneficially vested in the settlor. A less drastic result may be that the trust is upheld, with the letter of wishes construed as part of the terms of the trust; a construction which may still have dire tax consequences for the settlor. Consequently, letters of wishes must be drafted so that there is no room for arguing that the letter fetters the trustees' discretion or forms part of the trust deed. A further possibility is that a letter of wishes setting out what is to happen to trust assets on the settlor's death may be regarded as a testamentary document – which would then be void for lack of the requisite testamentary formalities.*⁸

Does a letter of wishes create legal obligations?

*Offshore jurisdictions rarely provide explicit legislation in this regard.*⁹ *Both a New South Wales case and a Bahamian case have also held that while the trustee may take a letter of wishes into account when exercising his discretion, he is not bound to do so.*¹⁰ *There appears to be no doubt that where the trust deed gives the trustees discretionary powers, and provides that the letter of wishes is not binding on the trustees, and also the clear evidence*¹¹ *is that the terms of the trust deed bestowing discretionary powers on the trustees are not intended to have effect, then those terms would be regarded as a sham and of no effect. Whether trustees are bound to take letters of wishes into account and, accordingly, whether the beneficiaries can compel them to do so, is a matter yet to be addressed by the courts.*

Are beneficiaries entitled to access to letters of wishes?

*In England it has been emphasised that beneficiaries have a basic right to inspect trust documents but has not clarified whether a letter of wishes qualifies as a trust document.*¹² *The issue arose in Hartigan's Nominees v Rydge Pty Ltd*¹³ *where the Court of Appeal of New South Wales held that the trustees were not under an obligation to disclose the contents of a letter of wishes to the beneficiaries, but the*

⁷ Which could have far-reaching income tax (Chapter 6) and estate duty (para 2.4.6) implications

⁸ See L Lacob "The Offshore Trust World" 2000 *Juta's Business Law* Vol 8 Part 2 82

⁹ The Belize Trusts Act of 1992 is one of the few exceptions in this regard. Section 13(4) provides with regard to a letter of wishes that "(a) the trustee may have regard to that letter ... in exercising any functions conferred upon by the terms of the trust; but the trustee shall not be bound to have regard to that letter ... and shall not be accountable in any way for the failure or refusal to have regard [to it]."

¹⁰ See *Harrington Nominees v Rydge Pty Ltd* (1992) 27 NSWLR 405; *Bank of Nova Scotia Trust Co (Bahamas) Ltd v De Barletta* (1994) *J Int L* 35

¹¹ For example, where there is evidence that the settlor has been told by an offshore trustee that a standard-form discretionary trust with a letter of wishes is less expensive than a tailor-made fixed trust. See L Lacob *supra* 83

¹² See *Re Londonderry's Settlement* [1965] *Ch* 118

¹³ *Supra*

case lacks a clear ratio.¹⁴ In a different set of circumstances it may well be held that the Court could come to a different conclusion.¹⁵

If a settlor of a trust does not intend the trust beneficiaries to have access to a letter of wishes, it would be more prudent to state this explicitly in the trust deed. The lack of authority on the matter in South Africa and a recent case¹⁶ highlighting trustees' duties to provide detailed information about trust affairs to all potential beneficiaries "raise the possibility that tax authorities in South Africa may be able to obtain information from beneficiaries which they would be unable to obtain directly from trustees in an offshore jurisdiction. It should further be noted that the trend of judicial decisions internationally is towards disclosure of information to beneficiaries."¹⁷

Because of the uncertainty in law regarding letters of wishes settlors should

- *not have a letter of wishes signed by the settlor but instead the trustee should simply draft a memorandum or file notice of the settlor's wishes;*
- *if a letter of wishes is used, do not expect the trustees to be under a legal obligation to take it into account;*
- *express a letter of wishes to be confidential and not legally binding and ensure that it accords with the terms of the trust deed, but not to mention it in the trust deed;*
- *bear in mind that although incorporation by reference is not allowed in South African law¹⁸ there is the danger that it will be allowed by the proper law of the offshore trust."¹⁹*

There is clearly no consistent view that can be drawn as to the substance of all Offshore Trust Arrangements. An in depth analysis of the trust deed, an overall assessment of

¹⁴ In the *Harrington* case Mamey JA held that a letter of wishes did not qualify as a trust document for it was directed to administration matters and was, moreover, likely to have been given on a confidential basis. His view was that while it may have been discoverable in proceedings by a beneficiary for breach of trust (for example, in an action alleging that trustees had not taken account of certain relevant considerations), the Court should not otherwise order disclosure. Sheller JA held that the letter of wishes was a trust document but because it was intended to be confidential, it was effectively handed to trustees on condition that it be withheld from beneficiaries. Kirby JA dissented, holding that it was a trust document because trustees interpret their duties under the trust deed in its light, so that the trust deed is effectively supplemented by it. See L Lacob "The Offshore Trust World" 2000 *Juta's Business Law* Vol 8 Part 2 82

¹⁵ *Ibid* 84

¹⁶ *Doyle v Board of Executors* 1999 (2) SA 85 (C)

¹⁷ See L Lacob *supra* 84

¹⁸ See *Moses v Abinader* 1951 (4) SA 537 (A)

¹⁹ See L Lacob *supra* 84

actions of the Trustees and a review of the letter of wishes submitted to the trustees and their reactions thereto, will shed light on the true contractual position between the Settlor, Trustees and Beneficiaries.

PART C

C.1 WHAT ARE THE MAIN TAX BURDENS FACING A SOUTH AFRICAN RESIDENT DONOR? – A LIST

The right to arrange one's tax affairs to fall outside of Taxing Statutes is best described by the following quote:

In the case of *CIR v Simpson*.²⁰

“In a Taxing Act one has to look merely at what is clearly said. THERE IS NO EQUITY ABOUT A TAX. There is no presumption as to a tax. Nothing is to be read in, nothing to be implied. One can only look fairly at the language used.”
(Emphasis added)

Our right to arrange our affairs outside of the taxing statutes have been circumscribed in relation to donations to trusts and benefits received from trusts, by certain anti-avoidance provisions contained in Section 7 of the Income Tax Act No. 58 of 1962 as amended, which attributes income earned in the hands of other parties in the hands of donors. Similar provisions exist in Paragraphs 68 – 72 of the 8th Schedule in relation to capital gains realised. Distributed capitalised revenue gains are attributed in terms of Section 25B(2A) of the Income Tax Act and capitalised capital gains by Paragraph 80(3) of the 8th Schedule, in the hands of SA resident beneficiaries in the year of distribution.

There are further general anti-avoidance provisions contained in Section 103 (1) and relating to the use of assessed losses in Section 103 (2). I will contain this discussion to transactions, operations and schemes other than in the context of business. The criteria necessary for the Commissioner to apply Section 103 (1) in this context are set out in both sub-Paragraph b (bb) and its sub-paragraph (ii). Sub-section Paragraph b (bb)

²⁰ 1949 (4) SA 678 (A), 16 SATC 268

requires for its application, that the transaction, operation or scheme “*must be by means or in a manner which would not normally be employed*”. Therefore one would look at the nature of the scheme in context, for example the sale of assets below market value to a family trust.

Sub-Paragraph (ii) of Section 103 (1)(b)(bb) requires that in order for its anti-avoidance provisions to be effective that, “*in entering into or carrying out the transaction, operation or scheme of the nature of the transaction, operation or scheme in question, rights and obligations are created between person/s, which are not normal*”. It has been held that there is a presumption that rights and obligations are normal when dealing at arm’s length.²¹

A general burden of proof rests with the South African taxpayer to show that any amount is not liable to any tax charge under the Income Tax Act.²²

In Section 103 the Commissioner bears the burden of proof to demonstrate the application of Section 103 (1) b (bb) and sub-paragraph (ii).

It was further held the objective of this Section is to suppress mischief and promote remedies.²³

²¹ Hicklin 41 SATC 179

²² Section 82 (a)

²³ Ferera 38 SATC 66

C.1.1 A DETAILED ANALYSIS OF THE LIST OF TAX BURDENS

C.1.1.1 DONATIONS TAX – THE MOST COMMON TRIGGERS OF DONATIONS

TAX IN SETTLING TRUST ASSETS

1. Sale of assets below market value by the settlor to the trustees.²⁴
2. Donations at adequate valuation of cash or assets by a natural person exceeding R30,000 during any year of assessment²⁵ and in rarer circumstance.
3. Donations by a Body Corporate at the instance of any person is deemed to be a donation by that person. Donations tax is recoverable from that Body Corporate by that person, if the donation is not made in the ordinary course of business under normal income earning operations of that Body Corporate. This section will apply if the donation is not made in the ordinary course of the normal income-earning operations of that Body Corporate²⁶ and the selection of donee was made at the instance of the person making the donation. (Paraphrased).²⁷

This provision would apply to offshore trusts in the instance where the donor selects one or more donees. This section is applicable, in my opinion, where the trust deed provides for donations to be made to vested beneficiaries not listed in the agreement of trust.²⁸

²⁴ Section 58

²⁵ Section 56 (2)(b)

²⁶ Section 57 (2)(a)

²⁷ Section 57 (2)(b)

²⁸ “Trust” means any Trust Fund consisting of cash or other assets, which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a Deed of Trust or by Agreement or under a Will of a deceased person.

C.1.1.2 ESTATE DUTY – THE MOST COMMON CONDITION GIVING RISE TO ESTATE DUTY

Arrangements which exceed the Property planning limits of the fourth item of deemed property, which includes the deceased's estate property, the deceased was competent to dispose of in terms of Section 3 (3)(d) read with Section (3)(5).

To avoid this provision, a trust established by the donor should not demand a right to revoke or vary the donation provisions unilaterally.²⁹ The avoidance of this section will be examined in more detail in Paragraph D.3.

C.1.1.3 INCOME TAX – ATTRIBUTIONS OF INCOME TAX

C.1.1.3.1 SECTION 7 – ATTRIBUTIONS OF INCOME TO PERSONS OTHER THAN A TRUSTEES

These are contained in Section 7. The most applicable sections are:

1. Section 7 (5)

This section attributes income as a result of a donation, settlement or other disposition subject to a stipulation or condition, until either such condition takes place, or the death of the donor, whichever occurs first.

2. Section 7 (6)

Right to receive income, revocable by the person granting the right the income, is deemed to be income of the person conferring the right.

3. Section 7 (7)

Gratuitous cession of income, under which the donor is able to regain the income. Such income is deemed to be the income of the donor.

²⁹ Section (3)(5)(b)(ii) Estate Duty Act No. 45 of 1945.

4. Section 7 (8)

This has been specifically enacted to tax income received as a result of a donation to a non-resident, in the hands of the South African donor.

There are two exemptions:

1. *“Donations made to foreign entities of a public character and to control foreign entities as defined in 9D; and*
2. *A proviso exempting income taxed in terms of Section 9E, which will be revoked on 30 June this year for years of assessment commencing after this date”.*

This will not be discussed in this report.

C.1.1.3.2 TAX BURDENS FACING TRUSTEES AND BENEFICIARIES – SECTION 25B – TAXATION OF TRUSTS, THEIR TRUSTEES AND THEIR BENEFICIARIES

Taxation of trusts – Section 25B

In sub-paragraph 1 – Taxes vested rights to Income in the hands of beneficiaries and non-vested rights, in the hands of the trustees.

In sub-paragraph 2 – Taxes income vested in beneficiaries at the discretion of trustees in the hands of such beneficiaries.

Sub-section 2A – Taxes retained income of trusts, specifically offshore trusts not taxed in South Africa in the hands of beneficiaries on the distribution of such income.

Sub-section 3 – Deems expenses of the trust to be linked to the Income attributed to beneficiaries in Sub-section 1 and 2.

Sub-section 4 – Links deemed expenses to the deemed income.

Sub-section 5 – Ring fences any excess of expenses over income in the trust.

Sub-section 6 – Allows the beneficiary to deduct this assessed loss remaining in the trust against deemed trust income he/she may receive in the following year.

Sub-section 7 – does not apply the deeming provisions where, as set out in Sub-section 1, the beneficiary is not subject to tax in the republic on such income.³⁰ Therefore non-resident beneficiaries are not taxed in South Africa on any non-South African source income or South African exempt income e.g. dividends and interest subject to the rules in Section 10.1, distributed to them.

C.1.1.4 EXEMPTION FROM GROSS INCOME – CAN A TRUST’S INCOME BE EXEMPT FROM TAX IN THE CONTEXT OF AN OFFSHORE TRUST?

The general exemption provisions for trusts are contained in:

“Section 10 (1)(f) – receipts and accruals of all religious, charitable and educational institutions of public character, which carry on religious, charitable and educational activities as a case may be, in the republic whether or not supported wholly or partly by grants from public revenue.”

This exemption is not applicable to trusts conducting religious, charitable or educational activities outside South Africa. This provision will not apply to offshore trusts, the subject of this report since they do not conduct their activities in the republic.

³⁰ Inserted by Section 32 (1)(d) of Act 59 of 2000

C.2 CAPITAL GAINS

C.2.1 CAPITAL GAINS – A LOOK AT THE 8th SCHEDULE

ATTRIBUTIONS OF CAPITAL GAINS – PARAGRAPH 68 TO 72 OF THE 8th SCHEDULE

This is contained in part 10 of the 8th Schedule of the Income Tax Act 58 of 1962 as amended and is specifically set out in Paragraphs 68 – 72. The wording of these paragraphs is not much different from those contained in Section 7 of the Income Tax Act.

C.2.1.1 ATTRIBUTIONS OF CAPITAL GAINS TO DONORS – PARAGRAPH 70 OF THE 8th SCHEDULE – THE PARAGRAPH MOST APPLICABLE TO ATTRIBUTIONS OF GAINS IN OFFSHORE TRUSTS TO SOUTH AFRICAN DONORS

Paragraph 70 deals with the attribution of capital gains subject to conditional vesting.

This applies as follows:

- (a) *“A person has made a donation, settlement or other disposition that is subject to a stipulation of condition imposed by THAT PERSON OR ANYONE ELSE, in terms of which a capital gain or portion of any capital gain attributable to that donation, settlement or other disposition, shall not vest in the beneficiaries of that donation, settlement or other disposition or some of those beneficiaries until the happening of some fixed or contingent event. (Emphasis added)*

- (b) *A capital gain that is attributable to that donation settlement or other disposition has arisen during a year of assessment throughout which the person who made that donation settlement or other disposition has been resident.³¹*

³¹ Resident is defined in Section 1 of the Income Tax Act;

- (c) *That capital gain or a portion thereof has not vested, during that year in any beneficiary who is a resident, that capital gain or that portion thereof must be taken into account in determining the aggregate capital gain or aggregate capital loss of the person who made the donation settlement or other disposition and disregard it when determining the aggregate capital gain or aggregate capital loss of any other person”.*

C.2.1.2 PARAGRAPH 71 OF THE 8th SCHEDULE – OTHER LIKELY CAPITAL

ATTRIBUTIONS – REVOCABLE VESTING RIGHTS

Paragraph 71 – Attributes Capital Gains subject to revocable vesting. This revocable vesting right is unlikely to be applied in practice, as such donated assets will be deemed to comprise property at market value in the deceased donor’s estate, in terms of Section 3 (3)(d) of the Estate Duty Act No. 45 of 1955.

C.2.1.3 PARAGRAPH 72 OF THE 8th SCHEDULE – ATTRIBUTION OF CAPITAL

GAINS VESTING IN A NON-RESIDENT

Paragraph 72 – where a resident makes a donation to trustees and the trustees vest a capital gain in a person who is not a non-resident, the capital gain is disregarded when determining the aggregate capital gain or aggregate capital loss of the person in whom it vests and is taken into account when determining the aggregate capital gain or capital loss of the resident making the donation, settlement or other disposition³².

C.2.1.4 PARAGRAPH 73 OF THE 8th SCHEDULE – ANTI-OVERLAP RULE

CONTAINED IN THE ATTRIBUTION PROVISIONS OF THE 8TH SCHEDULE

³² Paragraph 72 (a) of the 8th Schedule

There is an anti-overlap rule pertaining to actual income accrued and gains realised in paragraph 35 (3) of the 8th Schedule. Attributed capital gains and income are legal fictions and therefore this provision cannot help mixed income and capital gains attributed to certain people. A special provision is therefore required – this is found in Paragraph 73 of the 8th Schedule. This applies where both an amount of income and capital gain is realised as a result of a donation, settlement or other disposition and there is an attribution of income and capital gains. The section precludes the double counting of the total of the income attributed, in terms of Section 7, and capital gains attributed, in terms of Part X of the 8th Schedule.³³ This attribution shall not “*exceed the amount of the benefits derived from that donation settlement or other disposition*”.³⁴ The attribution is allocated: Firstly, *to the total amount of that Income and Gain attributable in terms of Section 7,*³⁵ i.e. the balance is attributed to the capital gains.³⁶

This implies one first attributes income gains and, if there is also a capital gain, the balance of the benefits is categorised as such and attributed to the donor.

³³ Paragraph 73 (1) of the 8th Schedule

³⁴ Paragraph 73 (1)(b) of the 8th Schedule

³⁵ Paragraph 73 (1) (a) of the 8th Schedule

³⁶ Paragraph 73 (1)(a) and (b) of the 8th Schedule

C.2.2 CAPITAL GAINS REALISED ON SETTING UP THE TRUST

C.2.2.1 TRANSFER OF ASSETS TO TRUSTEES BY THE DONOR

This always arises on the setting up of the trust.

Disposal by the Donor by way "*The sale or donation ... of an asset*"³⁷ to the trustees.

C.2.2.2 CAPITAL GAINS REALISED BY TRUSTEES VESTING AN INTEREST IN AN ASSET HELD BY A TRUST – PARAGRAPH 11 (1)(d) OF THE 8th SCHEDULE

The vesting of an interest in an asset in a trust of a beneficiary is treated as a disposal.³⁸

This is the creation by the trustees of a personal right between the beneficiary/ies and the trustees.

C.2.2.3 ATTRIBUTION OF CAPITAL GAINS TO DONORS – PARAGRAPH 11 (2)(e) OF THE 8th SCHEDULE – AVOIDANCE OF DOUBLE COUNTING AS A DISPOSAL, THE TRNASFER OF VESTED TRUST ASSETS TO VESTED BENEFICIARIES

The transfer of the vested assets by the trustees to vested beneficiaries does not result in a further disposal by the trustees.³⁹

³⁷ Paragraph 11 (1)(a) of the 8th Schedule

³⁸ Paragraph 11 (1)(d) of the 8th Schedule

³⁹ Paragraph 11 (2)(e) of the 8th Schedule

C.2.2.4 WHEN DO BENEFICIARIES PAY TAX ON CAPITAL GAINS REALISED? –

PARAGRAPH 80 (3)(b) OF THE 8th SCHEDULE

Attributions of capital gains realised by a non-resident trust are contained in Paragraph 80 (3), where

“during any year of assessment in which a resident acquires a vested right to any amount represented capital of any trust which is not a resident from gains realised by the non-resident trust in the previous year of assessment of which the resident had a contingent right to that capital. Paragraph 80 (3) (a)(i) or

(ii) any amount which would have constituted a capital gain of that trust had that trust been a resident and

(b) that capital gain had not been subject to tax in the republic in terms of provisions of this Act. That amount must be taken into account with the purpose of calculating the aggregate capital gain or the aggregate capital loss of that resident in that year of assessment”.

PART D

CAN THE TAX IMPACTS LISTED IN THIS REPORT BE AVOIDED? – AN ANALYSIS OF THE PLANNING SOLUTIONS, THEIR RISKS AND HOW BEST TO CONTROL THEM

Now that it is established what a trust is, how it is formed, how donations tax income, capital gains and estate accruals may be attributable to South African Resident donors and beneficiaries, one may then examine possible ways to avoid these attributions.

D.1 THE TYPICAL STRUCTURE OF THE “SCHEME” CURRENTLY USED IN PRACTICE ANALYSED AGAINST LIMITS IMPOSED BY SECTION 103 (1)

- A. An offshore trust is established by a South African donor by way of donation or sale of the trust assets to non-resident trustees. The trust deed grants the trustees full discretion as to distribution of trust capital and income, in addition to timing, quantum and persons (subject normally, to a list of persons) who will benefit.
- B. The trust is not effectively managed as envisaged in 9D in South Africa. This means that strategic decisions are not made in the republic.⁴⁰
- C. The trust deed contains normal contractual provisions.⁴¹

⁴⁰ Effective Management is defined by the OECD as the place at which strategic decisions are made. This is supported by Revenue’s Practice Note in this matter.

⁴¹ Hicklin 41 SATC 179. There is a presumption that rights and obligations are normal when dealing at arm’s length.

The trustees and donor deal at arm's length in terms of the rights and obligations the parties agree to. The donor is not connected to the Trustees. The donor lists various beneficiaries and grants normal rights to trustees.

One of these rights is to empower the trustees to distribute the trust assets to another trust.

The trustees have a common law duty to act in the best interests of the beneficiaries.

After due consideration of their duties, the trustees determine that by entering into a transaction or series of transactions, they can avoid South African tax liabilities in favour of their South African resident beneficiary/ies.

One need not consider tax avoidance as a business normality in considering that one is dealing with non-trading trusts in this report.⁴²

The trustees therefore decide to donate their trust assets to a new trust.

For Revenue to attempt to apply Section 103(1) the tax liability of a South African resident must be fairly imminent.⁴³ An imminent liability exists in relation to the donor of a discretionary trust in terms of the attribution rules contained in Section 7(8) and Section 7(5) as well as Paragraph 70 and 71 limited in the anti-overlap attribution rule contained in Paragraph 72 of the 8th Schedule, in that, any Income or capital gains currently earned, will be attributable in the current year to the South African resident donor. Smith's case further established the principle that avoiding a liability is given its ordinary meaning i.e. getting out of the way of the liability. This would certainly be the case as a result of this transaction being concluded, in that there is an imminent liability for income tax and capital gains tax in the hands South African donor being income tax in terms of Section 7(5) and Section 7(8) and capital gains tax in terms of Paragraph 70 of

⁴² Ferera 38 SATC 66

⁴³ Smith 26 SATC 1. A 1963 case.

the 8th Schedule. These taxes accrue on an annual basis to a South African resident taxpayer. In the Smith case, income-earning assets were sold to avoid income tax. Here income and capital gain producing assets are distributed to a non-resident trust, to avoid the attribution of income tax and capital gains tax to the South African resident donor.

The assets in the new trust would earn income and realise capital gains.

A trust is a conduit,⁴⁴ the trustees have the right to determine which assets to distribute. If they decide to distribute the original trust capital to South African resident beneficiaries at par this would not realise any capital gains in the hands of the South African beneficiaries.⁴⁵

The accumulated capital gains and retained income will become taxable in the hands of South African beneficiaries, if distributed to a South African Resident beneficiary in terms of Section 25B (2A). The trust assets of the second trust could be distributed to a third non-resident trust, in an attempt to avoid this provision.

Tax avoidance cannot be argued to be a business normality in terms of Section 103 (1).⁴⁶

If there is insufficient unity in a scheme, one can look at a part of scheme for purposes of the general anti-avoidance provisions.⁴⁷

If the nexus between the first, second and third trusts is broken, the retained income and capital gains can be distributed to a third non-resident trust i.e. not formed in South Africa nor effectively managed in South Africa, which will result in capital being received by the third trust. The new trust capital held by the third trust is distributed as such to South African resident beneficiaries at par without incurring a capital gain.

⁴⁴ Estate Munro 1 SATC 163 and Trustees of Hull Fund 5 SATC 201

⁴⁵ Paragraph 80 (3) of the 8th Schedule

⁴⁶ Ferera 38 SATC 66

⁴⁷ Louw 45 SATC 113

Attributions in terms of Paragraph 80 (3) of the 8th Schedule are constrained by Section 103 (1).

Rights and obligations between the trustees of the second and third trusts must be obtained by means, or in a manner normally employed in such an arrangement. Alternatively and in addition, the rights and obligations must be normally created between the parties. There is a presumption that rights and obligations are normal if dealing at arm's length.⁴⁸

The question therefore needs to be asked: would the constitution of the third trust be challenged in that it was formed by means, or in a manner not normally employed? This could possibly be answered as follows:

*“The formation of the third trust is motivated in the same way as the second and is premised on the trustees duty to act in the beneficiary's best interest. This interest in the context of a South African tax resident beneficiary extends to tax minimisation. The counter argument, purely in a business context which is not the subject of this paper, is that tax avoidance cannot be argued to be a business normality in terms of Section 103 (1)”.*⁴⁹

The donor or beneficiary, as the case may be has to discharge the onus of proof imposed on him in terms of Section 82 that any amount is exempt from liability⁵⁰ or must be disregarded or excluded in terms of the 8th Schedule.⁵¹

Section 103 (7) states that the taxes to be considered by the Commissioner in his anti-avoidance considerations includes taxes levied in terms of any act administered by him.

This allows the Commissioner to determine the liability for any tax duty or levy imposed

⁴⁸ Hicklin 41 SATC 179

⁴⁹ Ferera 38 SATC 66

⁵⁰ Section 82 (a)

⁵¹ Section 82 (c)

by the Income Tax Act 58 of 1962 being income tax, donations tax, secondary tax on companies, withholding taxes on donations and capital gains tax and to allow the operation of Section 103 (1) if these taxes or estate duty, regional services council levies, value added tax, import duties, stamp duties or transfer duties are avoided.

If the scheme is conducted by such means or manner and creates rights and obligations as set out above, I submit that it could not be successfully set aside in terms of Section 103 (1) – a detailed conclusion is found in Part E of this report.

D.2 PLANNING OPPORTUNITIES TO AVOID DONATIONS TAX – EXEMPTIONS AND PLANNING OPPORTUNITIES CONTAINED IN SECTION 54 AND SECTION 56

Planning opportunities for assets located outside the Republic (the following is paraphrased)

Donations tax is levied in terms of Section 54,⁵² subject to the provisions of Section 56.

The disposal of the trust assets by the trustees to another trust is exempt from donations tax.⁵³

It is not clear if this is a revesting or a cancellation of a donation if distributed to the donor as beneficiaries. The distribution therefore, by the non-resident trustees of the trust to the trustees of a new trust is exempt from donations tax. As it is disposed of under and in pursuance of the trust deed.

⁵² The value of any property disposed of (whether directly or indirectly and whether or not they are in Trust) under donation by any Resident, in this part, referred to as the Donor.

⁵³ Section 56 (1) – Donations Tax should not be payable in respect of the value of any property which is disposed of under a Donation –
(1) if such property is disposed of under and in pursuance of any Trust.

“There are five exemptions for:

Donations consisting of any right in property situated outside the republic and acquired by the donor:

1. *Before he became a resident of the republic for the first time⁵⁴.*
2. *By inheritance from a person who, at the date of his death, was not ordinarily resident in the republic, or by a donation, if, at the date of the donation, the donor was a person (other than a company) not ordinarily resident in the republic.⁵⁵*
3. *Out of funds derived by him from the disposal of any property in 1 and 2 above. If the donor disposes of the last mentioned property and replaces it successively with other properties (all situated outside the republic) and acquired by the donor of funds derived by him from the disposal of any of the said properties, out of funds derived by him from the disposal of, or from revenue from any of those properties, or⁵⁶*
4. *out of funds derived by him from a trade carried on by him outside the republic, or⁵⁷*
5. *in the use of immovable property, not less than ten years before the date on which the donation takes effect”.⁵⁸*

Planning opportunities flowing from these rights:

⁵⁴ Section 56 (1)(g)(i)

⁵⁵ Section 56 (1)(g)(ii)

⁵⁶ Section 56 (1)(g)(iii)

⁵⁷ Section 56 (1)(g)(iv)

⁵⁸ Section 56 (1)(g)(v)

1. A person becoming a South African resident for the first time may donate his assets acquired by him prior to his date to a foreign trustee.
2. A resident earning foreign trade income should always donate this income as there is no similar exemption from estate duty contained in the Estate Duty Act. It is therefore advisable for South African residents to donate such income during the resident's life-time.
3. A resident should dispose of foreign immovable property held by him for more than ten years . A trust can be an ideal vehicle to receive such donation, giving its flexible nature.

D.3 PLANNING OPPORTUNITY TO AVOID PROPERTY ACCRUALS FOR ESTATE DUTY

One needs to examine the property planning limits of the 4th item of deemed property, i.e. property the deceased was competent to dispose of in terms of Section 3 (3)(d) read with Section (3)(5).

The planning constraint is:

The first trust established the donor should not demand a right to revoke or vary the donation provisions unilaterally.⁵⁹

⁵⁹ Section (3)(5)(b)(ii) Estate Duty Act No. 45 of 1945.

D.3.1 ACCEPTABLE CONTROL OPTIONS THAT WILL NOT INVOKE SECTION 3 (3)(d) ARE:

D.3.1.1 The right of the donor to veto the decision of his trustees; and

D.3.1.2 The right of the donor to hire and fire the trustees.⁶⁰

Benefits of these control mechanisms are that they allow:

- Better access to assets
- No estate duty liability indirectly borne via the estate on behalf of the heirs
- Therefore, a Donor can influence Trustees to this extent without triggering the deeming provision of Section 3 (3)(d).⁶¹

D.3.2 INTEREST-FREE LOANS

The disposal of assets into the first trust by way of sale at market value on interest-free loan will result in the waived interest not being deemed property for estate duty purposes as it is not property arising on death.

D.3.3 PLANNING OPPORTUNITY USING SECTION 25B⁶²

NON-RESIDENT TRUST

“where a resident trust acquires a vested right to an amount representing capital of a non-resident trust and –

- (a) *such capital arose from income of the trust (or receipts and accruals which would have constituted income if the trust had been a resident)⁶³ during any past years during which the resident had a contingent right to such income; and*

⁶⁰ Revenue Practice – accepts the above control mechanisms as not triggering Section 3 (3)(d) of the Estate Duty Act

⁶¹ Assets the deceased was competent to dispose of i.e. if he could revoke any donation or settlement of property to a Trust. These Trust assets will be dutiable in his Estate, notwithstanding his position in relation to the Trustees in his lifetime.

⁶² Meyerowitz on Income Tax 2003-2004

⁶³ Section 25B(2A) with effect from 1 January 2004

- (b) *such income (or receipts and accruals) has not been subject to tax in the Republic, then the accumulated income accruing to the resident must be included in his income in the year of accrual to him of the capital.*

Thus, if a person has had a contingent interest in a non-resident trust for, say, twenty years during which income or the receipts and accruals referred to is accumulated in the trust and his contingent interest ripens into a vested interest in the year he is a resident of the Republic, he will be liable for that year for tax on the accumulated income accruing. It will be immaterial whether the taxpayer was always a resident or when he became a resident or when he became a resident. His liability arises from the fact that he was a resident in the year the capital accrued to him. Conversely, no liability will arise if the capital accrues to a non-resident even though he may have been a resident during the period of this contingent interest prior to his becoming a non-resident.

It will be prudent exercise to keep a record of the accumulated amounts to enable the resident to discharge the onus of proof should Revenue contest the amount of the accumulation.

PLANNING OPPORTUNITY

A South African who ceases to be a tax resident prior to vesting or distribution of trust assets to him, will, it appears, avoid the application of this section even though he was a resident for every year of the trust's existence and accumulation of income prior to his tax residency.

In practice, one would have to track the original capital and its subsequent disposals and re-acquisitions of new investments separating original capital from accumulated revenue and capital gains to discharge the onus imposed by Section 82.

This can be practically achieved by designating:

- The original capital as falling into for example, an account number one.
- Realised revenue gains and the subsequent re-investment of such profit in new investment as account number two.

- Realised capital gains and the subsequent re-investment of such gains in new investment as account number three.
- Lastly, dividends received which are exempt from South African Income Tax to be treated in the same way as realised revenue and capital gains to be placed in account number four.

D.3.4 PLANNING OPPORTUNITY USING SECTION 7(8)

Where by reason of, or in consequence of a donation, settlement or other disposition made by a resident, income is received by a person who is not a resident, there will be included in the income of that resident so much as of any income is as attributable to the donation, settlement or other disposition.

The natural reading of the words would indicate that, at the time of donation to the non-resident, the donor had to be a South African tax resident.

Therefore, if a person donates his assets to a non-resident prior to becoming a tax resident it is submitted that Section 7(8) attributions could not be applied to subsequent income accruals in the hands of non-resident trustees.

PART E

E. WHAT CONCLUSIONS CAN BE DRAWN IN RELATION TO SECTION 103 (1)?

The conclusions regarding the avoidance of donations tax are contained in part D.2 and estate duty on part D.3 of this report. With focus on the suggested conclusion on Section 103 (1).

E.1 ARE THE RIGHTS AND OBLIGATIONS AND ARE THE MEANS , AND OR THE MANNER IN WHICH THE SCHEME IS EXECUTED NORMAL?

E.1.1 IN THE CONTEXT OF:

THE DONOR – The right to grant the trustees authority by means of the deed of trust to distribute the trust assets to another trust is generally contained in discretionary trust deeds in South Africa and wherever else English is spoken.

E.1.2 THE BENEFICIARIES – Have, in the context of a discretionary trust, a spes of trust distributions. This is a real right against the trustees to act in the beneficiary's own best interests. The beneficiaries have no obligations in a trust arrangement.

E.1.3 THE TRUSTEES – The obligation of the trustees to act in the best interest of the beneficiaries is universal. Does this duty extend to minimising the taxpayer's tax liability in his home jurisdiction?

The trustees have a right contained in the trust deed to distribute the trust assets to another trust. The means or the manner must be those normally employed in carrying out such an operation.

E.1.4 WHEN WOULD SECTION 103 (1) BE APPLIED?

I submit the opinion that the nexus between the initial donation by the donor to the trustees of the first trust and their subsequent trust/s must be broken. A donation made by the donor in contemplation of its on donation by the non-resident trustees to other trust/s would not be by means, or in a manner, normally employed in such circumstances on the basis of an objective analysis of the establishment of discretionary trusts World-wide.

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F.3 TABLE OF STATUTES:

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