

**A DISCUSSION ON COUNTERING OFFSHORE AVOIDANCE THROUGH THE
USE OF TRUSTS: A SOUTH AFRICAN PERSPECTIVE**

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Signed at _____ on this _____ day of MARCH 2014

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CHAPTER 5 CONCLUSION

CHAPTER 1 INTRODUCTION

1.1 Background information

In their book, *Offshore Insight* J Ware and P Roper¹, states the following:

*“The number of persons participating in offshore activities has increased over the last thirty years, **as has the number of trusts and companies (my own emphasis)**. This trend shows no sign of abating as witnessed by the nearly one million companies that have been incorporated in the past ten years. Many of the world leading financial institutions continue to increase their offshore activities, e.g. CNN, Chase Manhattan, City Bank, Goldman Sachs, Charles Schwab, Bank of America, Barclays Bank, Rothschilds, Royal Bank of Canada and Deutsche Morgan Grenfell, to name a few...*

*The significance of the offshore arena...lies in the amount of money that is placed there. It is estimated that 60% of the world’s money is offshore. Vast sums of money continue to gravitate to the offshore market **where it is likely to receive favorable tax treatment and experience fewer restrictions (my own emphasis)**...*

There are currently more than 60 offshore financial centers in the world, many within the jurisdictions of the worlds major powers (with their perceived high tax levels).

It was recently estimated that more than US \$5 trillion is held offshore. If cognizance is taken of the fact that total world central bank reserves were US \$1 trillion as far back as 1991, this provides some idea of the relative size of offshore wealth today.

The popularity of offshore structures and transactions seems set to continue.”

One of the most common ways to pay less or no tax at all is to establish a legal entity in a sound offshore tax haven jurisdiction.² Typical legal structures so established are companies and trusts.³ These jurisdictions offer low or no taxes and as such offer favorable tax advantages for companies and trusts wishing to pay low tax or no tax.⁴ The idea behind establishing these entities is that once the assets are transferred to the legal structure, that tax

¹ J Ware and P Roper *Offshore Insight* (2001) 2-4 (inclusive)

² Ware and Roper Op cit (n1) 25

³ Ware and Roper Op cit (n1) 25

⁴ Ware and Roper Op cit (n1) 25

will be levied in the hands of the legal entity. The object of establishing an entity in tax haven jurisdictions is not necessarily to pay less tax but rather, to increase after- tax disposable income.⁵

According to the South African Revenue Service (“SARS”) impermissible tax avoidance has been an increasing problem universally. From Australia continuously expressing concerns over tax avoidance and evasion, specifically with regards to schemes involving offshore tax havens such as the Channel Islands⁶ to the United Kingdom who imposed new provisions to combat hostile avoidance schemes in the cross- boarder context.

A 2004 study in the US also reported that two- thirds of US companies who operated for the years 1996 to 2000, failed to pay federal income taxes on their profits for those years. More specifically the report states that for the year 2000, 94 percent of all companies operating in the US for that year paid less than 5% of the profits they reported for financial accounting purposes.⁷ The Organization for Economic Co-operation and Development (“OECD”)⁸ has continuously expressed concerns about harmful tax competition being propelled in part, by various tax havens located worldwide.⁹

Investing offshore has an alluring and exotic appeal to it and it seems as if it will continue to be used as a way of avoiding tax particularly in the absence of anti- avoidance measures. This

⁵ A Ginsberg *International Tax Havens* (1990) v

⁶ SARS Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act of 1962 (2005)

⁷ United States, *Comparison of the Reported Tax Liabilities of Foreign- and- US- Controlled Corporations, 1996-2000* (Washington, DC.: US General Accounting Office 2004).

⁸ The OECD was established in 1961 to contribute to the economic growth and development of its member countries. Even though its main focus is member countries, it affects non- member countries as well. They promote economic development by issuing publications and statistics on topics such as corporate governance, trade and tax, e- commerce etc. It uses these publications to encourage dialogue, consensus and peer review to achieve economic development and change in the market economy. (See OECD “History of OECD” on www.oecd.org/document/63/0,2340)

⁹ OECD *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD 1998 report)

incites more taxpayers to engage in offshore tax avoidance to the detriment of their countries own tax base and economy.

1.2 Statement of problem

It is no secret that the applicability of taxes differ from natural to juristic persons, from entity to entity and from one country to another and as such there is an attraction to have ones tax affairs subject to no tax or low tax. With political and currency uncertainty or risks, interest rate fluctuations, application of high tax rates in country of residence¹⁰ and the credit crunch,¹¹ taxpayers (“TP”) will therefore want to ensure that foreign income and assets are hidden from the local revenue authority and kept outside its taxing net.

Curiosity and interest has also peaked recently, due to high profile court prosecutions like the Swiss Bank UBS AG and the Liechtenstein Global Trust Group cases where the US and other countries prosecuted.¹² In order to minimize tax exposure a TP will get involved in tax avoidance schemes so as to minimize the tax payable.¹³ In doing this, they may cross the line between tax avoidance and tax evasion.

It is clear that there are many types of offshore business vehicles that are utilized for offshore avoidance. However, this paper will focus specifically on trusts. It is submitted that there is a nexus between the existence of tax havens and the use of offshore trusts for tax avoidance purposes. It is further submitted that there are two main trigger mechanisms for investing offshore in trusts.

¹⁰ Ginsberg Op cit (n5) 7

¹¹ Congressional Research Service *Tax Havens: International Tax Avoidance and Evasion* (2013) page 5 at para 3.

¹² Congressional Research Service *Tax Havens: International Tax Avoidance and Evasion* (2013) page 5 at para 3.

¹³ M Stiglingh, AD Koekemoer, L van Schalkwyk, JS Wilcocks, RD de Swardt SILKE: *South African Income Tax* (2012) 787; See also AW Oguttu *Offshore trusts and income tax avoidance : the lures and the pitfalls from from a South African perspective*, International Journal of Private Law (UPL) vol 5, No. 4, 2012

Firstly is the very existence of tax havens with its many advantages that easier facilitate tax avoidance. As was so eloquently put by J Ware and P Roper in the book, *Offshore Insight*, “Much of the worlds transactions take place in what is colloquially known as the tax haven jurisdictions. At it simplest level, a tax haven is a place where tax rates are zero, assets are protected and privacy is virtually guaranteed (my own underlining and emphasis). This would tend to suggest that funds placed in these jurisdictions would thus be secure and unfettered(my own underlining and emphasis). Because of this, a substantial part of the world wealth today resides in tax havens... ”¹⁴

Secondly are the actual structural features of a trust itself that make them one of the chosen vehicles used for offshore avoidance. Traditionally trusts are used to enable the legal separation and control of assets from the beneficiaries of the trust. This is exactly what cannot be achieved through a company. A trust ensures that assets are held, protected and transferred between generations and in some cases are used as a means of wealth planning. Asset protection, succession planning and flexibility provided by trusts coupled with the fact that it is relatively inexpensive to form both offshore and onshore, makes them an exceptionally useful entity. These incentives are not provided by a company. It is therefore prudent to understand the mechanics of a trust both locally and internationally. ¹⁵

1.3 Objective of study

The incentives mentioned in 1.2 above makes a trust one of the preferred mediums used by taxpayers for asset protection and tax avoidance.¹⁶ It is for this reason coupled with Treasury’s 2013/ 2014 budget comments to clamp down on trusts used to avoid tax that I have chosen to limit this work to the use of trusts as a vehicle for offshore avoidance. At the time of writing this thesis, the 2014/2015 budget had not yet been released.

In considering this, I will address the two incentives for offshore avoidance through trusts mentioned above. These are (i) the very existence of tax haven jurisdictions and (ii) the actual structural features of a trust that makes them the ideal choice to avoid tax. These incentives need to be addressed in order to aid in the minimization of tax avoidance.

¹⁴ Ware and Roper Op cit (n1) 3

¹⁵ Ware and Roper Op cit (n1) 16

¹⁶ Ware and Roper Op cit (n1) 35

Since the very existence of tax havens propell offshore avoidance through trusts, the topic of tax havens will be discussed and since offshore avoidance is dealt with on an international scale, this work will also consider some of the international initiatives taken to minimize the issue as well as consider the effectiveness of those initiatives.

Thereafter, this paper will consider the anatomy or unique features of an offshore trust as a preferred vehicle used in tax avoidance. In considering these, I will look at the establishment of trusts in offshore jurisdictions.

I will also consider the new Generally Accepted Avoidance Rule (GAAR) and some of the anti-avoidance measures put in place to curb the use of trusts established in offshore jurisdictions for tax avoidance from a South African perspective. To this end, I will consider whether the South African measures put in place addresses the problem of tax avoidance through the use of offshore trusts. Lastly, this paper will discuss some of the my findings on the topic.

CHAPTER 2 TAX HAVENS: THE PROPELLER FOR OFFSHORE AVOIDANCE

2.1 Introduction

As discussed in chapter 1, one of the most effective ways of avoiding tax is to set up a trust in a tax haven jurisdiction, where tax is favorable and limitations are minimal. As tax havens are sovereign states, with its own tax laws, individual countries cannot by their own accord stop or abolish them.¹⁷ The only way to deal with tax havens would be on an international scale. It is necessary to consider tax havens as its very existence is one of the trigger mechanisms that encourage offshore avoidance. This chapter will consider tax havens as well as some of the international initiatives undertaken to counter tax avoidance on an international level.

2.2 Defining a tax haven

At the outset, it is worth noting that there is no formal or precise technical definition for the concept of a “tax haven”.¹⁸ There is no globally accepted definition of what exactly a tax-haven is.¹⁹ It is internationally accepted that there is no one size fits all objective test that can be employed to identify a country as a tax haven.²⁰ The reason it cannot be precisely defined lies in the fact that the definition can be given either a broad meaning or a precise one.²¹

Broadly speaking, it can be said that any country can be regarded as a tax-haven because almost every country has a lower rate of tax applicable to a certain activity than that applied by another country for the same activity. An example of this is the fact that each country’s income tax rates applicable to any given activity will differ from country to country. Thus if the definition of a tax haven is limited solely on the tax rates applicable in different jurisdictions, then the ensuing definition is unlikely to be meaningful in practice. This is

¹⁷ OECD *The OECD’s project on Harmful Tax Practices: Update on progress in member countries* (2006) at para 6

¹⁸ OECD *Harmful Tax Competition: An Emerging Global Issue* (1998) at para 42 (The 1998 report)

¹⁹ M Hampton *The offshore Interface: Tax Havens in the Global Economy* (1996) 9

²⁰ United Nations *Ad Hoc Group of Experts on International Tax Matters* at 30-31

²¹ Hampton Op cit (n19) 10

because for e.g some high tax countries may offer tax advantages similar to tax- havens, where tax exemptions are only granted for certain types of businesses.²²

By the same token, if it is precisely defined as a country or territory that applies no or low income tax on all or certain income items or on capital gains this would encompass almost all countries. Attempts to provide a precise definition are therefore bound to be unsuccessful.²³

The use of the term tax haven has become frowned upon by revenue bodies and tax advisors since the term tax haven generally implies bypassing a country's tax laws. The term is thus used interchangeably with the more preferred term "offshore finance centers".²⁴

It has been stated²⁵ that the term "offshore finance centers" is broader and encompasses the following three classes of jurisdictions:

- Countries where there are no relevant taxes (the so-called tax paradises) like the Cayman Islands, Bahamas and Bermuda
- Countries where taxes are levied only on internal taxable events, but not at all or at a very low tax rates on profits from foreign sources
- Countries which grant special tax privileges to certain types of companies or operations, such as the Channel Islands, Isle of Man, Liechtenstein and Monaco

According to the OECD it is a country or territory who levies no or low tax, coupled with the fact that that country generally makes itself available for the avoidance of tax that would normally be payable in high tax countries. A tax haven is distinguished by the OECD from a so called "preferential tax regime" where the country receives huge amounts of revenue from

²² Hampton Op cit (n19) 10

²³ United Nations *Ad Hoc Group of Experts on International Tax Matters* at 30- 31

²⁴ L Olivier and M Honiball: *International Tax: A South African Perspective* (2008) 563

²⁵ Ginsberg Op cit (n5), See also Ware and Roper op cit (n1) 21

its income tax system but where the tax system itself has features amounting to harmful tax competition.²⁶

2.3 What are the features of a tax haven jurisdiction?

The features or characteristics of tax haven jurisdictions have been classified into the following four categories according to the OECD's 1998 Report:²⁷

No or low taxes

This is said to be the starting point in identifying a jurisdiction as a tax- haven. As stated above, it must be combined with a situation where the jurisdiction offers itself as a place where non- residents can escape tax in their country of residence.

Lack of effective exchange of information

Tax haven jurisdictions are often characterized by high level of secrecy, more specifically in the banking and commercial sectors.²⁸ They typically have laws or administrative practices in place, which offer strict secrecy and protection against scrutiny from tax authorities thereby preventing the effective exchange of information. This is extremely beneficial to taxpayers in that their privacy is virtually guaranteed²⁹ and tax authorities find it difficult to identify who the relevant investors are for purposes of collecting taxes.³⁰ Most users of tax havens see these secrecy provisions as important and are concerned with them to ensure that their affairs remain confidential.³¹ In order to reassure these users or potential users, many tax havens have introduced confidentiality laws imposing criminal sanctions on bankers or other professionals who betray client confidentiality.³² The most notable examples of such tax havens are Switzerland and Liechtenstein .³³

²⁶ OECD *Harmful Tax Competition* (1998 report) at paragraph 42

²⁷ OECD *Harmful Tax Competition* (1998 report) at pages 22-25 (inclusive)

²⁸ OECD *Harmful Tax Competition* (1998 report) at paragraph 54

²⁹ Ginsberg Op cit (n5) at 2

³⁰ A Ogleby *Tolley's Tax Havens: A Practical guide to the leading tax havens of the world* (1 ed) (1990) 7

³¹ Ogleby Op cit (n 30) 7

³² Ogleby Op cit (n30) 7

³³ Ogleby Op cit (n30) 7

Lack of transparency

A lack of transparency in the operation of the jurisdiction's legislative, legal or administrative tax practices and the existence of provisions that prevent the effective exchange of information is another key characteristic of a tax haven. This feature in itself encourages illegal activities such as money laundering and tax evasion. With countries enacting laws disallowing the provision of information to tax authorities, many tax administrators lacks the power to compel such information.³⁴

No substantial activities

This specifically refers to the fact that the tax haven does not require a normal/ commercial operational business activity (as is required by non- tax haven jurisdictions) to take place within their jurisdiction. In the absence of this specific element, it implies that such jurisdictions are possibly solely in existence for the purposes of avoiding tax since it indicates that such jurisdictions do not provide a legitimate legal or commercial environment or offer any economic advantages that would attract substantive business activities.³⁵

Other non- tax factors such as a relaxed regulatory framework that is offered by tax havens may also attract taxpayers to invest in tax havens as this will allow them to conduct business much more freely and easier.³⁶ Moreover it has been noted that other characteristics of a tax haven includes a lack of exchange controls in the country.³⁷ This in itself is a major attraction for taxpayers utilizing tax havens because this will permit money to be transferred subject to minor restrictions. On the flip side, non- tax haven countries who levies high taxes usually has strict exchange controls in place which inhibit domestic residents to freely move their money at any time.

³⁴ OECD *Harmful Tax Competition* (1998 report) at paragraph 53

³⁵ OECD *Harmful Tax Competition* (1998 report) at paragraph 55

³⁶ OECD *Harmful Tax Competition* (1998 report) at paragraph 56

³⁷ See Ginsberg at pg 9 where he states that the common advantages of a tax haven includes freedom from tax liability, strict laws of secrecy for banking and commercial transactions and no exchange controls. See also Hampton at 12. See also United Nations Ad Hoc Group of Experts on International Co- operation in Tax Matters at 36.

2.4 International initiatives taken to curb the development of tax haven jurisdictions

There have been and still are many international “attacks” to clamp down on tax havens and harmful tax practices, the most noteworthy of them being the OECD’s initiative on “*Harmful Tax Competition*”. In their book *Offshore Insight*,³⁸ Ware and Roper divides these into two broad categories. One being money laundering and the second being harmful tax practices and tax harmonization. I shall discuss some of these below the format of which is taken from Olivier and Honniball³⁹ and from Ware and Roper.⁴⁰ These include:

The United Kingdom: The UK Edwards Report and the KPMG Report

(i) The Edwards Report

The so called UK Edwards report was a review of financial regulation of international financial centres in the British Crown Dependencies jurisdictions of Jersey, Guernsey and the Isle of Man, the combating of international financial crime and their co- operation with other authorities and countries. Edwards was commissioned to undertake the review as a result of the British Government’s view that a large portion of the UK’s income tax was lost to tax havens.⁴¹ On 19 November 1998 when the report was published the converse was revealed. The gist of the report’s findings was that these jurisdictions were well regulated and amongst the best offshore financial centers. Despite this, these jurisdictions still undertook steps to comply with the report’s recommendations mostly as it pertains to the structure and composition of regulatory bodies.⁴²

(ii) The KPMG Report

The UK government commissioned the global accountancy firm KPMG in 2000 to investigate financial regulation and legislation of certain overseas territories and to produce a report on its findings. The report was jointly published in 2000 by the UK government and the

³⁸ Ware and Roper Op cit (n1) 21

³⁹ L Olivier and M Honniball *Taxation of Trusts: A South African Perspective* (2009) 564

⁴⁰ Ware and Roper Op cit (n1) 26- 27

⁴¹ Ware and Roper Op cit (n1) 32

⁴² Ware and Roper Op cit (n1) 32

governments of six overseas territories, namely Aguililla, Bermuda, British Virgin Islands, Cayman Islands, Montserrat and the Turks and the Caicos Islands. The findings of the report were in general positive towards the aforesaid territories and the report contained a number of recommendations. Olivier and Honniball⁴³ acknowledge the criticism in *Diamond and Diamond*⁴⁴ that because the report was partially financed by these jurisdictions themselves it was not very critical of these territories or their administration.

The European Union initiatives

There have been a number of EU initiatives against tax havens. A report was released in 1992 by a committee of experts on the taxation of companies within the EU. This report contained recommendations and conclusions on the subject matter. In 1997 European committees of Finance Ministries (ECOFIN) produced a code of conduct group with the purpose of setting up ways to recover tax lost to offshore financial centres. Also in November 1998 the European Commission accepted a communication on unacceptable State Aid in respect of direct business tax and as part of this initiative the Commission launched a number of State Aid investigations (the Gibraltar exempt offshore company rules and qualifying offshore company rules).

G7: The 1998 initiatives and the Financial Action Task Force (FATF) of the Groups of Seven Nations

The FATF was set up in 1989 by the G7 summit held in Paris. The main purpose of the FATF is to develop and promote policies to combat money laundering in general. The FATF collaborates with international organizations on existing initiatives rather than develop new initiatives. The FATF attends international anti- money laundering events so as to observe developments in non- member countries. The FATF has built up relations with non- members as well as with international and regional bodies.⁴⁵

⁴³ Olivier and Honniball Op cit (n39) page 565

⁴⁴ WH Diamond and DB Diamond *Tax Havens of the World* (Release number 108 January 2002) (2002)

⁴⁵Ware and Roper Op cit (n1) at chapter 9

Furthermore in 1998 the G7 committed themselves to take global action on tax related issues by facilitating information exchange amongst member states. They agreed to implement the EU and OECD initiatives on harmful tax competition and information exchange. At G7 summit held in 1999, member countries confirmed their support for the initiatives taken by the OECD on harmful tax practice and urged all jurisdictions to comply therewith. They also called for countries to implement a plan of action in respect of access to bank information and exchange thereof. In 2001 the G7 acknowledged the OECD for their continued dialogue with non- member countries and for their commitment to eradicate harmful tax practice.

The OECD Campaign on Harmful Tax competition

Probably the most noteworthy international initiative undertaken against tax havens and harmful tax practice is that of the OECD. In terms of article 13 of the OECD Convention, the Commission of the European communities participate in the OECD's work. This means that the initiatives undertaken by both the OECD and the EU must be read together. In fact it was noted by Arnold and McIntyre (2002 at page 138) that the code of conduct of the EU is much wider than that of the OECD in that the initiatives of the OECD is limited to geographical mobile activities for e.g. financial services.⁴⁶

The 1998 Report

As with the EU initiative, the OECD has condemned harmful tax practices are promoted by the existence of a number of tax havens. In this regards the OECD issued the 1998 Report in which the criteria are set out for what constitutes a tax haven and what constitutes harmful tax practices (see discussion above) both within the OECD countries and outside these countries.

The 2000 Report

In June 2000 they issued another Report called "*Towards Global Tax Co- operation- Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices*". This 2000report was an update to the 1998 report. The 2000 report identified thirty five jurisdictions that have met the criteria and qualified as tax havens. These countries are typically used by TP's to set up

⁴⁶Olivier and Honniball Op cit (n39) 563

offshore trusts to avoid tax. In chapter 3 of the 2000 report, paragraph B 17 lists the following jurisdictions:

“Andorra, Anguilla, Antigua and Barbuda, Aruba, Commonwealth of the Bahamas, Bahrain, Barbados, Belize, British Virgin Islands, Cook Islands, the Commonwealth of Dominica, Gibraltar, Grenada, Guernsey, Sark, Alderney, Isle of Man, Jersey, Liberia, the Principality of Liechtenstein, The Republic of the Maldives, the Republic of the Marshall Islands, the Principality of Monaco, Montserrat, the Republic of Nauru, Netherlands Antilles, Niue, Panama, Samoa, the Republic of the Seychelles, St Lucia, the Federation of St Christopher and Nevis, St Vincent and Grenadines, Tonga, Turks and Caicos, US Virgin Islands, and the Republic of Vanuatu”.

The OECD initiated dialogue with non- member countries. The 2000 report urges non-member countries to comply with the 1998 report.

The 2001 Progress Report

In 2001 the OECD issued another report: the 2001 report called *“The OECD’s Project on Harmful Tax Practices”*. The 2001 report merely reiterates the criteria for identifying tax havens as per the 1998 report and stated that they recognized that every jurisdiction had the right to determine whether to impose direct taxes or not and, if so, to determine the appropriate tax rate.⁴⁷ Furthermore they stated that many of these jurisdictions do not impose direct taxes and do not need to do so in order to fulfill their commitments.⁴⁸ In paragraph 28 and 29 respectively, the 2001 report states the following:

“The Committee has decided that concomitants will be sought only with respect to the transparency and effective exchange of information criteria to determine which jurisdictions are considered as uncooperative tax havens...the jurisdictions that have made concomitants prior to the issuance of this report will be informed that they can choose to review their concomitants in respect of the co- substantial activity criterion”.

This paragraph effectively to relax the 1998 requirement of lack of substantial activity for identifying a tax haven.

⁴⁷ The 2001 Report :“The OECD’s Project on Harmful Tax Practices (the 2001 report) See Chapter 4 at paragraph 16

⁴⁸The 2001 Report: See Chapter 4 Paragraph 17

The 2004 Progress Report

A progress report⁴⁹ was issued in 2004 by the OECD noting that many non- member OECD countries have committed to the principles of transparency and exchange of information. A Model agreement on exchange of information was also developed by the OECD.

The 2006 Progress Report

The 2006 report was released in May 2006 entitled “*Tax- Co- operation: Towards a Level Playing field*”. This report compares the tax disclosure standards applied in the countries surveyed by the OECD. It contains recommendations to impose legislation that compels the adequate record keeping, maintenance and retention of accounting records so as to better explain the transactions of the entity concerned including trusts.

The OECD stated that:

“...by promoting the implementation of principles of transparency and effective exchange of information, OECD countries seek to enable each country to retain sovereignty over national tax matters and to apply effectively its own tax laws. The decisions on the appropriate rate of tax is a sovereign decision of each country. The OECD countries do not seek to dictate to any country, either inside or outside the OECD, whether to impose a tax, what tax it should be or how its tax system should be structured. The aim of this work is to create an environment in which all countries, large and small, OECD and non- OECD, those with an income tax system and those without, can compete freely and fairly thereby allowing economic growth and increased prosperity to be shared by all. Transparency and international co- operation through exchange of information are important elements of such an environment”.⁵⁰

2.5 Conclusion: What is the future of tax haven jurisdictions?

In my view the longevity of tax havens are under threat by the above initiatives, particularly those undertaken by the OECD. The OECD seems to have reconciled itself to the fact that its onslaught is confined to tax evasion and illegal tax avoidance. Since then, this has led to them focusing on the issues of effective exchange of information and transparency. Together with

⁴⁹ OECD *The OECD's Project on Harmful Tax Practices: The 2004 progress report* at para 12-19

⁵⁰ OECD *The OECD's Project on Harmful Tax Practices: Update on progress in member countries* (2006) at para 6

the help of co-operative tax havens the OECD issued a model agreement on effective exchange of information called “*The Model Agreement on Exchange of Information on Tax Matters*”. This agreement allows countries to assess whether their residents are involved in offshore tax avoidance. The OECD has engaged in dialog with many member and non-member countries. A number of tax haven jurisdictions have agreed to co- operate with this agreement and implement transparency and information exchange. In addition the OECD has requested non-member countries to co-operate and associate themselves with this agreement as well. However by the same token, it is worth noting that the OECD does not intend to dictate international tax rates or for that matter impose a tax rate at all on these jurisdictions.⁵¹

Even though tax havens are under threat, this doesn’t necessarily mean the total extinction of tax havens. There are many difficulties that hinder the complete extinction of tax havens. Examples of these are the rise of e- commerce and the complexities ancillary thereto. With the rise of e- commerce, so- called invisible businesses are created because of the fact that there is no paper trail as opposed to the traditional way of doing business. In addition, country borders are distorted and issues such as residency arise because of this and with modern technology such as the internet, many will capitalize on this market for their own gain. Indeed, the rise of virtual tax havens and e- commerce marks the way for challenging times from an international tax perspective.

What is interesting is that the OECD has not acknowledged that they themselves have benefited from their involvement in tax havens and it may just be possible that these governments have no desire to abolish tax havens.⁵² Cohn in paragraph 6 notes that funds should not remain in tax havens; but rather be invested into rich and stable economies in the world.⁵³ This begs the question, whether this is merely an attempt by the governments of

⁵¹ OECD *The OECD’s Project on Harmful Tax Practices: Update on progress in member countries* (2006) at para 6

⁵²M Grundy *Essays in International Taxation* (2001) 2

⁵³II Cohn “*Prepared Testimony of Rueven S. Avi- Yohan, Irwin I Cohn Professor of Law, University of Michigan Law school before the US Senate Permanent Subcommittee on investigations, hearing on Offshore Transactions*” August 1, 2006.

powerful nations to protect their tax revenues? Surely if the powers that be willed it, harmful tax practices could be stopped immediately?⁵⁴ It seems as though developed countries receive advantages from tax havens.

Undoubtedly even though the main function of a tax haven is to avoid current and future taxes and exchange controls; they do also have their advantages as well. From the perspective of the tax haven jurisdiction, most of these jurisdictions have no means of support, apart from tourism.⁵⁵ Take for instance the Caribbean. Most of them lack natural resources, capital and manpower. Most of them do not have an agricultural or industrial base and for the most part they are dependent on the outside world for supplies. For these countries, offshore businesses generate foreign exchange, tax revenue, create employment, economic diversification and will be much more profitable than tourism.⁵⁶ The advantages for the persons seeking to utilize the tax haven are that it provides protection against confiscation, sanctions, they are protected by high levels of secrecy etc.⁵⁷

All things considered, one has to question whether these initiatives will ultimately be successful. Up to this day the OECD's continues in its efforts to counter harmful tax competition. They have indicated that they will monitor the development of new tax havens and encourage tax havens to comply with the principle of transparency and effective exchange of information.⁵⁸

⁵⁴Grundy Op cit (n52) commenting on this aspect at 6-7

⁵⁵ Ginsberg Op cit (n5) 5 at para 3

⁵⁶Ginsberg Op cit (n5) 5 at para 4

⁵⁷Ginsberg Op cit (n5) 3

⁵⁸Olivier and Honniball Op cit (n39) 565

CHAPTER 3 THE ANATOMY OF OFFSHORE TRUSTS THAT INCITE TAX AVOIDANCE

3.1 Introduction

“Trusts have now pervaded all fields of social institutions in common law countries. They are like those extraordinary drugs curing at the same time toothache, sprained ankles and baldness, sold by peddlers on the Paris boulevards; they solve equally well family troubles, business difficulties, religious and charitable problems. What amazes the charitable skeptical civilian is that they really do solve them”. (The writer, Le Paulle, Civil Law Substitutes for Trusts’ 36 Yale Law Review 1147)

There seems to be an internationally held view that a trust can solve most, if not all legal impediments. It is often seen as a cure for all. It is estimated that more than 60% of the world’s transactions takes place offshore and further that more than 40% of these transactions are done by utilizing trusts.⁵⁹ This suggests that more than a quarter of the world’s wealth resides in offshore trusts.⁶⁰

In South Africa, trusts has grown into one of the most commonly used vehicles both onshore and offshore. More and more South Africans are making use of offshore trusts for a variety of beneficial reasons. If structured appropriately, an offshore trust can be an extremely beneficial vehicle for international financial management.⁶¹

Amongst others, it could be used as a direct investment vehicle, and provide income tax, wealth tax (such as estate tax, capital gains tax (“CGT”), inheritance tax, donations tax (“DT”) and transfer duty) and asset protection advantages. Trust assets are not liable to probate and a trust may be used to bypass forced rules of heirship, hold companies and other assets.⁶² Moreover, a trust can be used as a hedge against fluctuating currency and political

⁵⁹J Ware and PEW Roper “The World of offshore Sham trusts ” (1999) Insurance and Tax Journal at par 1; See also PEW Roper “Getting to Grips with offshore Trusts” (December 1998) Insurance and Tax Law journal at 5.

⁶⁰Ware and Roper Op cit (n1) 25 para4

⁶¹Ware and Roper Op cit (n1) 25 para4

⁶²Ware and Roper Op cit (n1) 59 para 3 and also page 35 para 2

uncertainty, to bypass exchange control, as a savings vehicle for children's education or retirement purposes etc.⁶³

One of the first questions that come to mind when dealing with offshore trusts is which country's law will apply in respect of the taxing rights of income and capital gains and also in respect of the validity of the trust. Is it South African domestic law or foreign law? As will be addressed later on in this chapter, a trust is regarded as a "person" for tax purposes in South Africa.⁶⁴ When a trust is set up in a low tax or no tax haven, this gives rise to tax advantages which the resident country of the founder can limit. When a trust is created offshore, South Africa does not have the taxing right to the income, save to the extent that such income is distributed to a South African beneficiary as such beneficiary will be taxed on their worldwide income. However, where an offshore trust has its place of effective management in South Africa then it may apply the resident based tax system in respect of the world wide income of the trust.

It is beyond the scope of this paper to discuss the concept and features of South African local trusts and so this chapter will focus on the features of offshore trusts that propel tax avoidance as well as the ways in which these trusts are used to avoid tax. The below discussion considers the concept of an offshore trust so as to appreciate how it can be used to avoid tax as well as the different types of offshore trusts that incite offshore avoidance as well as the general and special features of these trusts that incite residents to bypass taxes by utilizing these offshore trusts.

3.2 Offshore Trusts (foreign trusts)

3.2.1 The legal principles of offshore trusts and the formation of an offshore trust

⁶³RP Van der Westhuisen & MM Pace "*Wills and Trusts*" (2005) at 1; A Kaplan "*Trusts in Prime jurisdictions*" (2000) at 27; A Duncan "*Hidden Assets*" (2004) De Rebus 30

⁶⁴ Income Tax Act 56 of 1962

In the international context the term “offshore trust” is used to refer to a trust that is set up in a low tax or no tax jurisdiction.⁶⁵ However in the South African context, it is used more broadly and refers to a trust that is a non- resident of South Africa or a foreign trust.⁶⁶

Internationally, the term “settlor” is trite and is the equivalent of the South African “donor”. “Settlor” is not defined in South African law but in many international jurisdictions it is defined. In its wider context, this is the person that usually established the foreign trust and who made the donation to the said trust.⁶⁷

The trust concept developed from the English law of equity in feudal times and later transferred to all those jurisdictions that were influenced by English law. Most of these offshore jurisdictions introduced their own trust legislation so as to augment the English trust law. Examples of these are the British Virgin Islands Trust Amendment Act of 1993 and the Cayman Islands Trusts Law (2005 version).⁶⁸ These jurisdictions that have enacted their own trust legislation whilst at the same time adopting English trust law have the benefit of consolidating English trust law into their legal system and also the benefit of their legislation addressing certain grey areas. However in jurisdictions such as Monaco, Liechtenstein and Panama who enacted their own legislation and did not adopt the balance of the English trust law, lack the legal principles of equity applicable to English law of trusts.⁶⁹

As per the UK case of *Knight v Knight*,⁷⁰ there are three *essentialia* that need to be present in order for an offshore trust to be formed and come into existence. They are (i) there must be certainty of intention to create a trust; (ii) there must be certainty of the subject matter (i.e. trust property) and (iii) there must be certainty of objects (this includes the identity of the beneficiaries). According to Olivier and Honniball⁷¹ offshore trusts are generally formed in

⁶⁵Spitz *International Tax Havens Guide* (1999) 7

⁶⁶Olivier and Honniball Op cit (n39) 28

⁶⁷Olivier and Honniball Op cit (n39) 28

⁶⁸Olivier and Honniball Op cit (n39) 29

⁶⁹Olivier and Honniball Op cit (n39) 29

⁷⁰ Olivier and Honniball Op cit (n39) 32.

⁷¹Olivier and Honniball Op cit (n39) 32

one of two ways, viz (i) by declaration of the trustees (usually called a declaration trust or bare trust) or by settlement by a settlor upon the trustees. A declaration or bare trust is where one or more persons acknowledge that the property they hold, is held in their capacity as such and for the benefit of another. Declaration trusts are vested trusts and are recognized in most international jurisdictions that adopt the English law of equity. These are quite popular in the US and Australia.⁷² They are often used for the purpose of anonymity in commercial transactions like holding shares in private companies.

Regarding the second way of establishing an offshore trust, the trust will only be regarded as established if the settlement is transferred or delivered to the original trustee. However, where the settlor retains ownership of the property but it is placed under the control of the original settlor to be held in trust then the trust will also be established despite there being no transfer of ownership. Olivier and Honnibal⁷³ submits that this will be regarded as being validly “made over” in terms of our Trust Property Control Act⁷⁴ (“TPA”) and such a trust will be regarded as valid in South African law.

3.2.2 “Special” characteristics of an offshore trust that encourage tax avoidance

A discussion in 3.2.1 above highlighted some of the general characteristics of a trust that make them the vehicle of choice for tax avoidance. In addition to these characteristics, an offshore trust also has certain special characteristics that encourage offshore avoidance.⁷⁵

The letter of wishes

Also known as the “wish letter” this was developed to cushion the risks associated with many international trusts not being recognized as a contract. Unlike in South Africa, once the assets are transferred to the trust, the trustees no longer have any control of the assets of the trust and consequently the ability to instruct the trustees is lost by the settlor.⁷⁶

⁷²Olivier and Honnibal Op cit (n39) 33

⁷³Olivier and Honnibal Op cit (n39) 33

⁷⁴Trust Property Control Act 57 of 1988

⁷⁵D Davies, L Olivier, G Urquhart Juta’s Income Tax (2007) in par 17.2

⁷⁶Olivier and Honnibal Op cit (n39) 39

Something more was required than simply relying on the fiduciary duties of the trustees and regulatory oversight and hence the creation of the letter of wishes. Most international trusts when established have a letter of wishes as well. In short, this is simply “*an instrument outside the trust deed wherein the founder indicates to the trustees how they should exercise some of their powers*”.⁷⁷ The main feature of the letter of wishes is that it is a private communication between the settlor and the trustees which includes certain non-binding requests by the settlor to take matters stated in the letter into account when exercising their discretion.⁷⁸

The letter of wishes will typically deal with discretionary dispositions especially with regards to what should occur at or after the testators’ death, the exercise of investment powers, administrative power and matters which the founder would like to be kept away from the beneficiaries. The letter of wishes is separate from the trust deed and no beneficiaries therefore have access to it.⁷⁹ It is confidentially created by placing concerns, facts, beliefs or prejudices of the settlor in a document.⁸⁰ The provision of confidentiality is one of the main advantages of a letter of wishes as it is a private letter between the trustees and the founder. It is mostly used in discretionary trusts and is a huge advantage in that the settlor, it is submitted, can easily use this letter of wishes to manipulate the decision of the trustees, their distributions and hence the applicable tax.

A letter of wishes is also advantageous in establishing “secret trusts” as well. Secret trusts are not uncommon in South Africa as was shown in the case of *Lucas’ Trustee v Ismail and Ahmed*.⁸¹ In *casu* Mr. Ismail, who was a person of Indian heritage, was not allowed to own land in his name. He established a secret trust to arrange that a British Mr. Lucas held the

⁷⁷Editorial “Tax Briefs” Taxgram (July 1999) at 14

⁷⁸Olivier and Honniball Op cit (n39) 38

⁷⁹ Olivier and Honniball Op cit (n39) 38

⁸⁰ Olivier and Honniball Op cit (n39) 38

⁸¹*Lucas’ Trustee v Ismail and Ahmed* 1905 T.S. 239

property in trust for his benefit. These features makes an offshore trust very attractive to South Africans wanting to invest in an offshore trust.

The concept of “The Protector”

Many offshore trusts appoint a protector⁸². Generally, the protector is a third party who has administrative and certain discretionary powers which are set out in the trust deed. It is generally a person who is either a relative of the settlor or a professional person. A protector can be an individual or a corporate entity and most offshore jurisdictions require the protector to act in a fiduciary capacity.

The protector has a huge amount of power in that he/ she can veto decisions taken by trustees, approve which trust law is applicable, add and remove beneficiaries and thus they are empowered to change the beneficial interest of beneficiaries.⁸³ They also have the power to appoint and remove trustees and may guide the trustees in the exercise of their discretion in terms of distributions. They may also amend the trust deed for administrative reasons and thereby achieve certain tax advantages.

In South Africa, the concept of the protector is not formerly recognised. This being said, our TPA does not prohibit it. Both the letter of wishes and the protector allows a huge amount of flexibility for trustees and beneficiaries to manipulate tax payable and therefore encourage tax avoidance.

3.2.3 Some examples of the different types of offshore trusts: the advantages of offshore trusts that incite tax avoidance

There are many types of offshore trusts, to name a few there are offshore pension trusts, sharia compliant offshore trusts, US grantor trusts, the New Zealand foreign trust, Real-Estate Investment trusts, Offshore Pension trusts, Asset Protection trusts, Blind trusts, Purpose trusts, British Virgin Island trusts, the Cayman Island STAR trust etc. However, this paper will only discuss a few.

⁸²Ginsberg Op cit (n4) at 428

⁸³Olivier and Honniball Op cit (n39) 38

- **Asset Protection Trusts:** these are trusts which set in the interest of protecting assets. Often these types of trusts are not set up in the jurisdiction of the settlor and are mostly set up in tax haven jurisdictions.⁸⁴ The reason for this is the high level of secrecy and confidentiality that tax haven jurisdictions provide.⁸⁵ Mostly these are used for protecting assets from political and currency risk, from creditors, spouses, and children and from high taxes. Typically asset protection trusts are discretionary trusts and are by far the most popular offshore trust used to avoid tax. One of the major advantages of this type of trust is the fact that because they are geographically and jurisdictionally remote, creditors wishing to claim will find it a costly and difficult process.⁸⁶ Added to this is the uncertainty with regards to the application of foreign laws as far as creditors and other protections are concerned. To this end, the trust legislation in some tax haven jurisdictions has been adapted to withstand creditor attack.⁸⁷ Some examples of these are the Bahamas, Cyprus and the Cayman Islands.
- **Blind Trusts:** There are many kinds of blind trusts. First is the so called black-hole trust. This trust is “blind” because there are no beneficiaries and no real purpose which is ascertainable from the trust deed. Often these are used to hide assets from creditors, public scrutiny and for evading tax.⁸⁸ Secondly, the other type of blind trusts is used to keep the beneficiary in the dark of specific trust assets so as to avoid conflict of interests. Thirdly, is a so called political blind trust where it is specially created to fund a political party to ensure anonymous donations by the trust. Politicians then use these funds and can claim that they were not influenced by the donors as they were not aware of the identity of the donors.

⁸⁴Olivier and Honniball Op cit (n39) 52

⁸⁵Olivier and Honniball Op cit (n39) 466

⁸⁶Spitz Op cit (n65) 132

⁸⁷Olivier and Honniball Op cit (n39) 53

⁸⁸Olivier and Honniball Op cit (n39) 42, Ware and Roper Op cit (n) 63

Under a South African context, it is unlikely that the first type of blind trust will be recognised. It may be seen as a sham trust in that its true object and trust beneficiaries are not indicated with certainty. In the unlikely event where it is recognised as valid, it may come under attack under s80A of the Income Tax Act⁸⁹ (“ITA”) for tax purposes. Like in the case of *ITC 1699 63 SATC 175*, it may very well be seen as “abnormal” to remove one set of beneficiaries and replace them with a complete new set of beneficiaries.

- **The Purpose Trust:** has a specified purpose without any predetermined beneficiaries. Most jurisdictions class these beneficiaries as the owners of the trust assets. The advantage of this is that a company or individual taking advantage of a purpose trust can or hold assets in such a trust without being classed as the owner of the trust assets⁹⁰.
- **STAR Trusts:** receives its name from the legislation under which it was created namely the Special Trust Alternative Regime of the Trust Law (2001 Revision). A STAR trust can be created for a specific purpose of the growth and development of a business venture, unlike most trusts. What makes this trust unique is that it does not have to have any beneficiaries. However it must have a so called “enforcer” who enforces the trust deed provisions. This enforcer has the right to appoint beneficiaries at a later date. To this end, Olivier and Honniball⁹¹ raise the point that such beneficiary would not have a “contingent right” during the period where no beneficiary was appointed and as such any income or capital gain was received by the trust. This means that the roll- up provisions of s25B (2A) and paragraph 80 (3) of the eighth schedule to the ITA would not apply. This could be advantageous.
- **The New Zealand foreign Trust:** is formed under the trust law of New Zealand and is a discretionary trust. The beneficiaries of this type of trust may either be a resident or non- resident of New Zealand. However, the settlor must always be a non- resident in

⁸⁹ Income Tax Act 56 of 1979

⁹⁰Diamond and Diamond Op cit (n 44) at Bermuda- 21

⁹¹ Olivier and Honniball Op cit (n39) 45

New Zealand. New Zealand taxes trust income based on the source of the income.⁹² A New Zealand foreign trust which has at least one resident trustee will pull the New Zealand trust into the tax net of New Zealand and will be subject to tax in New Zealand for tax treaty purposes.⁹³

- **The Real Estate Investment Trust (REIT):** this provides a tax transparency for investment into property (commercial, industrial and residential). With a REIT, the beneficiaries are called “shareholders”⁹⁴ and as such are taxed as if they are directly invested in the relevant real- estate.
- **The BVI VISTA Trust:** also receives its name from the legislation under which it was created, namely the Virgin Islands Special Trust Act 10 of 2003 (VISTA). This type of trust allows the settlor to hold shares of a BVI (British Virgin Island) company in the trust for the retention by the trustees and to remove the trustees from management responsibility of BVI company held by the trust, save in certain circumstances such as the appointment and removal of trustees per the trust deed.⁹⁵ With these trusts, all the trust assets must be owned by the BVI company.

With the development of case law, trusts are often reluctant to hold shares in an offshore company in trust. However the VISTA Act limits trustee liability and removes the monitoring and intervention duties of the trustees. The main feature of this legislation is that it allows shareholders to set up a trust to hold his or her company and then disengage trustees from responsibility and allows the company and its business to be retained as long as the directors deem appropriate.⁹⁶

There are many reasons that offshore trusts are utilized, in the main it seems to be the tax benefit provided by them. The main tax benefit however is the fact that there is a separation of

⁹²Olivier and Honniball Op cit (39) 44

⁹³Olivier and Honniball Op cit (n39) 44

⁹⁴ Olivier and Honniball Op cit (n39) 44

⁹⁵Olivier and Honniball Op cit (n39) 47

⁹⁶Olivier and Honniball Op cit (n39) 50

legal and equitable ownership which keeps the trust assets outside the trust net of the settlor and beneficiaries.⁹⁷ Unless there are anti-avoidance rules in place, offshore trusts and non-resident trustees will not be subject to tax in the jurisdiction of the settlor or beneficiaries because of the fact that they are not resident in that jurisdiction.

3.3 Tax Residence of South African trusts: taxing rights to income from offshore trusts

It is important to draw a distinction between local and offshore trusts because the tax treatment for a South African resident trust and a foreign trust is different. If a trust qualifies as a resident of a contracting state or if it is subject to tax under the domestic laws of a specific taxing jurisdiction in accordance with Article 4 of the OECD Model Tax Convention then it is regarded as a person for treaty purposes. Article 3 (1) of the OECD Model Tax Convention defines a person as:

“the term “person” includes an individual, a company and any other body of persons”

It is clear that this definition is broad enough to include a trust as well. Trusts that are subject to tax in the domestic laws of a state qualify as “residents” in accordance with the OECD Model Tax Convention definition of “resident”. Article 4 defines “resident” as follows:

“1. For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;

⁹⁷Olivier and Honniball Op cit (n39) 53

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated". (Own highlighting and underlining)

According to Olivier and Honniball,⁹⁸ there is no hard and fast rule regarding the residency of a trust for tax treaty purposes. The residency of a trust may depend on the residence of the trustee, place of management of the trust, the location of the trust assets or the residence of beneficiaries.⁹⁹ A trust could be resident internationally, in its place of establishment, its place of administration, where the assets are situated or where the founder, trustees, beneficiaries are resident.¹⁰⁰ With companies, the test of management and control is a board level test as opposed to trusts it is a trustee's level test.¹⁰¹

From a South African domestic perspective, as of 1 January 2001, South Africa moved away from a sourced based system of taxation to a residence based system. In terms of the resident basis of taxation, the receipts and accruals of income derived by 'residents' from all sources are subject to tax. In other words, 'residents' are subject to tax on their worldwide income, irrespective of its source.

Whereas, in the case of 'non-residents', that is, persons who do not qualify as residents, only receipts and accruals from income derived from sources in or deemed to be within the Republic are subject to tax, in terms of the definition of " gross income" in S1 of the ITA. It follows therefore that the source principles established under the previous taxation regime are still of assistance to 'non-residents' to determine whether they are liable to tax in the

⁹⁸Olivier and Honniball Op cit (n39). 286 par2

⁹⁹Olivier and Honniball Op cit (n39). 286 par2

¹⁰⁰Olivier and Honniball Op cit (n39) 191 at pg. 68 par 2

¹⁰¹Olivier and Honniball Op cit (39) 69 par2

Republic. It is therefore important to establish whether the person is a “resident” or not per our ITA.

S1 defines a “resident” in the case of a natural person as a person who is ordinarily resident in South Africa or a natural person who complies with the requirements of the physical presence test. In the case “other than a natural person” which includes a trust, as being resident if it is incorporated, established or formed in South Africa or has its “place of effective management” (POEM) in SA but it specifically excludes a trust which is deemed to be a resident of another country for purposes of the applicable double tax agreement (“DTA”).

The ITA does not in turn provide definition for “established” or “formed” or POEM. One therefore has to look at the ordinary meaning assigned to those words. The place where the trust is established or formed or where it has its POEM is a matter of fact. This therefore denotes a factual enquiry into the facts of each case and each case must be decided on its own merit.

In order to establish where the trust was formed or established, one has to look at how the trust was created. Was it *inter vivos* or testamentary? Were the trustees resident in South Africa or if the trust is administered from South Africa then the trust itself will be regarded as resident in South Africa¹⁰².

Even where the trustees are themselves not resident in South Africa the trust will still be regarded as a resident. In the case of *Thibodeau V The Queen* 78 DTC 6376 (FCTD) (1978), the issue was whether the trust was resident in Canada and hence liable to Canadian tax. In *casu*, two trustees were resident in Bermuda whilst one trustee was resident in Canada. Even though trust investments were made at the recommendation of the Canadian trustees, the trust administration, meetings and decisions concerning the trust assets were all made in Bermuda. The trust deed itself however required that a majority decision be taken on all trust decisions and based on this the court found that, because the majority of the trustees were resident in Bermuda, the trust was resident in Bermuda. This case looked at the residency of the majority

¹⁰²SILKE Op cit (n13) 63

of the trustees, which in my view is not an accurate barometer in deciding the residency of the trust.

In the case of *Natal Estates V CIR*¹⁰³ the court held that because the trustees were resident in Natal and the trust fund was administered in Natal, that the trust was resident there.

It is submitted that that the place where the trustees are resident is not an effective way of determining trust residency. This is especially so where so called- straw man trustees are appointed by the donor or founder. The residency of trustees' is not a clear barometer that will always reveal the management or business of a trust.

The POEM however is not always straight forward because of the fact that the Act does not provide a definition for POEM. According to the SARS interpretation note 6 ("IN 6"), it refers to the place where the entity is managed on a regular day-to-day basis by senior management or directors. Although IN 6 refers to companies, this note can be applied to trusts as well. IN 6 has been a concerning point for non- natural TP's setting up offshore companies and trusts because of the fact that the definition of POEM in IN 6 is much wider than the internationally held view.¹⁰⁴ IN 6 provides that POEM is where the regular or day-to-day management of the company by its directors or senior management occurs or the POEM is the place where the board of directors meet. Put differently, POEM is where the decisions of the directors implemented, not the place where they were taken.

On the flip side of the coin, the OECD commentary provides that POEM is where the decisions are taken and not where they were implemented.¹⁰⁵ It further provides that the POEM is where the most senior person or group of persons makes the decisions. Until very recently, South Africa was faced with its first case of interpreting POEM. The case of

¹⁰³ *Natal Estates v CIR* 1948 (3) SA 866 (N)

¹⁰⁴ Ernst & Young "International Tax Issue 147- November/ December 2011 2012- Place of effective Management" last accessed on 18/02/2014, available at http://www.saica.co.za/integritax/2011/2012. Place_of_effective_management.htm

¹⁰⁵ OECD: *Model Tax Convention on Income and Capital Condensed version* (2010) 88- 89

Oceanic Trust Co. Ltd N.O (OTC) V SARS,¹⁰⁶ dealt with a trust (that was registered and established in Mauritius) that was a Resident in South Africa because it had its POEM in South Africa. In this case, the court accepted the views laid down in *HMRC v Smallwood and Anor*¹⁰⁷.

In the latter case the meaning of POEM was considered in the context of the liability of a trust for capital gains purposes in the United Kingdom. The salient principles extracted from this case are as follows:

- POEM is the place where the key management and commercial decisions are “in substance made”;
- POEM is ordinarily the place where the most senior people makes decisions or where the actions to be taken by the entity as a whole are determined;
- There is no hard and fast rule and all the facts and circumstances of a particular case must be examined to determine the POEM of an entity; and
- There can be more than one place of management but only one POEM at any given time.

The court in *Oceanic Trust*¹⁰⁸ was of the view that the facts pertinent to managing the trust were not enough and further it was not clear enough to determine whether the trust had its POEM in South Africa. However, the *Oceanic Trust*¹⁰⁹ case is important in that it aids TP’s to see how South Africa will apply the POEM concept in a court. It appears that the judgment supports the approach followed by the OECD. Moreover, the SARS discussion paper on IN 6 dealing with POEM, seems to indicate that South Africa will follow the approach used by the OECD¹¹⁰.

¹⁰⁶ *Oceanic Trust Co. Ltd N.O V The Commissioner for the South African Revenue Services* 22556/09 (2011)

¹⁰⁷ *HMRC v Smallwood and Anor* (2010) EWCA Civ 778

¹⁰⁸ *Oceanic Trust Co. Ltd N.O V The Commissioner for the South African Revenue Services* *Supra*

¹⁰⁹ *Oceanic Trust Co. Ltd N.O V The Commissioner for the South African Revenue Services* *Supra*

¹¹⁰ SARS Discussion paper on Interpretation Note 6 Place of Effective Management (2011) 11

In applying IN 6 on “Effective Management”, the meeting place of the trustees, the role played by the protector and investment managers should be determined when establishing the POEM of a trust. Olivier and Honniball suggest that the powers of a protector of a trust can affect the residence of trust and the POEM of a trust.¹¹¹ Olivier and Honiball also state that normally a trust is effectively managed where the trustees meet and conduct the business of the trust.¹¹² If the trustees control an investment manager and such manager has adequate authority to conduct investment decisions without reference to the trustees, the trusts will be effectively managed by the investment manager.

The POEM of the trusts’ assets are crucial in determining residence¹¹³. When a trust is resident in South Africa then it will be taxable on its world- wide income. South Africa applies the resident based taxed system to tax the world wide income of beneficiaries including the income of offshore trusts received by those beneficiaries. In chapter 4, I will discuss some of the anti- avoidance measures put in place to curb avoidance of paying tax by trusts.

3.4 Conclusion

One of the disadvantages of using offshore trusts is the fact that many people are unaware of the *essentials* that must be met in order to ensure that the trust is valid and in some instances they are under the mistaken impression that they can retain control of trust assets. The legislature is well aware that trusts are often used for its tax advantages and as a result they are slowly introducing legislation to curb this. This is more fully discussed in chapter 4.

¹¹¹Honiball & Olivier Op cit (n39) 70 par2

¹¹²Honiball & Olivier Op cit (n39) 71 par2

¹¹³ SILKE Op cit (n13) 63

CHAPTER 4 TAX AVOIDANCE (THE NEW GAAR) AND ANTI-AVOIDANCE MEASURES PUT IN PLACE TO COUNTER THE USE OF OFFSHORE AVOIDANCE THROUGH TRUSTS-A SOUTH AFRICAN PERSPECTIVE

4.1 Introduction

As mentioned in chapter 1 of this paper, tax avoidance through the use of offshore trusts are triggered by the very existence of the tax haven jurisdiction, as well as the actual structural features of a trust. With more and more taxpayers indulging in these schemes, it seems set to continue unless adequate anti- avoidance measures are put in place to counter it. National Treasury's comments on clamping down on trusts to avoid tax indicates that South Africa is aware of this problem.

One cannot have a discussion on offshore avoidance without first discussing tax avoidance in South Africa as well as some of the anti- avoidance measures put in place to counter this. This chapter will first discuss the new Generally Accepted Avoidance Rule (GAAR) and whether this addresses the problem of taxpayers investing in offshore trusts to avoid tax to the detriment of their countries tax base.

Thereafter, I will consider some of the specific anti- avoidance measures put in place to curb offshore avoidance, specifically with regards to trusts.

4.2 Tax Avoidance (the new GAAR): Background

The old GAAR found in s103 (1) of the ITA, was first introduced in 1978 as s90 and was subject to a number of improvements, the last of which was in 1996. In 2006 this section was repealed and replaced by s80A- L which applies to "impermissible avoidance arrangements" that was entered into on or after 2 November 2006. This introduced a number of new components whilst at the same time retaining a few conceptual elements of the old s103 (1).

There has been a myriad of case law on the old GAAR, which has helped with the interpretation and application of the section. Since there has to date been no case law on the new s80A-L, these principles as it applied to the old GAAR are still very useful to the application of the new GAAR.

It is beyond the scope of this paper to discuss each of the elements of the old s103 (1).

The old GAAR was repealed and replaced by the new GAAR to enable the SARS to combat tax avoidance more effectively in South Africa. The SARS felt that the section as it then read was inconsistent and at times was ineffective in deterring complex and sophisticated tax “products” that were increasingly being developed by creative structured finance firms, law firms, accounting firms and the like.¹¹⁴ The flexibility of these products (for example derivatives) coupled with the ease at which they could be combined with or substituted for other financial products, made it difficult to combat avoidance by simply using the specific anti- avoidance provisions.¹¹⁵ The new GAAR is now to be found in Part IIA, s 80A- 80 L of Chapter III in the ITA.

in addition to the GAAR, the ITA contains a number of specific anti- avoidance provisions which are developed to prevent and/ or counter specific schemes or operations that are aimed at tax avoidance. Some examples of these are s7 (2) - (10), paragraph (c) of the definition of gross income, the provisions of s 54- 62 dealing with donations tax. If for whatever reason a specific anti avoidance provision cannot be applied to deal with a situation designed to avoid tax, then the SARS as a last resort can invoke the provisions of GAAR. The new GAAR therefore acts as a so- called “safety net”¹¹⁶ where certain transactions are not dealt with by a specific anti- avoidance provision in the Act. The GAAR provisions apply to any arrangement entered into on or after 2 November 2006 or to any steps in or parts of an arrangement entered into on or after 2 November 2006.

4.3 Defining the concepts of “tax avoidance”, “tax evasion” and “legitimate tax planning”

One cannot have a discussion on offshore avoidance without first defining what “tax avoidance” is. This concept is always distinguished from the concept of “tax evasion”. “Tax avoidance” is different from “tax evasion” in the sense that tax evasion is regarded as being wholly non- compliant with the tax laws and hence illegal. It refers to illegal activities

¹¹⁴SARS Discussion Paper on Tax Avoidance and S103 of the Income Tax Act 1962 (2006 Discussion paper)

¹¹⁵The SARS 2006 Discussion paper at pg 1

¹¹⁶SILKE Op cit (n13) 789

deliberately undertaken to free the taxpayer of a tax burden. This often involves non-disclosure of the taxpayers true affairs, falsely declaring or hiding information from tax authorities for e.g. in tax returns and books of account. The OECD defines “tax evasion” as “*illegal arrangements through or by means of which liability to tax is hidden or ignored*” where “*the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities*”¹¹⁷.

On the other hand, “tax avoidance” is perfectly legal in the sense that it involves planning ones affairs within the confines of the tax laws in order to mitigate the amount of tax payable. This is normally done by using loopholes in the tax laws to achieve the desired result of avoiding or reducing tax liability. Albeit that this may not be in line with the spirit and purport of the tax laws, there is, technically nothing that can prevent a taxpayer from entering into a perfectly legitimate *bona fide* arrangement which achieves this desired result, however difficult this may be for tax authorities to accept.

This view has been repeatedly expressed in many courts such as in the case of Leven V IRC,¹¹⁸ where it was held that:

“It is trite law that His Majesty’s subjects are free, if they can, to make their own arrangements so that their cases may fall outside the scope of the taxing Act. They incur no legal penalties, and they, strictly speaking no moral censure if having considered the lines drawn by the legislature for the imposition of the taxes, they make it their business to walk outside them.”

In the case of IRC V Duke of Westminster,¹¹⁹ Lord Tomlin in his infamous dictum stated:

“Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inlands Revenue or fellow- taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax”.

¹¹⁷ OECD: *International Tax terms for the Participants in the OECD Programme of Cooperation with Non-OECD economies*

¹¹⁸ *Leven V IRC* (1928) AC 21

¹¹⁹ *IRC V Duke of Westminster* (1936) 19 TC 490 at page 520

In the case of *CIR V Delfos*¹²⁰, it was held that “if the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to receive the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently in the law the case might otherwise appear to be”.

Tax avoidance is synonymous with the concept of “tax mitigation” that was described in the case of *CIR V Challenge Corporation*¹²¹ where Lord Templeman described the following:

“Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to a reduction in his tax liability. [The General Anti Avoidance Rule] does not apply to tax mitigation because the taxpayer’s advantage is not derived from an arrangement but from the reduction of income which he accepts or the expenditure which he incurs”.

The Ralph Review of Business Taxation in Australia,¹²² has defined “tax avoidance” as “a misuse or abuse of the law” that “is often driven by the exploitation of structural loopholes in the law to achieve certain outcomes that were not intended by Parliament but also include the manipulation of the law and a focus on form and legal effect rather than substance”.

Michael Brooks and John Head, the economists have noted that “[i]n legal discussions of tax avoidance, the primary focus is clearly on contrived and artificial schemes, which do not change the substantive character of an activity or transaction but may serve nevertheless to bring the activity within some tax- exempt or more favorable legal category”.¹²³

The OECD defines “tax avoidance” as “An arrangement of a taxpayer’s affairs that is intended to reduce his liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow”.¹²⁴

¹²⁰ *CIR V Delfos* (1933) AD 242 at 253

¹²¹ *CIR V Challenge Corporation* (1987) AC 155

¹²² Australia, *Final Report of the Review of Business Taxation: A tax System Redesigned*, (Canberra: Australia Government Printing Service, July 1999) at s. 6.2 (c).

¹²³ Brooks, M and Head, J “*Tax Avoidance: In Economics, Law and Public Choice*”, in Cooper, GS *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications, 1997) at page 71

¹²⁴ OECD: *International Tax Terms...* op. cit.(n 114)

The enabling factors that encourage taxpayers to engage in tax avoidance and evasion seems to be vast and varied. The former Director of the Fiscal Affairs Department of the International Monetary Fund, Vito Tanzi identified “eight fiscal termites” in a 2001 article that were “*gnawing away at the foundations of [national] tax systems*”.¹²⁵ These international factors were e-commerce, electronic money, intercompany trade, the existence of offshore financial centers (aka tax havens), derivatives and hedge funds, a growing inability or unwillingness to tax financial capital, growing foreign activities and foreign shopping. Other major factors include growing deregulation, specifically in financial markets, globalization and rapid advances in computer and telecommunications technology. Market forces such as increasing inflation rates and behavioral attitude also play a role.

For South Africa in particular, these international factors create new opportunities for many multinational companies in the way they do business and share information.¹²⁶ New tax avoidance schemes are developed which could now “migrate” to South Africa.¹²⁷ South African domestic factors which encourage tax avoidance include political uncertainty, the rand to dollar fluctuations and changes to the South African income tax legislation over the past few years. As far as legislative changes are concerned, South Africa has moved from a source based system to a residence based system; it introduced “controlled foreign company rules” as well as capital gains tax into their legislation. Even though most of these were introduced to combat tax avoidance, the very complex nature thereof in some instances creates new opportunities for mischief.

The right of a taxpayer to arrange their affairs within the confines of the law is a principle recognized in many sovereign states and democratic societies throughout the world and the difficulty in overcoming offshore avoidance seems to be just that, i.e. that each sovereign or democratic state has this right. Furthermore, this “*should properly be regarded as a respectable contest between the fiscus and the taxpayer concerned, and should not “strictly*

¹²⁵Tanzi, V “*Globalization and the Work of Fiscal Termites*”, Finance & Development Magazine (March 2001)

¹²⁶ SARS Discussion Paper on Tax Avoidance (2005)

¹²⁷ SARS Discussion Paper on Tax Avoidance (2005)

*speaking” attract “moral censure” and, by necessary implication, should not be regarded an evil”*¹²⁸.

However, the adverse ripple effects of participating in tax avoidance schemes are varied and far-reaching and include but are not limited to revenue loss, an unfair shifting of the tax burden and erosion of tax bases.¹²⁹ The SARS discussion paper on Tax avoidance¹³⁰ notes that recent studies estimate that the total assets being held in tax havens ranged between US \$ 4 to 8 trillion, the concomitant thereof being annual revenue losses in excess of US \$ 50 billion to other countries.

SARS noted in its discussion paper on tax avoidance, that there are certain common characteristics shared by many of the most abusive avoidance schemes. These tell-tale signs are often referred to as “hallmarks” or “badges” of avoidance. One of these hallmarks is the use of tax- indifferent accommodating parties or special purpose entities. In the case of *IRC V Burmah Oil Co. Ltd.*¹³¹ Lord Diplock noted that “*The kinds of tax avoidance schemes that have occupied the attention of the courts in recent years... involve inter- connected transactions between artificial persons, limited companies, without minds of their own but directed by a single master mind*” (*my own underlining and emphasis*). In this case it was noted that a special purpose vehicle, may be described as a legal entity formed or established with a limited purpose or limited lifespan. These include companies, trusts, or partnerships. Such vehicles are either utilized to offset deductions to absorb any income that they derive from their participation in a scheme; or they use existing assessed losses.

4.4 GAAR: s 80A- L

Section 80A and L contain the heart of the GAAR. Section 80A deals with impermissible tax avoidance arrangements and defines what an impermissible tax avoidance arrangement is by describing the requirements that must be met in order to invoke the provisions of s80A. Section

¹²⁸ *Cot V Ferrera* 1976 (2) SA 653 (C)

¹²⁹ SARS Discussion Paper on Tax Avoidance (2005)

¹³⁰ SARS Discussion Paper on Tax Avoidance (2005)

¹³¹ *IRC V Burmah Oil Co. Ltd* (1982) STC 30 (HL) at page 32.

80 L then defines certain terms that are referred to in s80A. From this section it is clear that there are three crucial requirements that must be met. These requirements will now be discussed below.

4.4.1 Requirement 1: There must be an “Avoidance arrangement” as defined

Section 80L defines the terms “Arrangement”, “Avoidance”, “Impermissible avoidance arrangement” and “Party” as follows:

“Arrangement means any transaction, operation, scheme, agreement or understanding (whether enforceable or not), including all steps therein or parts thereof, and includes any of the foregoing involving the alienation of property”.

“Avoidance arrangement means any arrangement that results in a tax benefit”.

“Impermissible avoidance arrangement” means any avoidance arrangement described in section 80A;

“Party means any—

- (a) person;*
- (b) permanent establishment in the Republic of a person who is not a resident;*
- (c) permanent establishment outside the Republic of a person who is a resident;*
- (d) partnership; or*

*joint venture, who participates or takes part in an arrangement. In the case of Meyerowitz v CIR,¹³² the court considered the words “transaction, operation or scheme”. In *casu* the appellant submitted that the transactions were not part of a “preconceived” plan and that the continuity of the operations and connection between the different steps were lacking to such a degree that it could not constitute a “scheme”. The Appellate Division held that the transactions constituted a “scheme” from start to finish even though they were not all contemplated at the outset. The court said that the test is whether in retrospect, the different steps appear to be so closely connected with one another that they could ultimately lead to the avoidance of tax. Further that the fact that the intention to avoid the payment of tax appears only from later steps is of no consequence.*

¹³²*Meyerowitz v CIR* 1963 (3) SA 863 (A)

In the case of *CIR v Louw*,¹³³ the court found that there must be some unity amongst the various steps and furthermore that a ‘scheme’ could be regarded as having begun at the time that at least the broad path to be followed, and its ultimate result, were thought out and decided upon. As stated by Glegg¹³⁴, the “steps” referred to in the arrangement are arrangements within themselves. To this end, s 80H empowers the Commissioner to invoke the provisions of Part IIA to steps or parts of an arrangement. The above case law illustrates the principles that our courts will apply when dealing with an offshore trust that is set up in a tax haven to avoid tax.

4.4.2 Requirement 2: The “sole or main purpose” of the arrangement is to obtain a “tax benefit”

Since the avoidance arrangement must result in a “tax benefit”, it is necessary to consider these terms. In the SARS Draft Comprehensive Guide to the GAAR¹³⁵, it is pointed out that the “tax benefit” requirement operates at 3 broad levels.

- Firstly, one must establish that a “tax benefit” was derived before any arrangement is considered to be an “avoidance arrangement”;
- Secondly, once it is established that an “avoidance arrangement” indeed exists it must then be established whether deriving such a “tax benefit” was the “sole or main purpose” of the arrangement. This will ultimately establish whether the avoidance arrangement was an “impermissible avoidance arrangement”; and
- Thirdly, where the arrangement is carried out or entered into “in the context of business” a “significant” tax benefit must be derived when determining a “lack of commercial substance”.

Section 80 L defines “tax” and S1 defines “Tax benefit”. Insofar as the “liability for tax” is concerned, in the case of *CIR v King*¹³⁶; it was held that the tax liability under the GAAR is not an existing liability but rather an anticipated liability. Watermeyer J pointed out that:

¹³³*CIR v Louw* 1983 (3) SA 551 (A)

¹³⁴D Clegg; R Stretch *Income Tax in South Africa* Last Updated: Volume 1: April 2013 - SI 42

¹³⁵The SARS draft comprehensive guide to the Generally accepted avoidance rule (GAAR) 2011 at pg 16 para 3.3

“There are many ... ordinary and legitimate transactions and operations which, if a taxpayer carries them out, would have the effect of reducing the amount of his income to something less than it was in the past, or of freeing himself from taxation on some part of his future income. For example, a man can sell investments which produce income subject to tax and in their place make no investments at all, or he can spend the proceeds in buying a house to live in, or in buying shares which produce no income but may increase in value ... He might even have conceived such a dislike for the taxation under the Act that he sells all his investments and lives on his capital or gives it away to the poor in order not to have to pay such taxation. If he is a professional man he may reduce his fees or work for nothing ... He can carry out such operations for the avowed purpose of reducing the amount of tax he has to pay, yet it cannot be imagined that Parliament intended by the provisions of section 90 to do such an absurd thing as to levy a tax upon persons who carry out such operations as if they had not carried them out”.

In *Smith v CIR*¹³⁷ the court held that *“The ordinary, natural meaning of avoiding liability for a tax on income is to get out of the way of, escape or prevent an anticipated liability . . .”*

In the case of *Hicklin v SIR*¹³⁸ it was held that a liability for tax *“May vary from an imminent certain prospect to some vague, remote possibility In Newton’s case . . . Lord Denning spoke of ‘a liability which is about to fall on you’, which suggests one of some imminence. However, it is unnecessary and hence inadvisable to decide here whether a vertical line should be drawn somewhere along that wide range of meanings in order to delimit the connotation of ‘an anticipated liability’.*

Turning now to the requirement of “sole or main purpose”, establishing the “purpose” is crucial in determining whether an arrangement is an “impermissible avoidance arrangement”. Section 80A clearly states that an arrangement will be regarded as an avoidance arrangement where the “sole or main purpose” is to achieve a tax benefit. It should be noted that the new section refers to “the” purpose of the arrangement whereas the old s103 (1) refers to the purpose “of which” a transaction, operation or scheme was carried out or entered into. There exists a rebuttable presumption in s80G (1) that the sole or main purpose of the arrangement was to obtain a tax benefit until the party who receives such a benefit proves otherwise. De Koker¹³⁹ states that: *“...to discharge the section 80G onus, a taxpayer is required to give affirmative evidence that satisfies a court, upon a preponderance of probability, that “reasonably considered in light of the relevant facts and circumstances”, the obtaining of the tax benefit was not the sole or main purpose”.*

¹³⁶*CIR v King* 1947 (2) SA 196 (A)

¹³⁷*Smith v CIR* 1964 (1) SA 324 (A), See Also *Hicklin* at 193.

¹³⁸ *Hicklin v SIR* 1980 (1) SA 481 (A)

¹³⁹ AP De Koker (2009) SILKE on South African Income Tax

In the old s103 (1) the “purpose” requirement also existed, however originally it was proposed as being the “sole or one of the main purposes”. This received criticism on the grounds that it would make it too easy for the GAAR to apply to legitimate transactions. Under the old section, the taxpayers’ *ipse dixit* was considered. It was a subjective enquiry that was done taking into account all the facts and surrounding circumstances. In their discussion paper on tax avoidance and s103 (1) of the ITA, the SARS indicated a number of concerns that they had with the purpose requirement and therefore proposed that it be changed from a subjective enquiry to an objective enquiry with reference to the facts and circumstances of the case at hand so as to bring it in line with international jurisdictions.

The case law indicate that a subjective enquiry rather than an objective enquiry should be undertaken. In the case of Geustyn, Forsyth and Joubert,¹⁴⁰ with regard to the purpose requirement, Ogilve Thompson CJ stated that:

“...while it may be that effect and result as respectively used in subsections (1) and (4) of section 103 of the Act have the same meaning it is clear that the former subsection distinguished between “effect” and “purpose”. The vital enquiry on this part of the case relates to the question of whether or not avoidance, postponement or reduction of tax was the “sole or main purposes” of the conversion of the partnership into a company. The intention or purpose with which any particular transaction is entered into is a question of fact...”

In the Gallagher case,¹⁴¹ Corbett JA held:

“It is submitted in the heads of argument of appellant’s counsel that in determining the purpose of a transaction, operation or scheme an “objective” test should be applied. By an objective test in this context is evidently meant a test which has regard rather to the effect of the scheme, objectively viewed, as opposed to a “subjective test” which takes as its’ criterion the purpose which those carrying out the scheme intend to achieve by means of the scheme...In the circumstances it is appropriate to state that, in my view, the test is undoubtedly a subjective one.”

He held further that:

“If the subjective approach must be adopted (as it must) then it is obvious that of prime importance in determining the purpose of the scheme would be the evidence of the respondent, the progenitor of the scheme, as to why it was carried out”.

¹⁴⁰SIR v Geustyn, Forsyth and Joubert 1971 (3) SA 567 (A)

¹⁴¹SIR v Gallagher 1978 (2) SA 463 (A) at 471

Since the new GAAR requires an objective rather than the subjective approach under s103(1), the focus seems to be on the “purpose” of the arrangement itself as opposed to the purpose of the individual participating in the scheme.¹⁴² The need to change the purpose requirement from a subjective to an objective enquiry was based on an anomaly that existed in the old S103 (1). This anomaly was pointed out by Williams¹⁴³ that:

“In essence a taxpayer could with impurity enter into a transaction with the (subjectively) sole or main purpose of avoiding tax provided that there was no (objective) abnormality in the means or manner in the rights and obligations which was created. Conversely, a taxpayer could with impurity enter into a transaction which was objectively “abnormal” provided that he did not, subjectively, have the sole or main purpose of tax avoidance”.

In South Africa, there seems to be no unanimous view amongst tax scholars. Some advocate the subjective approach and others advocate the objective approach. Overseas jurisdictions have interpreted the “purpose” of an arrangement using an objective test and it has been suggested by Eddie Broomborg SC that the wording to s80G (1) likewise suggests that an objective enquiry is required.¹⁴⁴ Clegg and Stretch¹⁴⁵ also submit at paragraph 26.3.4 that an objective approach should be used. They state that *“the courts must take an objective view of the facts and circumstances – which include the ipse dixit of the taxpayer – in order to determine the actual purpose of the transaction”*.

Meyerowitz¹⁴⁶ on the other hand supports the subjective approach and states that because there is a rebuttable presumption that already presumes the existence of the purpose, that logic dictates that it is impossible for the taxpayer to now prove an objective purpose when it is already presumed. Davies *et al*¹⁴⁷ also maintains that the test remains subjective and that the case of *Gallagher*¹⁴⁸ is still the authority for this. They are of the view that despite the legislation referring to the word “its” that an arrangement in itself cannot in itself have a

¹⁴²AP De Koker *Silke on South African Income Tax: Being an exposition of the law, Practice and Incidence of Income Tax in South Africa* (2006)

¹⁴³Williams R.C (1997), The 1996 amendments to the General Anti- Avoidance Section of the Income Tax Act, SALJ vol 114 at page 675

¹⁴⁴Broomborg, E.B. (2007), “The new general anti- avoidance rule”, SAFA seminar, Cape Town

¹⁴⁵ D Glegg and R Stretch *Income Tax in South Africa*(2006)

¹⁴⁶Meyerowitz, D (2005)“What is tax avoidance?” *The Taxpayer* at 205

¹⁴⁷Davies *et al* Op cit ,(n75) 80A-7

¹⁴⁸*SIR v Gallagher* 1978 (2) SA 463 (A)

purpose and that the *ipse dixit* of the taxpayer will still be evaluated together with the objective facts of the case at hand so as to arrive at the true purpose. In the context of an offshore trust that is set up in a tax haven to avoid tax, I agree with Davis *et al* in that the trust does not have a mind of its own. The trustees are the mind of the trust and therefore the subjective intention or the *ipse dixit* of the trustees will have to be looked at in order to establish what the sole or main purpose was behind the transaction, operation or scheme at hand. I do believe that this must be looked at together with the facts of the matter at hand. I do not believe that one can override the other but that they are equally important and must both be looked at together. The words “solely or mainly” is defined in the ITA but was reviewed by our courts.

In the case of *King*¹⁴⁹ the word “main” was considered and it was stated that the taxpayers “dominant purpose needs to be established”. In the case of *SBI v Lourens Erasmus (Edms) Bpk*,¹⁵⁰ it was defined in a purely quantitative measure of more than 50%. In the case of *Ovenstone v SIR*¹⁵¹ it was held that one should look at when the arrangement was implemented as opposed to when the purpose was first formulated. Put differently, the time of implementation is important and not the time of conceptualization. These principles are still very relevant under the new GAAR.

4.4.2 Requirement 3: Broadly speaking the Avoidance arrangement was “abnormal”, “lacking in commercial substance” (only applies in the context of business) or it was abusive of the provisions of the Act

Once it has been determined that the arrangement amounts to an “avoidance arrangement” as defined the next step is to now determine whether such avoidance arrangement amounts to an impermissible avoidance arrangement. This involves distinguishing whether the arrangement was entered into or carried out “in the context of business” or “in a context other than business”. The so called “tainted elements” must then be applied to the respective scenario.

¹⁴⁹ *CIR v King* 1949 (2) SA 196 (A)

¹⁵⁰ *SBI V Lourens Erasmus (Edms) Bpk* 1966 (4) SA 434 (A), 28 SATC at page 233

¹⁵¹ *Ovenstone V SIR* 1980 (2) SA 721 (A)

If the avoidance arrangement is in the “**context of business**”, then only ONE of four of the tainted elements must be met, namely:

4.4.2.1 The avoidance arrangement was carried out or entered into by “means or in a manner” not “normally” employed for bona fide business purposes other than obtaining a tax benefit(business purpose test);

The “business purpose test” remains an “abnormality” test as was the case with the old S103(1) in that the test is to look at whether the “manner” in which the transaction was carried out or entered into was one which would not normally be employed for bona fide business purposes. It is not whether the scheme itself had a commercial purpose.¹⁵²

In an article dealing with the introduction of the business purpose test, Williams¹⁵³ states that:

“...the section does not say that the enquiry is into whether the transaction “was entered into for bona fide business purposes”, but is expressed in the subjunctive, the operative phrase being “would not normally be employed for bona fide business purposes, other than the obtaining of a tax benefit”. I believe, therefore, that the section does not mandate an enquiry into whether or not the particular taxpayer entered into a particular transaction for bona fide purposes, but that it necessitates an enquiry into a hypothetical situation: whether the manner in which the transaction was entered into “would no normally employed” for bona fide business purposes”.

The Act does not define the word “business” but does define the word “trade” which includes a “business”. To determine whether a person is carrying on a business is a factual question that must be decided on the facts of each case. There is therefore no one- size- fits all approach. In the case of Modderfontein Deep Levels Ltd v Feinsten¹⁵⁴Wessels J stated that:

¹⁵²The SARS 2006 Guide at para 6.2

¹⁵³Williams RC, The 1996 Amendments to the General Anti Avoidance Section of the Income Tax Act, SALJ, Vol 114, part IV at pg 675

¹⁵⁴Modderfontein Deep Levels Ltd v Feinsten 1920 TPD at 288

“To constitute a business there must either be a definitive intention at the first act to carry on similar acts from time to time if opportunity offers, or the acts must be done not once or twice but successively, with the intention of carrying it on, so long as it is thought desirable”.

4.4.2.2 The avoidance arrangement “lacks commercial substance” (in whole or in part) (commercial substance test);

Section 80C(1) gives us the general rule for determining whether an anti- avoidance arrangement lacks commercial substance and s80(2) contains a list of characteristics that indicate lack of commercial substance. This is not a *numerous clausus*.

The general rule is that an “avoidance arrangement” will lack commercial substance if it would result in a “significant” tax benefit for the party but does not have a significant effect on either the “business risks” or “net cash flow” of that party.

The term “significant” has not been defined in the Act. Silke¹⁵⁵ submits that courts may view it either subjectively, from the view of the specific taxpayer at hand or apply an objective test looking at what the ordinary man on the street would do. For a more detailed discussion on substance over form, see discussion under 4.6.

The legal substance refers to the true state of affairs or true legal rights and obligations that flow from the transaction, whereas the legal form is what the taxpayer has actually done. Silke¹⁵⁶ suggests that this possibly points to the economic or commercial effect thereof. One of the indicators of lack of commercial substance is the presence of **round trip financing**. S80D (1) deals with when round trip financing will be regarded as an avoidance arrangement.

S 80 D (3) then further provides that *“the term ‘funds’ includes any cash, cash equivalents or any right or obligation to receive or pay the same.* S 80 D (2) then states that the round trip provision applies to any round trip amounts without having regards to certain events. These

¹⁵⁵SILKE Op cit (n13) 790

¹⁵⁶SILKE Op cit (n13) 791

events therefore means that the fact that the flow of funds takes place during different years of assessment is therefore of no relevance.¹⁵⁷

The next indicator of lack of commercial substance is the presence of or inclusion of a **tax-indifferent or accommodating party** as set out in S80E. S80E (1) defines when a party is tax indifferent or accommodating. S 80E(2) provides that a “*person may be an accommodating or tax-indifferent party whether or not that person is a connected person in relation to any party*”. Section 80E (3) so called “safe- harbour rules” read with subsection (4) then tells us when the provisions of s80E are not applicable.

Silke¹⁵⁸ illustrates the necessity of these “safe harbour provisions” by using an example of a South African company who purchases stock from a foreign company. He illustrates that any transaction conducted in a tax haven is vulnerable to attack under the provisions of s80A-L unless that it can be shown that the sole or main purpose was not to achieve a tax benefit.

4.4.2.3 The avoidance arrangement has created “rights and obligations that would not normally be created between persons dealing at arm’s length”(**abnormality or arm’s length test**);

This requirement will be met if the rights and obligations would not “normally” arise or be created between persons dealing at “arms’ length”. The case of *Hicklin*¹⁵⁹ is very helpful in that it tells us what constitutes an “arm’s length transaction” and can thus be applied to the current s80 A when deciding whether the transaction, operation or scheme was “normal” or not. One first has to determine if it was done at arms’ length and this case postulates that.

This question on what constitutes an arms’ length transaction is answered by Trollip’s judgment where he says that:

*“As far as “normality” is concerned, when the transaction, operation or scheme” is an agreement as in the present case, it is important, I think, **to determine first whether it was one concluded at “arms length”**”. That is*

¹⁵⁷SLIKE Op cit (n13) 791

¹⁵⁸SILKE Op cit (n13)792

¹⁵⁹ *Hicklin v SIR* 1980 (1) SA 481 (A)

*the requirement postulated in paragraph 103(1)(b)(ii). For dealing at arms length is a useful and often easily determinable premise from which to start the enquiry. **It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself....hence, in an at arm's length agreements the rights and obligations it creates are more likely to be normal than abnormal** in the sense envisaged by para (ii). **And the means or manner employed in entering into it or carrying it out are also more likely to be normal than abnormal** in the sense envisaged by para (i). **The next observation** is that, when considering the normality of the rights or obligations so created or of the means and manner so employed, due regard had to be paid to the surrounding circumstances. As already pointed out s103(1) itself postulates that thus what might be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances. **The last observation** is that the problem of normality or abnormality of such matters is mainly a factual one. The Court hearing the case may resolve it by taking judicial notice of the relevant norms or standards or by means of the expert or other evidence adduced ...by either party.”.*

The current s80A is not suggesting that the parties in fact acted at arms' length because it says “it creates rights and obligations” between parties that “would otherwise” (emphasis) have acted at arms' length. This tells you that it's a hypothetical test.

4.4.2.4 The avoidance arrangement results directly or indirectly in the “misuse or abuse of the provisions of the GAAR” (misuse or abuse test).

This requirement confirms that the normal rules of interpretation and the constitution (namely the purposive and contextual approach) must be followed when interpreting legislation. Put differently, it seeks to ensure that the purpose of the legislation and the intention of the legislature with regards to other provisions of the Act as well as the provisions of s80A-L are taken into account when interpreting legislation.

It is suggested by the SARS in their draft comprehensive guide to the general anti avoidance rule that the misuse or abuse requirement was developed by the Canadian GAAR. The Canadian case of *Canada Trust co Mortgage Co v Canada (2005 SSC 54)* might provide some guidance to this requirement, which is not discussed in this paper.

Note that when the avoidance arrangement is in a “**context other than business**” only ONE of three of the above tainted elements must be met and that the lack of “commercial substance”

element only applies to the “context of business”. In the context of an offshore trust that has been set up in a tax haven to avoid tax, one will also need to determine if it was in the context of business or not and apply the relevant test. Also there is no business purpose test in that the avoidance arrangement was carried out or entered into by “means or in a manner” not “normally” employed for *bona fide* purposes other than obtaining a tax benefit.

One has to ask the question of whether or not the new GAAR has met its objective in the context of an offshore trust. It is submitted that it does not because the new GAAR provisions are too wide to meet the objective with specific regards to an offshore trust. The intention of the legislature was to have a “catch- all” GAAR provision which is widely designed to cover all forms of arrangements or schemes. However, as pointed out by Cilliers¹⁶⁰ one has to exercise caution with having a GAAR that is too wide as this may create uncertainty as to the area within which taxpayers are regarded as having trespassed and further with the amount of tax that is payable. To this end, it seems that the special provisions of s25B and s7 of the ITA better achieves the purpose, insofar as an offshore trust is concerned. These sections are more fully discussed under 4.7 below.

It is submitted that the application of certain international concepts that were adopted by South Africa, such as the “misuse and abuse test” be applied with caution having regard to our own legislation, common law and legal precedents. It is submitted that although the new GAAR has tightened the gaps on TP’s wishing to gain a tax benefit, these provisions are too general to apply specifically to an offshore trust that has been set up in a low or no tax jurisdiction for the purposes of avoiding tax.

Given the fact that it has now been seven years down the line since the new GAAR has been enacted with no case law on it, I am of the view that the section was merely enacted to be used as a scare tactic by the SARS and possibly even with the intention of limiting taxpayers wanting to structure their affairs in the most tax efficient manner. I am further of the view that because there has been no case law under the new GAAR, that the SARS will be reluctant to invoke the provisions because it is open to creative interpretations.

¹⁶⁰Cilliers, C (2006), The proposed S80A (c) (ii) of the Income Tax Act: Should it be enacted? The Taxpayer, October: 182- 187

South Africa like many other countries, such as Australia, Canada, New Zealand and even the UK has not found it an easy task to apply the GAAR. Despite this, it is still a crucial piece of the legislation that each country needs to retain and for these reasons will probably not do away with it. There is some room for enhancement which would create clarity, transparency, certainty and most of all ensure that tax abuse is properly curtailed.

4.5 Other provisions

In addition to the new GAAR, the Taxation Administration Act 28 of 2011 (Tax Admin Act) now gives the SARS even sharper teeth. It has introduced a new set of rules that deals with “reportable arrangements”. “Reportable arrangements” used to be dealt with under s80S of the ITA which is now replaced by s35 of the Tax Admin Act.

Just like its predecessor, the new s35 places a duty on the promoter of the arrangement, company or trust which derives or assumes that it will derive a tax benefit or financial benefit as a result of the reportable arrangement, to disclose the arrangement and the important details of the arrangement to the SARS within a prescribed period and within a specific manner.

Of note is s212 of the Tax Admin Act which provides that for each month that the participant fails to report the arrangement, but up to 12 months, a fine of R 100 000 (in the case of the promoter) can be levied by the SARS and a fine of R50 000 (in the case of other participants) can be levied by the SARS. Where the anticipated tax benefit exceeds R5 000 000 then the penalty can be doubled and where it exceeds R10 000 000 it can be tripled. This therefore means that there will be a monthly penalty of R300 000 (in the case of the promoter) and R150 000 (in the case of other participants) which the SARS may impose for every month that the participant fails to report the arrangement. If one does the sums then a participant may be liable for a penalty of up to R1 800 000 or R3 600 000 in the case of promoters¹⁶¹.

This is a huge change to the old s80S in the ITA where the penalty was capped at a maximum of R1 000 000, which the SARS in certain cases could reduce! Now s217 of the Tax Admin Act provides for the SARS to remit the penalty in whole or in part but only up to a maximum of R100 000 and where (a) reasonable grounds existed for the non-compliance and (b) the

¹⁶¹ENS Tax Article on Reportable Arrangements, November 2012, N Baepi, Senior Associate

non-compliance has been remedied. Further s218 also allows for remittance of the penalty where “exceptional circumstances” exists per those listed in s218 (2) that prevented the participant from reporting the arrangement under Tax Admin Act.

It is beyond the scope of this paper to discuss these sections in detail but at a first glance thereof, it seems that these sections has given the SARS an even more empowering position over the TP. Some would even say that this new section in the context of countering tax avoidance through offshore trusts that are set up in tax haven jurisdictions is comparable to using a sledge hammer to crack a nut.

4.6 The common law doctrine of substance over form and sham transaction and the NWK¹⁶² case.

A discussion on substance over form and sham transactions together with the recent case of NWK, is a necessary one so as to appreciate how our court swill deal with an offshore trust that was set up in a tax haven to avoid tax, particularly so called sham trusts.

By way of some background, “substance” refers to the true essence or true intention of the transaction or the scheme whereas “form” refers to the actual transaction itself or the contract for purposes of deciding tax liability. The case law below makes it clear that our courts will not be fooled by sham transactions and will not condone such transactions to escape tax liability.

In the case of *Kilburn v Estate Kilburn*,¹⁶³ Wessels ACJ held that “it is a well-known principle in our law that courts will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance”.

In the case of *Ladysmith (Pty) Ltd and Another v CIR*,¹⁶⁴ the court acknowledged the principle founded in the case of *Duke v Westminster*,¹⁶⁵ that each man is entitled to arrange his affairs in such a way that they fell outside the ambit of certain taxing provisions of the Act. However the

¹⁶² *Commissioner, SARS v NWK Ltd* (2010) Taxpayer 203

¹⁶³ *Kilburn v Estate Kilburn* 1931 AD 501 at 507

¹⁶⁴ *Erf 3183/1 Ladysmith (Pty) Ltd and Another v CIR* 1996 (3) SA 942 (A) 58 SATC 229

¹⁶⁵ *Duke v Westminster Supra*

court noted that it was for the court to decide whether this was in fact successfully arranged. In *casu*, Hefer JA held that the agreements were independent of each other to the extent that none of them could have been concluded without the other. To this end, he held that the agreements could not be regarded as separate. Here the court looked at the true intention of the parties by looking at the substance of the transaction and by interpreting the express, implied and tacit terms of the agreements that were concluded. The court ignored the disguised transaction and considered the true intention of the parties.

Insofar as simulation or sham transactions are concerned, the leading cases on the subject are the *Zanberg*¹⁶⁶ and the *Randles*¹⁶⁷ cases. These cases establish the South African common law rule or principles on the subject.

In the *Zandberg*¹⁶⁸ case, Innes JA said “*Not infrequently, however (either to secure some advantage which otherwise the law would not give, or escape some disability which otherwise the law would impose), the parties to a transaction endeavor to conceal its real character. They call it by name, or give it a shape, **intended not to express but to disguise its true nature.** And when a court is asked to decide any rights under such agreement, it can only do so by giving effect to what the transaction really is; not what in form it purports to be...But the words of the rule indicate its limitations. **The Court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulation intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be.** The enquiry, therefore is in each case one of fact, for the right solution of which no general rule can be laid down”.*

In the case of *Randles*,¹⁶⁹ the court said “*I wish to draw your particular attention to the words “a real intention”, definitely ascertainable, which differs from simulated intention”, because they indicate clearly what the learned judge [in Zandberg case] meant by a disguised transaction”. *Randles* held further that “**a transaction is not necessarily a disguised one because it is devised for the purpose of evading the prohibition in the Act or avoiding liability for the tax imposed by it. A transaction devised for that purpose, if the parties honestly intend it to have effect according to its tenor, is interrupted by the Court according to its tenor, and then the only question is whether, so interrupted, it falls within or without the prohibition or tax.**”*

¹⁶⁶*Zandberg v Van Zyl* 1910 AD 302 at 309

¹⁶⁷*CCE v Randel Brothers & Hudson Ltd* 1941 AD 369, 33 SATC 48

¹⁶⁸*Zandberg v Van Zyl* Supra 309

¹⁶⁹*CCE v Randel Brothers & Hudson Ltd* Supra 369

Put differently, a transaction will not be regarded as a sham or simulation if the parties genuinely intended that their contract will have effect in accordance with its tenor, and that rule is applied even if the transaction is devised solely for the purpose of avoiding tax. This is the rule of law established in our courts through a long line of carefully considered reasoning and decisions.¹⁷⁰

“A disguised transaction...is in...essence...a dishonest transaction: dishonest, in as much as the parties to it do not really intend it to have, inter partes, the legal effect which its terms convey to the outside world. The purpose of the disguise is to deceive by concealing what is the real agreement or transaction between the parties. The parties wish to hide the fact that their real agreement or transaction falls within the prohibition or is subject to tax, and so they dress it up in a guise which conveys the impression that it is outside of the prohibition or subject to the tax. Such a transaction is said to be in fraudem legis, and is interpreted by the courts in accordance with what is found to be the real agreement or transaction between the parties. Of course, before the court can find that a transaction is in fraudem legis in the above sense, it must be satisfied that there is some unexpressed or tacit understanding between the parties

Of course, before a court can find that a transaction is in fraudem legis in the above sense, it must satisfied that there is some unexpressed agreement or tacit understanding between the parties. If this were not so, it could not find that the ostensible agreement is a pretence.(emphasis- ie its' not enough to just allege a sham transaction is present- you must look at the tacit intentions etc). The blurring of this distinction between an honest transaction devised to avoid provisions of a statute but disguised to make it appear as if it does not, gives rise to much of the confusion which sometimes appears to accompany attempts to apply the maxim quoted above... ”.

The principle of “substance over form “ therefore confirms the practice that the true intention behind a transaction is of utmost importance- irrespective of what is recorded in the respective agreements! However, this principle only applies where *the parties to it do not really intend it to have, inter partes, the legal effect which its terms convey to the outside world (Randles case.)*¹⁷¹

¹⁷⁰ TS Emslie, D Davis, S Hutton *Income Tax: Cases and Materials* (2004) 896- 897

¹⁷¹ *CCE v Randels Brothers & Hudson Ltd Supra*

It should be noted however that this principle of “substance over form” has its limitations and cannot simply be used to ignore agreements where the parties in fact and in law, intended to give effect to the agreement. This was expressed in the case of Cape Consumers¹⁷², where it was said that “*The doctrine of the disguised transaction is not a panacea for the appellant to ignore agreements where the parties in fact and in law intend that they must be given their legal effect. This is precisely what occurred in the instant case and accordingly there exists no basis to ignore such agreements*”.

In the NWK Ltd¹⁷³ case, Lewis JA affirmed that a taxpayer is free to arrange his affairs so as to minimize tax liability and that there is nothing wrong with arrangements which are tax-effective. However, she qualified this affirmation by stating that “But there is something wrong with dressing up or disguising a transaction to make it appear to be something that it is not...”

The SCA in the case of NWK,¹⁷⁴ surprisingly disagrees with our common law principle re sham or simulated transactions which have been laid down by our courts over the years. The court sought to overturn the common law principle and replace it with a new common law rule. With respect, there are number of flaws in this judgment and a number of points that can be made on this judgment. I will not traverse all of them save as to state that, it is quite concerning that the court repeatedly used the words of “avoidance” and “evasion” interchangeably throughout the judgment which as was pointed out by the honorable Judge Dennis Davis is a novel concept in our fiscal legislation.¹⁷⁵ The problem with referring to them interchangeably is that each concept as explained earlier, has very different meanings with very different consequences that flow from them. This makes it rather confusing to follow the new NWK rule if the word “evasion” is used as opposed to the word “avoidance” in its conventional sense.

Even if we assume that the learned judge’s view is correct, she herself didn’t apply her own method. She applied the principle found in Randles.¹⁷⁶ This is strangely interesting and this in itself makes her finding with regard to her own view *obiter*.¹⁷⁷

¹⁷² *CIR V Cape Consumers (Pty) Ltd* 1999 (4) SA 1213 (C) at 1224H- I

¹⁷³ *SARS v NWK Ltd. 2010 Taxpayer* 203

¹⁷⁴ *SARS V NWK Supra*

¹⁷⁵ TS Emslie and DM Davis *Cumulative Supplement to Income Tax Cases and Materials* (2011) (3 ed) 193

¹⁷⁶ *CCE v Randel Brothers & Hudson Ltd Supra*

4.7 Anti avoidance measures put in place to counter tax avoidance through offshore trusts

I will now consider some of the anti- avoidance measures put into place to counter tax avoidance, specifically as it pertains to offshore trusts. It is beyond the scope of this paper to discuss the anti- avoidance measures put into place with regards to local trusts and so this will not be discussed. A trust is regarded as a “person” for tax purposes¹⁷⁸. The income or capital of a trust can be taxed in the hands of the trust or the beneficiaries. Despite there being many tax advantages with using offshore trusts, these advantages seems to be rapidly declining with the implementation of anti- avoidance legislation in most high- tax jurisdictions. These anti- avoidance legislation no doubt plays a major role in eliminating tax avoidance through the use of offshore trusts

.4.7.1 Income Tax principles applicable to offshore trusts

The income tax provisions which specifically apply to offshore trusts in the ITA are s25B and the s7 (8) tax back provision. These are now discussed below.

Taxing the beneficiary: The Conduit pipe principle

Section 25B embodies the commonly known conduit pipe principle, which provides that income which is paid to or allocated to a beneficiary in the year that the income was received by the trust or accrued to the trust, will be taxed in the beneficiaries hands and those beneficiaries will be deemed to have receipts or accruals for tax purposes and have incurred expenses relating thereto themselves, even though the trust received the income and incurred the expenses.¹⁷⁹

Section 25B (1) provides that any income received by or accrued to a trust will be deemed to accrue to an ascertained beneficiary who has a vested right to the income (e.g. in terms of a

¹⁷⁷ Eddie Broomberg NWK Case study (2011) SAFM Seminar

¹⁷⁸Income Tax Act 56 of 1979, S1 definition of “person”

¹⁷⁹Income Tax Act 56 of 1979, section 25B

deed or will).¹⁸⁰ This section further determines that if the beneficiary has no vested right¹⁸¹ to the income, it will be deemed to accrue to the trust itself. A vested right for purposes of s25B

¹⁸⁰The South African Financial Planning Handbook 2010 at page

¹⁸¹Our courts have dealt with the distinction of “vested rights” and “contingent rights” over the years. The following has been held in the case of *ITC 76*:

“Vesting implied the transfer of dominium, ... A vested right was something substantial; something which could be measured in money; something which had a present value and could be attached. A contingent interest was merely a spes- an expectation which might never be realized. From its very nature it could not have a definite present value. In the income tax sense, therefore, a vested right was an accrued right.”

It is not a necessary consequence of vesting that the beneficiary should have a legal right to claim payment. The income vests in the beneficiaries because they each acquire an immediate right to the income (*dies credit*) although enjoyment had been postponed (*dies venit*) [*ITC 1328*].

A right “vests” in a beneficiary when he or she acquires it immediately, although its “beneficial use” or enjoyment may be postponed [*Greenberg V Estates Greenberg 1955 4 All SA 29 (A)*]. Thus, the acquisition of the right is certain and unconditional [*Colonial Trust Ltd Appellant V Estate Nathan Respondents 1940 AD*].

The *locus classicus* case on the difference between the two rights is the SCA case of *Colonial Trust Ltd Appellant V Estate Nathan Respondents, Supra*

In this case, judge Watermeyer J.A stated that the word “vests” drew a distinction between what is certain and what is conditional. He held as follows:

“...the words “vests” bears different meanings according to its context. When it is said that a right is vested in a person, what is usually meant is that such person is the owner of that right,---that he has all the rights of ownership in such right including the right of enjoyment. If the words “vested” were used always in that sense, then to say that a man owned a vested right would mean no more than a man owned a right.

But the word is also used in another sense, to draw a distinction between what is certain and what is conditional; a vested right as distinguished from a contingent or conditional right. When the word “vested” is used in this sense Austin (Jurisprudence, vol. 2, lect. 53), points out that in reality a right of one class is not being distinguished from a right of another class but that a right is being distinguished

(1) may also be obtained by way of the exercise of discretion of trustees¹⁸². This means that if the beneficiary did not have a vested right in terms of the trust deed, vesting will occur when the trustees decide to make a discretionary distribution to a specific beneficiary. It is no surprise therefore that the most common trust used to avoid tax is a discretionary trust as this creates more flexibility in terms of avoiding tax.

The conduit pipe principle further embodies the principle that income will retain its nature in the hands of the beneficiary. This means for e.g. that if interest is received by the trust and such trust pays the interest over to a trust beneficiary that such income will retain its nature as interest income in the hands of the beneficiary. The only exception to this rule is an annuity¹⁸³.

Taxing the resident beneficiary on income from offshore trusts: S 25B (2A)

In the absence of s7 applying, s25B (2A) of the ITA is the only section that taxes the income of an offshore trust in the hands of a resident beneficiary. Section 25B (2A)¹⁸⁴ provides that

from a chance or a possibility of a right, but it is convenient to use the well-known expressions vested right and conditional or contingent right.

*Now whenever a bequest is made in words which indicate that the right bequeathed is not to be enjoyed or exercised until some future date (that is some date after the testator's death), then **the question always arises whether the words indicating future enjoyment were inserted for the purpose of making the bequest conditional or merely for the purpose of postponing the enjoyment of the bequest. The answer to that question depends ultimately upon the intention of the testator as gathered from the terms of the will, but there are many rules of construction which assist in the decision of the question. If the bequest is unconditional, then the legatee acquires a vested right in the bequest from the date of death of the testator (dies cedit) though he cannot enjoy it until the time arrives for enjoyment (dies venit); if on the other hand the bequest is conditional, he acquires no right – see Voet (36.2), who follows the Roman law, which can be found fully explained by writers such as Goudsmit, Pandects. para. 63; Thibaut, para. 93; Salkowsky (1.1.19) and (3.3.183).***”.what I have said is trite law...”

¹⁸²Income Tax Act 56 of 1979, section 25B(2)

¹⁸³M Botha, L Rossini, W Gcach, B Goodall, L du Preez and P Rabenowitz *The South African Financial Planning Handbook* (2010) at page791- 793

¹⁸⁴Income Tax Act 56 of 1979

where a resident receives any amount that is capital of an offshore trust, then that amount must be included as income in the hands of the beneficiary during the relevant tax year under following circumstances:

- If that capital arose from receipts or accruals of an offshore trust, that would have been regarded as income had that trust been a resident trust in any prior tax year during which that resident had a contingent right to that amount; and
- If that amount was not subject to tax in South Africa.

This section therefore only applies when the resident beneficiary acquires a vested right to the trust income and will therefore mean that the resident beneficiary is subject to South African tax the moment he acquires the vested right to the trust income. In an attempt to clarify the meaning of contingent right for purposes of s25B(2A), Jooste *Offshore trusts and Foreign income- the specific anti- avoidance provisions (2002) Acta juridica-* Revenue Law 186 at 203 states the following:¹⁸⁵

“S 25B (2A) is undoubtedly aimed primarily at discretionary offshore trusts and this raises the vital question whether a beneficiary of such a trust has a contingent right within the meaning of the provision. Some commentators are of the view that the interest of such a discretionary beneficiary may not be a “contingent right” but more properly described as a spes, ie a mere “hope”. It is submitted that the interest of the discretionary beneficiary is a “contingent right” within the meaning of S25B(2A). As stated in Cameron (2002) 557: “If, however, the trustee has a discretion not merely how but also whether to pay income or distribute capital to the beneficiary the latter’s right is merely contingent. The same is true if the trustee has a discretion as to how much to pay or distribute. One advantage of this is that a merely contingent right is not in general subject to income tax nor does it form part of the beneficiary’s estate for insolvency or estate duty purposes”.

*Meyerowitz (2007-2008) at 16.144A)*¹⁸⁶ is of the view that the only requirement is that beneficiary should have a contingent right to the amount in any prior tax year. He submits that it is therefore not necessary for the beneficiary to have been a resident during such prior tax year.

¹⁸⁵ Olivier and Honniball Op cit (n39) 98

¹⁸⁶ Olivier and Honniball Op cit (n39) 89

Section 7 Tax back provisions

Section 7 can however override the “conduit” principle of s25B. Section 7(2) to 7(8) (inclusive) determine that certain amounts are for eg taxable in the hands of the person who made the “donation, settlement or other disposition” (hereinafter referred to as the “DOS”), even though a beneficiary has a vested right to an amount or has actually received it.

Section 7(2) to (8) are anti-avoidance measures which will deem the income to be that of another person other than the person who actually received or accrued it. These sections attempt to ensure that where a person gratuitously disinvests themselves of an asset, any income from that asset will be taxed in the donor's hands.

Taxing the non- resident offshore trust: s7 (8)

Section 7 (8) specifically refers to a DOS made by residents to non- residents and includes trusts. For this section to apply the following must be met:

- A DOS must have been made by a South African resident;
- An amount must have been received by or accrued to a non- resident (in *casu* an offshore trust) “*by reason of*” or “*in consequence of*” the DOS; and
- The amount would have constituted income had that non- resident been a resident

Section 7 (8) uses the words “attributable to” which according to Olivier & Honniball¹⁸⁷ could suggest that apportionment is required. Unlike s7 (5) that refers to “*income*”, this section refers to “*amount*” received by a non- resident which indicates that it was the intention of the legislature that this apply to offshore trusts and any subsidiary companies held by those trusts.¹⁸⁸

Both s7 (5) and s7 (8) has the requirement that the income must be received by the trust “as a consequence of” the DOS. The words “*in consequence of*” denotes that there must be a causal nexus between the donation made and the amount received by the non- resident beneficiary or

¹⁸⁷ Olivier and Honniball Op cit (n39) 97

¹⁸⁸ Olivier and Honniball Op cit (n39) 88

trust (See the Widan¹⁸⁹ case). The two leading cases dealing with the issue of causation are the cases of Widan¹⁹⁰ and Kohler¹⁹¹.

In the Kohler¹⁹² case, the sole question was whether on a proper construction of the section, it was “by reason of” the donation, settlement or other disposition made by the TP to the minor children that the amounts had been received by or accrued to or deemed to have been received by or accrued to the TP. The court held that the section required a strict interpretation- some limit had to be placed by the legislature in the taxability of a parent in respect of a benefit derived by a minor child from such a settlement. The court held further that although the original DOS may have been a “*causa sine qua non*”, it was not the “cause” “by reason of which” the amounts in issue were derived by the minors. In *casu*, the court did not deal with the issue of income which was derived by the DOS but rather income that was derived by the use of the income generated by the DOS. In other words it deals with” income on income”.

The real or actual proximate cause (not a remote cause) of the income is to be established (Kohler¹⁹³ case). In the Widan case, the court held that the words “by reason of” was said to refer to the proximate and not the remote cause (a proximate cause is that there must be a close link between the DOS and the income which arose there from). The court held that if one assumes that one had to apply the proximate cause in favor of the TP then it did not necessarily follow that one had to apply the cause nearest in time. Further the court held that the words “*by reason of*” imply that here must be some causal link between the DOS and the income earned in question.

A question that comes to mind is whether this case over ruled the Kohlers case and whether the court reached a different decision because of the set of facts? Certainly what helped with this

¹⁸⁹*CIR V Widan* 1955 (1) SA 226 (A), 19 SATC

¹⁹⁰*CIR V Widan Supra*

¹⁹¹*Kohler V CIR* 1949 SA 1022 (T), 16 SATC

¹⁹²*Kohler V CIR Supra*

¹⁹³*CIR v Kohler Supra*

case is the fact that it was clearly orchestrated. It is submitted that the case of Widan overrides that of Kohler.

As regards the question of whether or not s7 (8) only applies to a South African Resident who made the DOS or to a non- resident who made the DOS and thereafter became a South African resident, *Jooste (2002) at page 197* states the following:

“It is submitted that S7 (8) is ambiguous in this regards and being a provision designed to prevent tax avoidance a court may give it its wider meaning. As stated by Botha JA in Glen Anil Development Corp Ltd v SIR, the contra fiscum rule of interpretation does not apply to tax avoidance provisions and they should be interpreted.

“...in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed.”

*If the disposition giving rise to the operation of S7 (8) was an interest- free or low interest loan and the loan is still outstanding **when the non- resident becomes a resident**, it is arguable, on the basis that the loan is a continuing donation, that S7 (8) becomes applicable once residence status is attained. In CIR v BeroldHoexter JA held:*

“When the taxpayer sold and transferred a large number of valuable assets to Luzen, he did so on credit and without charging interest on the purchase price. In effect he lent a substantial sum of money to Luzen, and as long as he refrained from compelling Luzen to repay that sum, there was a continuing donation by him to Luzen of the interest on that loan.”

It must also be borne in mind that in these circumstances, no matter what form the disposition takes, if foreign income accrues to the offshore trust and is not distributed in the year of accrual, but is retained and capitalized, it is possible that S7 (5) of the Act may operate and deem the income to be the immigrants' n that year”.

*...It is not an express requirement of S7 (5), **as it is in S7 (8), that the donor must have been a resident at the time the donation was made** and it is difficult to see how such a requirement can be implied”.¹⁹⁴*

(own highlighting)

¹⁹⁴ Olivier and Honniball Op cit (n39) 98

To this end, Olivier & Honniball ¹⁹⁵ submits that if a non- resident who has not yet become a South African resident has donated assets to an offshore trust, then s 7(8) cannot be invoked. I agree with this submission since s 7 (8) only applies to a resident and since SARS also supports this view in its CGT like provision, paragraph 72. Further, if such non- resident has made an interest- free loan to an offshore trust, only the continuing donation made after he has become a South African resident will invoke the provision of s7 (8)¹⁹⁶.

4.7.2 Capital Gains Tax (“CGT”) provisions applicable to offshore trusts

The CGT provisions specifically applicable to offshore trusts are paragraph 72 and 80(3).

Taxing the donor

Paragraph 72 will apply where a resident donor makes a donation, settlement or other disposition to a non- resident beneficiary. In this situation, the resident donor will be taxed on the gain and not the non- resident beneficiary. As an anti- avoidance measure, the gain is therefore attributed to the resident donor even though the non- resident beneficiary actually received the gain. The import of this would be to ensure that CGT is levied in transactions like these, irrespective of the non- resident beneficiary being the recipient thereof. This paragraph is the equivalent of the s7(8) tax back provisions relating to income.

It is suggested by Williams (2005) 404¹⁹⁷ that in order for the SARS to enforce this provisions, they would have to solely rely on the disclosure by the beneficiary in these circumstances as they would have no other means of obtaining this information. There seems to be room for South Africa to improve of their legislation in respect of these disclosures. This provision is the equivalent of section 25B(2A) in that it curbs tax avoidance in circumstances where capital is accumulated in an offshore trust and is then only distributed in subsequent years to the beneficiaries.¹⁹⁸

¹⁹⁵ Olivier and Honniball Op cit (n39) 99 para 3

¹⁹⁶ *Trends and Developments Trusts & Trustees* (2001) 7 (5): 4-7, available at <http://tandt.oxfordjournals.org/content/7/5/4>

¹⁹⁷ Olivier and Honniball Op cit (n39) 96

¹⁹⁸ Meyerowitz in para 39.16.9

4.7.3 Transfer Pricing Rules and Offshore trusts

TP's often use the transfer pricing rules to manipulate prices across borders and hence avoid tax in their country of residence. It is therefore necessary to consider these rules in the context of an offshore trust that has been set up in a tax haven to avoid tax. The provisions of transfer pricing is an anti-avoidance mechanism. In the context of offshore trusts however, it is worth noting that transferring funds to offshore trusts will invoke the provisions of s31 of the ITA.

By way of background, the term "transfer pricing" refers to a situation whereby related or connected parties transfer goods or services between each other and set the prices to their respective benefit. Usually the transfer price is set by a taxpayer when he sells, buys, or shares resources with a "connected person".¹⁹⁹

The transfer price is always contrasted with the "market price"; the market price being the price that the goods, services or resource sharing would fetch in the open market where the transaction is concluded between persons who are not connected persons.²⁰⁰ This is also referred to as an arm's length transaction. A transfer price is therefore always more than or less than the actual price that is payable for the goods or services in the open market.

Section 31 of the ITA includes in the definition of "service" the granting of financial assistance which includes a loan, debt or advance. Section 31(2) allows the Commissioner to adjust a price to an arm's length price if any services or goods are provided between a non-resident and resident, and the price payable is not one which would normally be charged between people dealing at arm's length with each other.

Based on the foregoing legislation, if a resident taxpayer makes an interest free loan to an offshore trust, the resident taxpayer can be assessed in terms of s31. When the loan is made, a rate of interest equal to either the South African prime rate plus two basis points or the Inter Bank rate plus two points (as indicated in the SARS practice note 2), that should have been charged by the lender. The Commissioner will be entitled to tax the lender on the interest

¹⁹⁹Income Tax Act 56 of 1979, S1

²⁰⁰ BJ Arnold and MJ McIntyre *International Tax primer* (2 ed) (2002) 55

income that should have been received had the loan agreement been concluded in terms of the arm's length principles.

4.7.4 Offshore Trusts and the Source Rules

In the context of a resident taxpayer setting up an offshore trust in a tax haven, any non-resident offshore trust will be subject to tax on income which is from a South African source or which is deemed to be from a South African source. This is subject to the provisions of any applicable DTA. Section 9 of the ITA sets out the "deemed source" rules and the case of *CIR v Lever Bros Unilever Ltd 14 SATC 1*²⁰¹, provides the principles for the general source rules. I shall not discuss this, save as to state that it is a two stage test where, firstly one has to establish the originating cause of the income and secondly one has to then look at the location of the cause.

4.8 National Treasury's Intention to amend the laws applicable to the taxation of trusts

In the 2013/2014 budget, it was announced that National Treasury intended to amend the laws applicable to the taxation of trusts because of the problem of tax avoidance which is facilitated by the use of trusts. In the main, they seek to abolish the conduit pipe principle in its entirety. Their proposals include the following:

- Discretionary trusts will no longer act as flow through vehicles and instead will be taxed at a trust level (i.e. as an entity) with distributions being deductible payments in the trusts hands to the extent of current taxable income. Tax free distributions to beneficiaries will be allowed except where they give rise to deductible payments (i.e. there appears to be a symmetry principle) and these tax free distributions will be included as income in the hands of the beneficiary.
- Trading trusts will also be taxable at the entity level with distributions being deductible to the extent of current taxable income. A trading trust according to the proposal will be

²⁰¹See also the case of *Transvaal Associated Hide & Stein Merchants v COT Botswana 29 SATC 97; Millin v CIR 3 SATC 170*

one which either conducts a trade or one in which beneficial ownership is freely transferable by beneficiaries.

- Distributions from “offshore foundations” will be treated as ordinary revenue. This proposed amendment is designed to cushion the income from being taxed globally.
- Concern was expressed in the proposals regarding the use of trusts to avoid estate duty (which is a long standing issue), but no further details were provided. This concern is surprising indicators in previous years was that estate duty was on the way out.
- The proposals will not apply to trusts created for the legitimate needs of a minor or people with disabilities (i.e. special trusts).

It seems as if the abolishment of the conduit pipe principle will do no more than create loopholes for income splitting than is currently possible through the S7 tax back provisions. Currently, income- and CGT splitting does not happen often due to the attribution rules contained in S7 and in the Eighth Schedule of the ITA. The founder/donor was taxed on such income/CGT. The Society of Trusts and Estate Planning Practitioners (“STEPP”) held meetings with Treasury on the subject and gave recommendations. On 24 May 2013 they reported back as follows as regards to *“Offshore Foundations: Treasury confirmed that all distributions made by offshore foundations would be treated as income in the hands of such beneficiaries, and hence taxed at their marginal rate of tax. This punitive regime extends even to core capital distributed from the foundation. Essentially, Treasury seems to want to disincentivise the use of offshore foundations in their entirety.”*

This is yet another attempt by Treasury to tighten the screws on offshore avoidance through the use of offshore entities. However, Treasury’s representatives have confirmed to STEPP that the proposed punitive measures will not extend to offshore trusts at this juncture. They specifically communicated to STEPP that it is not their intention to tax distributions made by offshore trusts in the ambit of the proposed legislation, and that they have no intention of amending the way in which distributions made by such trusts to resident beneficiaries are taxed in the foreseeable future. However, this was qualified by saying that that is not to say that they will not focus on offshore trusts in the future, they simply have no intention of doing so at this point in time. This should come as a huge relief to many, as the majority of queries raised by many

in the industry were regarding the view that the proposed treatment of foundations will also apply to offshore trusts.

4.9 Conclusion

With the above anti- avoidance measures in place, it can be deduced that the legislation in its current form has tightened the screws on taxpayers wishing to make use of offshore trusts to avoid tax. It is also clear with the new legislative proposals that even more measures are going to be put in place to close in on tax payers that use trusts to avoid tax. Even though this is not current law, taxpayers are strongly cautioned to pause and wait until clarity is received on these proposals. These new proposals may make it even harder for taxpayers to avoid tax via trusts and may even mean the demise of the use of trusts. More insight can only be given once sight is had of what Treasury includes in their first draft of the amending legislation.

CHAPTER 5 CONCLUSION

This paper has considered countering tax avoidance through the use of offshore trusts. In particular it has considered the proposition that tax avoidance through the use of offshore trusts are encouraged by two factors, viz the very existence of tax havens and the unique features of an offshore trust.

It has been established that offshore tax avoidance is a growing global problem and as such some of the international initiatives undertaken to counter this were considered, the most noteworthy was that of the OECD. To this day the OECD continues in its onslaught against tax havens and tax avoidance but despite these initiatives, this does not guarantee the total abolishment of these jurisdictions. Factors such as e-commerce for example hinder the complete eradication of these jurisdictions.

It is noted that the fact that South Africa has a resident based tax system in itself is a useful tool to curb tax avoidance. This is so because South African residents are taxed on their worldwide income. With a non-natural person, like a trust its residency is determined with reference to whether it was incorporated, established or formed in South Africa or if it has its POEM in South Africa. The POEM is the most important test with regards to offshore avoidance and yet there is no statutory definition for the term in South African legislation. It is therefore recommended that South Africa formerly include a definition of POEM into the Act. Even though the SARS has a an interpretation in their SARS note, the SARS notes are not binding law and as such our courts must at this stage adhere to the OECD guidelines.

One of the ways used internationally to curb tax avoidance is to force resident taxpayers to disclose their offshore investments and/ or interests. Countries like the UK²⁰² and the US have rigid reporting requirements in place. It seems that South Africa lacks a set of rigid reporting requirements which compels its taxpayers to do just this. S 7(10) of the ITA merely requires

²⁰²The Income and Corporations Act of 1988, S745.

the taxpayer to report in writing to the SARS when submitting his/ her tax return. It is suggested that South Africa implement rigid reporting requirements which places time limits on taxpayers within which to report their offshore investments or interests and to make these subject to penalties in the event that they do not comply. This will no doubt force South African resident taxpayers to comply and may even curb tax avoidance.

It is submitted that what South Africa could do, is to charge interest on income accumulated in offshore trusts. This approach is followed in both the US and the UK. In terms of the UK's Finance Act of 1991, interest is charged to beneficiaries who receive capital payments from offshore trusts.

It is submitted that the new GAAR does no more than act as a scare tactic to taxpayers wishing to avoid tax by setting up an offshore trust in a tax haven. Eight years has elapsed since it has come into effect and still no case law has been reported on the new GAAR. In the context of an offshore trust established in a tax haven to avoid tax, the new GAAR is too wide in its application and they are better dealt with under the specific anti avoidance measures of s25 B and s7.

With the advent of the new proposed abolishment of the institution of trusts, it appears that investing offshore via trusts may be under threat. However, this by no means, indicates that the powers that be should relax in their effort to tighten the screws as investing offshore via trusts is still a viable tax planning tool for many tax payers.

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