A COMPARISON OF TAX LEGISLATION OF TRUSTS BETWEEN SOUTH AFRICA AND THE UNITED STATES OF AMERICA ON EMIGRATION

by

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ABSTRACT

A COMPARISON OF THE TAX LEGISLATION OF TRUSTS BETWEEN SOUTH AFRICA AND THE UNITED STATES OF AMERICA ON IMMIGRATION

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An estimated 81 142 South Africans emigrated to the United States of America in 2010 (The World Bank, 2010). If only one of these emigrants were a creator, donor or beneficiary of a South African trust, then it is important to determine the tax implications both in South Africa and the United States of America for the creator, donor or beneficiary. In South Africa, the income and gains of the South African trust will be taxed in the hands of the donor, beneficiary or the trust itself. But, in the United States of America, the tax consequences could get rather complicated.

The main purpose of this study was to make a theoretical comparison of the tax consequences of South African trusts both in South Africa and the United States of America and determine the effect of the emigration of the South African donor and/or beneficiaries to the United States of America.

Based on the literature reviewed, the donor will be taxed in South Africa if a donation, settlement or other disposition was made, the beneficiary will be taxed if he/she has a vested right to income and no donation, settlement or other disposition was made and the South African trust will be taxed on any taxable income retained in the trust that is not taxable in the hands of the donor or beneficiary. In the United States of America, the South African trust will be liable for tax depending on its status as a business, investment or ordinary trust and furthermore on its status as a grantor or non-grantor trust.

Keywords: d*omestic trust, donor, foreign trust, grantor, grantor trust and non-grantor trust.*

OPSOMMING

'N VERGELYKENDE STUDIE VAN DIE BELASTINGWETGEWING VAN TRUSTS TUSSEN SUID-AFRIKA EN DIE VERENIGDE STATE VAN AMERIKA MET EMIGRASIE

deur

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'n Geskatte 81 142 Suid-Afrikaners het in 2010 na die Verenigde State van Amerika geëmmigreer (The World Bank, 2010). Indien slegs een van hierdie emigrante 'n stigter, skenker of begunstigde van 'n Suid-Afrikaanse trust sou wees, dan is dit belangrik om die belastinggevolge in Suid-Afrika en die Verenigde State van Amerika, vir genoemde stigter, skenker en begunstigde te bepaal. In Suid-Afrika word die trust se inkomste en winste of in die hande van die skenker, begunstigde of die trust self belas. In die Verenigde State van Amerika kan die belastingimplikasies egter ingewikkeld raak.

Die hoofdoel van hierdie studie was om 'n teoretiese vergelyking te tref tussen die belastingimplikasies van die Suid-Afrikaanse trust in Suid-Afrika en die belastingimplikasies in die Verenigde State van Amerika, en verder om die effek van emigrasie van die Suid-Afrikaanse skenker en/of begunstigdes na die Verenigde State van Amerika te ondersoek.

Uit die literatuur wat geraadpleeg is, blyk dit dat die skenker in Suid-Afrika belas word op die inkomste van die trust indien hy 'n skenking, oormaking of ander soortgelyke beskikking gemaak het, die begunstigde word belas op inkomste waarin hy/sy 'n gevestigde reg het en die trust word belas op enige inkomste wat nie uitgekeer word nie en nie in die hande van die skenker of begunstigde belasbaar is nie. In die Verenigde State van Amerika, word die Suid-Afrikaanse trust belas op grond van die trust se status as 'n besigheids-, beleggings- of gewone trust. Verder hang die belasting-aanspreeklikheid van die trust in die Verenigde State van Amerika af van die trust se status as skenker trust of nie-skenker trust.

Sleutelwoorde: *binnelandse trust (domestic trust), buitelandse trust (foreign trust), nie-skenker trust (non-grantor trust), skenker (donor), skenker (grantor) en skenker trust (grantor trust).*

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

An estimated 81 142 South Africans emigrated to the United States of America in 2010 (The World Bank, 2010). If only one of these emigrants were a creator, donor or beneficiary of a South African trust, then it is important to determine the tax implications both in South Africa and the United States of America (hereafter referred as the United States) for the creator, donor or beneficiary.

As indicated by Handler (2006:24), it is possible that all income of the trust is taxable in the hands of the grantor (also settlor or creator), irrespective of whether any income is distributed to the grantor. A trust where income is taxable in the hands of the grantor (e.g. a grantor trust) has no independent existence from the grantor for United States income tax purposes.

In other instances, it may be possible to elect the trust's corporate status for United States tax purposes (Forst, Hodges, Kautter, Sheppard & Henderson, 2008:184).

However, a South African trust is a person as defined by section 1 of the Income Tax Act No 58 of 1962 and therefore has independent existence from the grantor. Taxation of a South African trust is mainly regulated by section 7 and section 25B of the Income Tax Act.

If then, for example, after emigration of the grantor, the South African trust is taxable as a grantor trust in the United States but the trust itself remains a South African resident for South African tax purposes, it is entirely possible that double taxation might arise.

An extensive search of leading electronic journal databases, such as EBSCOHost, Google Scholar, Proquest and SA ePublications, suggests that many articles have been written

with regard to specific problems arising from the taxation of foreign trusts in the United States.

A literature review will therefore be conducted of the normal tax legislation both in South Africa and the United States, as well as the double tax treaties between South Africa and the United States.

An overview will then be given as a means to compare the tax implications for the South African trust and its creator, donor and beneficiaries in South Africa and the tax implications for the same entities in the United States.

1.2 PROBLEM STATEMENT

Through research it was determined that many articles have been written in the United States to deal with the specific problems arising from the taxation of foreign trusts in the United States However, no reference could be found to deal with the specific tax implications from a South African perspective, relating to a South African trust when the creator and, or beneficiaries emigrate to the United States.

1.3 PURPOSE STATEMENT

The main purpose of this study is to make a theoretical comparison of the tax consequences of the South African trust in South Africa and the same trust in the United States and determine the effect of emigration of the South African donor and or beneficiaries to the United States.

1.4 RESEARCH OBJECTIVES

The study will aim to achieve the following specific research objectives:

- to investigate the South African normal tax implications of a South African trust before and after the creator, donor and/or beneficiaries emigrate to the United States;

- to investigate the United States normal tax implications of a South African trust before and after the creator, donor and/or beneficiaries emigrate to the United States;
- to determine how double taxation is regulated in South Africa and the United States; and
- to compare the South African and United States tax implications.

1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

This study aims to establish a better understanding of the tax implications, in South Africa and the United States, and the theoretical thinking and definitions relating to these tax implications. The study will focus on a South African trust, its creator, donor and beneficiaries, in circumstances where the creator, donor and/or beneficiaries emigrate to the United States.

The tax implications, in South Africa and the United States, of the South African resident trust will be discussed with reference to the key definitions and legislation, of South Africa and the United States, in order to make a comparison and create a better understanding of the effect of emigration of the creator, donor and/or beneficiaries.

1.6 DELIMITATIONS AND ASSUMPTIONS

The study will not cover the various and extensive reporting requirements stipulated by United States law.

The study will only focus on the South African trust with a South African resident creator, South African donor and South African beneficiaries before their emigration to the United States. Furthermore, the study will only look at the United States tax implications of the South African resident trust and no other foreign trusts. The study will only focus on the literature and legislation relating to the United States Federal Code of Revenue and not those applicable to the individual states of the United States.

1.7 DEFINITION OF KEY TERMS

This study involves a number of key concepts. The manner in which these key terms are defined for the purposes of this study is considered below.

For the purposes of the South African tax consequences, the definitions of *donor* and *resident trust* are significant and for the purposes of the United States tax consequences, the definitions of *domestic trust*, *foreign trust*, *grantor*, *grantor trust* and *non-grantor trust* are fundamental to this study.

Accumulation distribution: When a trust has undistributable net income and the distribution exceeds the distributable net income, that excess distributed from the undistributable net income is referred to as an accumulation distribution (Jetel, 2008:62).

Administration: "... [M]eans the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions" (Department of the Treasury, 1999:39).

Automatic migration provisions: "... [I]f the trust instrument provides that a United States court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the United States" (Department of the Treasury, 1999:39).

Beneficiary: Any person "... that could possibly benefit (directly or indirectly) from the trust (including an amended trust) at any time, whether or not the person is named in the trust instrument as a beneficiary and whether or not the person can receive a distribution from the trust in the current year" (Department of the Treasury, 2010a:5).

Control: "... [M]eans having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions" (Department of the Treasury, 1999:40).

Corpus: Defined as the main body or mass of a structure (Oxford Dictionaries, Not dated).

Court: Includes any federal, state or local court (Department of the Treasury, 1999:39).

Distributable net income: Trust's taxable income adjusted for personal exemptions or distributions and tax-exempt income (Jetel, 2008:61).

Domestic trust: Any trust would be classified as a domestic trust if any United States court has primary jurisdiction over its administration (referred to as the court test) and one or more United States persons have the authority to control all substantial decisions thereof (referred to as the control test) (McNamara, 2006:344).

Donor: Donor is any person that makes a donation, settlement or other distribution (section 1 of the Income Tax Act).

Foreign trust: Foreign trust is any trust that is not a domestic trust (section 7701(a)(30)(E) of the Small Business Job Protection Act of 1996).

Grantor: This is any person who creates a trust or directly or indirectly makes a gratuitous transfer of cash or other property to a trust. A grantor includes any person treated as the owner (Department of the Treasury, 2010a:3).

Grantor trust: This is a trust that is treated as 'owned' by its settlor (i.e. the 'grantor') (Hester, Pfeifer & Henderson, 2002:141).

Gratuitous transfer: Any transfer not made at market value. It will also include a transfer of property to a trust even if it was not treated as a gift for gift tax purposes (section 671 of the Internal Revenue Code of 1986).

Non-grantor trust: This is any trust other than a grantor trust (Hester *et al.*, 2002:142).

Offshore trust: A foreign trust for United States income tax purposes that would not be able to claim income tax treaty benefits (generally because it is based in a tax haven) (Vetter, 2003:72).

Owner: "An owner of a foreign trust is the person that is treated as owning any of the assets of a foreign trust under the rules of sections 671 through 679 ..." of the Internal Revenue Code (Department of the Treasury, 2010a:4).

Person (for purposes of the double tax agreement between South Africa and the United States): Includes an individual, an estate, a trust, a partnership, a company and any other body of persons (Department of State, 1997).

Person (for purposes of the Income Tax Act of South Africa): Includes an insolvent estate, the estate of a deceased person and any trust (section 1 of the Income Tax Act).

Primary supervision: "... [A] court has or would have the authority to determine substantially all issues regarding the administration of the entire trust" (Department of the Treasury, 1999:39).

Resident of South Africa: Means any natural person who is:

- ordinarily resident in the Republic of South Africa; or
- during any of assessment was physically present in South Africa for more than 91 days, and physically present for more than 91 days in each of the five preceding years of assessment. The aggregate total of days in the preceding years of assessment should also exceed 915 days (section 1 of the Income Tax Act).

Resident trust: This is any trust formed in South Africa or which has its *place of effective management* in South Africa (section 1 of the Income Tax Act).

Settlor: This is the same as the grantor (Handler, 2006:24).

Substantial decisions: "... [M]eans those decisions that persons are authorised or required to make under the terms of the trust instrument and applicable law and that are not ministerial" (Department of the Treasury, 1999:40).

Throwback tax: Tax payable on the accumulation distribution arising when a distribution exceeds the distributable net income of the trust (Jetel, 2008:62).

Undistributable net income: Distributable net income of previous years not distributed (Jetel, 2008:62).

Withholding agent: Person responsible to withhold tax from payments made to foreign persons (Pharies & Glasser, 2011:175).

Table 1.1 refers to abbreviations used in this dissertation as contained in the literature under review.

Table 1.1: Abbreviations used in this dissertation

Abbreviation	Meaning
CFC	controlled foreign corporation
DNI	distributable net income
DTA	double tax agreement
FPHC	foreign personal holding companies
PFIC	passive foreign investment companies
UNI	undistributable net income

1.8 RESEARCH DESIGN AND METHODS

The aim of this study is to determine what the tax implications, in South Africa and the United States, would be if a donor/settlor emigrates to the United States. A comparative study will therefore be conducted based on the review of available literature and legislation regarding the tax consequences of the foreign trust in the United States and the tax consequences of the South African trust in South Africa in order to come to a proper understanding of this specific aim.

An extensive search of leading electronic journal databases, including EBSCOHost, Google Scholar, Proquest and SA ePublications was done to formulate a better understanding of the issues, debates, theoretical thinking and definitions with regard to the specific problems arising from the taxation of foreign trusts in the United States.

A literature review will provide a good understanding of the issues in this area and the current theoretical thinking and definitions, but it is limited to existing studies and publications and cannot provide any new insights or validate existing insights.

In the following chapters, the literature and legislation of each country will be discussed. The taxation of the resident trust in South Africa will be discussed in Chapter 2. In Chapter 3, the taxation of the foreign trust in the United States will be discussed and in Chapter 4, the double tax agreement between the United States and South Africa will be discussed, as well as the foreign tax relief available to each country's residents. The benefits and uses for the foreign trust in the United States will be discussed in Chapter 5, and finally, in Chapter 6, a comparison is made between the South African and United States tax legislation and the effect of emigration on the tax liability in each country.

CHAPTER 2

TAXATION OF A RESIDENT TRUST IN SOUTH AFRICA

2.1 INTRODUCTION

In this chapter, the South African tax implications for a resident trust in South Africa will be researched. General rules will be discussed with specific reference to the definitions of *gross income* and *resident*. Specific rules applicable to certain types of incomes will also be discussed, as well as capital gains tax consequences, which may arise on disposal of assets by the resident trust. These rules will then be applied to the resident trust.

It should also be noted that any reference to *person* in this chapter, includes a trust as a trust is specifically included in the definition of *person* in terms of section 1 of the Income Tax Act.

The normal tax implications will be discussed in two parts. Firstly, an overview will be given of the general tax rules and those rules applicable to the trust and then an overview will be given of the tax consequences of capital gains realised on disposals made by the trust.

2.2 NORMAL TAX IMPLICATIONS (EXCLUDING CAPITAL GAINS TAX)

The general tax rules, with specific reference to gross income and income exempt from normal tax, applicable to residents of South Africa and persons not residing in South Africa, are discussed in terms of the Income Tax Act. The specific rules that can be applied to the taxation of trust income are also discussed.

2.2.1 General rules

In terms of section 1 of the Income Tax Act, included in the gross income of a resident is the total amount received by or accrued to or in favour of the resident, whether in cash or

otherwise. A South African resident will therefore be taxed on his/her worldwide income. Included in the gross income of a non-resident, however, will only be the receipts or accruals from a source within or deemed to be within South Africa (section 1 of the Income Tax Act). In *CIR v Lever Brothers & Unilever Ltd*, 1946 AD 441 (14 SATC 441), the court held that the source of income would be determined by what the original cause of the income was and where this original cause was situated, and the source of interest was therefore determined to be where the credit was supplied and not where it was productively applied or paid back. In *Boyd v CIR*, 1951 (3) SA 525 (A) (17 SATC 366), the court held that the source of dividends was where the shares were situated and therefore where they were registered.

A *trust* will be considered to be a resident when it is formed or effectively managed in South Africa. Until recently, the only guidance for the meaning of *the place of effective management* was found in Interpretation Note 6 (South African Revenue Services, 2002), where it provides that, irrespective of where the overriding control is exercised, *the place of effective management* will be where the day-to-day or regular management is undertaken, or where the trustees meet. The recent court case of *Oceanic Trust Co. Ltd N.O. v Commissioner for the South African Revenue Services* (case number: 22556/09, as yet unreported) is, however, the first judgement by a court in South Africa that provides guidance on this matter. The court found that *the place of effective management* would not necessarily be where the decisions are implemented, but where significant commercial and management decisions are made. Even though the trust will be a resident for the purposes of this study, the residency of the donor or beneficiaries may change, which will result in different inclusions and exemptions.

A non-resident, whether a natural person or a legal person, may receive an interest exemption in terms of section 10(1)(h) of the Income Tax Act if the requirements as set out in the section are met. This interest would include dividends deemed to be interest in terms of section 8E of the Income Tax Act and interest incurred or accrued in terms of section 24J(1) of the Income Tax Act. In order to qualify for this exemption, the non-resident (if a natural person) may not be physically present in South Africa for more than 183 days and may not carry on a business through a permanent establishment in South Africa. If the interest of a non-resident does not qualify for this specific interest exemption,

he/she may still utilise section 10(1)(i)(xv) of the Income Tax Act if he/she is a natural person.

Income such as interest, dividends and certain royalty payments could be exempt from normal tax in terms of section 10 of the Income Tax Act. Interest from a South African source is exempt in terms of section 10(1)(i)(xv) of the Income Tax Act. This exemption applies only to natural persons and the maximum amount of the exemption for the 2012 year of assessment for a South African source interest is R33 000 (over 65 years of age) and R22 800 (under 65 years of age). The first R3 700 of this exemption amount can be claimed by a resident against foreign source interest and dividends.

Dividends that are exempt from normal tax are determined by section 10(1)(k) of the Income Tax Act. Any legal person or natural person will receive this exemption on any South African source dividends or on foreign dividends that were paid from profits already subject to tax in South Africa. The exemption does not apply to dividends distributed on shares included in a collective investment scheme in property, section 11(s) dividends from a collective investment company and dividends on shares held as trading stock.

Another exemption that may be claimed is the exemption of any amount that was subject to withholding tax in terms of section 35 of the Income Tax Act (section 10(1)(l) of the Income Tax Act). In terms of section 35 of the Income Tax Act, withholding tax at a rate of 12% should be paid on income derived from royalties or similar payments received by a person who is not a resident of South Africa.

Withholding tax is also payable where a non-resident sells immovable property situated in South Africa where the proceeds exceed R2 million (section 35A of the Income Tax Act). The amount withheld would be 5% in the case of a natural person, 7,5% in the case of a company and 10% in the case of a trust.

The above-mentioned rules are applicable to all persons liable for tax in South Africa. There are, however, some sections in the Income Tax Act specifically applicable to all trusts, its donors and beneficiaries and these will be discussed next.

2.2.2 **Tax liability of trusts**

As discussed above, persons who are residents of South Africa must include their worldwide income in their gross income. In terms of section 1 of the Income Tax Act, a *person* includes any trust, therefore a trust might be liable for income tax in South Africa if it has taxable income.

A tax liability of a trust is mainly regulated by the provisions of section 7 and section 25B of the Income Tax Act. According to section 25B(1), where an amount accrues to a trustee during a year of assessment and the beneficiary has a vested right, then that amount will be deemed to have accrued to the beneficiary. Section 25B(2) further states that the beneficiary will also be deemed to have acquired a vested right when the trustees exercise a discretion in terms of the trust deed. In terms of section 25B(1), however, the terms of section 25B will be subject to the provisions of section 7, therefore the rules in terms of section 7 must be applied first, before section 25B is applied. It follows that in order to determine the correct taxpayer, section 7(2) to section 7(8) should be applied first and if applicable, the donor will be taxable. Secondly, the provisions of sections 25B(1) and 25B(2) together with section 7(1) should be applied where the beneficiary will be taxable (i.e. if the beneficiary has or acquires a vested right, which will be discussed below). Lastly, the provisions of section 25B(1) should be applied where the trust will be taxable.

Two key factors that should be established in terms of section 7 of the Income Tax Act are whether a person has a vested right to an amount and if a donation, settlement or other disposition was made. In terms of section 7(1), a person has a vested right where an amount is deemed to have accrued to him/her. In terms of sections 7(2) to 7(8), however, the person that makes the donation, settlement or other disposition is taxable on the trust income, even if the beneficiary has a vested right or has received it. Where a donation, settlement or other disposition was made by a donor and income was derived by a recipient in consequence of such donation, settlement or other disposition, section 7 of the Income Tax Act provides that another person, for example, the donor spouse or donor parent, could be liable for the tax. It is important to keep in mind that the provisions of sections 7(2) to 7(7) of the Income Tax Act are applicable to donors who could be either

South African residents or non-residents, whereas section 7(8) of the Income Tax Act only applies to a South African resident donor.

The donor spouse would be liable for tax if the recipient is the spouse of the donor and the income was derived by a trade carried on (solely or partly) by the donor, or income was derived in consequence of the donation, settlement or other disposition, or was a transaction, operation or scheme carried on with the sole or main purpose to reduce, postpone or avoid a tax liability (section 7(2) of the Income Tax Act). The donor parent would be liable for tax if income is received by or accrued to a minor child (18 years and younger) or was accumulated for the benefit of such child, and such income was derived in consequence of a donation, settlement or other disposition made by that parent (section 7(3) and section 7 (4) of the Income Tax Act).

Other instances where the donor will be liable for tax on income are where, in terms of section 7(5) of the Income Tax Act, a donation, settlement or other disposition is subject to a stipulation or condition and the beneficiary cannot receive the income or a vested right until it is met. The donor will also be liable for tax on income where he/she retains the power to revoke or confer the right of a beneficiary to receive income (section 7(6) of the Income Tax Act) or if he/she cedes the income or right to receive income to another person, but retains ownership of the asset (section 7(7) of the Income Tax Act).

Lastly, the resident donor will be liable for tax on income and that income which accrued to or was received by a non-resident (section 7(8)(a) of the Income Tax Act). The resident donor may, however, deduct an expense, allowance or loss incurred by the non-resident in terms of section 7(8)(b). The deduction may, however, not exceed the income.

Some relief is provided for the donor where he/she incurred a tax liability on income that did not accrue to him/her, such as the tax liability incurred in terms of sections 7(2) to 7(8) of the Income Tax Act. The donor will be able to recover the tax from the person who received the income (section 90 of the Income Tax Act). The donor can also recover the tax against the asset that generates the income (section 91(4) of the Income Tax Act).

It could be concluded that if a beneficiary has a vested right to income, the beneficiary will be liable for tax thereon, unless the provisions of section 7 of the Income Tax Act is applicable and the donor is liable for tax. If neither the provisions of section 7 applies nor does the beneficiary have a vested right to income, the trust will be liable for tax.

It should be noted that if the beneficiary or donor is taxable on the income or gains, the nature of the income will stay the same as that of the trust. In *Armstrong v CIR*, 1938 AD 343 (10 SATC 1), it was determined that the conduit principle will be applied to trust income, where the trust income keeps its identity up to the person in which it is ultimately taxed. It was also made clear in *SIR v Rosen*, 1971 (1) SA 172 (A) (32 SATC 249) that the income will keep its identity even if it was paid in an annuity or otherwise.

2.2.3 **Donation, settlement or other disposition**

From the above, it is important to determine if a donation, settlement or other disposition was made. By including the term *other disposition* in section 7 of the Income Tax Act, it widens the scope of what would constitute a *donation*. This will be discussed in more detail below.

One important example that may amount to a donation, settlement or other disposition as defined is an interest-free or low-interest rate loan. In *Joss v SIR*, 1980 (1) SA 664 (T) (41 SATC 206), the court held that due to the fact that no interest was levied on a loan, it influenced the eventual income distributed to the beneficiaries. In effect, the disposition did not occur at the full value and therefore it is considered to be a disposition for the purposes of section 7 of the Income Tax Act. It was further held in *CIR v Berold*, 1962 (3) SA 748 (A) (24 SATC 729) that the interest-free loan will constitute a continuous donation for the purposes of the application of the provisions of section 7 of the Income Tax Act.

The market-related interest that should have been levied will be the maximum amount that will be taxable in the donor's hands. This will be applied cumulatively over any year of assessment.

Another instance that will qualify as a donation, settlement or other disposition is when an asset is sold at less than market value. The excess of the market value over the proceeds will constitute a donation, settlement or other disposition (section 7(9) of the Income Tax Act). In *Ovenstone v SIR,* 1980 (2) SA 721 (A) (42 SATC 55), the court found that where the proceeds are minimal, the entire disposition will be deemed as free, but if a substantial part of the value was paid, only the balance will be considered as free. Consequently, only the portion of the amount considered as free, will be subject to the donation distribution rules in terms of section 7 of the Income Tax Act.

2.2.4 **Deductions and allowances**

Section 25B(3) of the Income Tax Act provides that a deduction or allowance may be claimed against any amount to which it applies. The expenses should be deducted on a pro-rata basis in proportion to the income (section 25B(1) of the Income Tax Act).

The normal income tax rules should, however still be considered, such as no expense may be claimed against exempt income (e.g. section 10(1)(k) dividends) in terms of section 11(a) of the Income Tax Act as the expense was not incurred in the production of income (section 23(f) of the Income Tax Act).

Another aspect to be considered is the limitation of the deductions or any losses incurred as any deductions and losses may not exceed the total income accrued to the beneficiary (section 25B(4) of the Income Tax Act). Expenses may be deducted against all income and not just specific income.

The beneficiary may, however, not utilise a loss from a trust against income other than income from the trust. The trust may utilise the loss if it is a South African taxpayer, otherwise the beneficiary may utilise it in future years of assessment (section 25B(5)(a) of the Income Tax Act). On the other hand, if the trust is not a South African taxpayer, it may not utilise the loss and it must be transferred to future years of assessment for the utilisation of the beneficiary (section 25B(5)(b) of the Income Tax Act).

2.3 CAPITAL GAINS TAX IMPLICATIONS

There are two instances when a disposal by a trust will occur. Firstly, when a transaction for the disposal of the asset to a third party was entered into, and secondly, when a trust asset is vested in a beneficiary. Vesting should be unconditional and the proceeds will be determined as the market value on vesting (paragraph 2 of the Eighth Schedule to the Income Tax Act).

Paragraph 80 of the Eighth Schedule to the Income Tax Act provides for the treatment of a capital gain (and not a loss) that vests in a resident beneficiary. Where the resident beneficiary receives a vested right in the trust asset (paragraph 80(1) of the Eighth Schedule to the Income Tax Act) or the resident beneficiary receives the gain and not the asset (paragraph 80(2) of the Eighth Schedule to the Income Tax Act), the gain may be transferred to the resident beneficiary and will not be taxable by the trust. If, however, a donation was made by a parent to a minor child, a spouse, a resident donor and a non-resident beneficiary receives the benefit, or a person retains the right to revoke certain rights, the person making that donation will be liable for tax on the capital gain (paragraphs 68, 69, 71 and 72 of the Eighth Schedule to the Income Tax Act). The amount subject to capital gains tax in the hands of the donor is limited to the benefit actually received by the trust (paragraph 73 of the Eighth Schedule to the Income Tax Act).

In terms of paragraph 80 of the Eighth Schedule to the Income Tax Act, a capital loss cannot be distributed to a beneficiary. Two methods are proposed to utilise the capital loss in the trust. One method is the distribution of capital gains to a non-resident beneficiary and the other is to delay vesting of the capital gain in the beneficiary until the subsequent year of assessment (Stark & Stiglingh, 2008:737).

In order to determine the capital gain or loss, it is important to determine the base cost of the asset vested in or interest of the beneficiary. In terms of paragraph 81 of the Eighth Schedule to the Income Tax Act, the base cost of a discretionary interest in a trust is nil. The base cost of a vested right will, however, be determined as the market value on the day the interest vests.

2.4 SUMMARY

Income and gains earned by the South African trust will mainly be taxed in one of three ways. Firstly, the donor spouse or donor parent of a minor child, the person retaining the right to revoke certain rights or the person who invokes a stipulation or condition on a disposition or the resident donor making donations where a non-resident beneficiary receives the benefit, will be liable for tax in terms of sections 7(2) to 7(8) of the Income Tax Act if the donor made a donation, settlement or other disposition. Then the beneficiaries will be liable for tax in terms of section 7(1) and section 25B of the Income Tax Act if they have a vested right to income or a distribution was made and there was no donation as defined. Lastly, the trust will be liable for tax on all income not distributed or to which no beneficiary has a vested right.

All worldwide income will be included in the taxable income of the resident trust, resident donor or resident beneficiary. A natural person who is a South African resident is eligible for an interest exemption in terms of section 10(1)(i)(xv) of the Income Tax Act and both legal and natural persons are eligible for a dividend exemption in terms of section 10(1)(k) of the Income Tax Act on South African dividends or dividends paid from profits already taxed in South Africa.

Only South African source or deemed source income will be included in the taxable income of the non-resident donor or beneficiary. The non-resident (natural and legal person) is eligible for an interest exemption in terms of section 10(1)(h) of the Income Tax Act and the non-resident natural person will also be eligible for the section 10(1)(i)(xv) interest exemption. The non-resident (natural or legal person) will also be eligible for the section 10(1)(k) dividend exemption. Another exemption the non-resident will be eligible for is where withholding tax was paid on royalties or similar payments (section 10(1)(l) of the Income Tax Act).

In the following chapter, an overview will be given of the tax implications of foreign trusts in the United States in order to determine what the tax consequences of a South African trust will be if it would become taxable in the United States due to immigration of the donor and beneficiaries.

CHAPTER 3

TAX IMPLICATIONS FOR FOREIGN TRUSTS IN THE UNITED STATES

3.1 INTRODUCTION

In this chapter, the tax implications for foreign trusts in the United States are discussed in order to determine what the tax consequences of a South African trust will be if it would become taxable in the United States due to immigration of the grantor (i.e. donor) and beneficiaries. It is important to determine the trust's status for United States tax purposes as this will determine the person liable for tax and the calculation of the tax liability. In this respect, the trust can be classified as a business trust, investment trust, grantor trust or non-grantor trust and the tax consequences for each will differ.

3.2 DETERMINING THE TYPE OF TRUST

The tax implications for trusts in the United States generally depend on the type of trust such as whether it is a domestic trust or foreign trust, a business trust, investment trust or ordinary trust and a grantor trust or a non-grantor trust. The non-grantor trust can further be defined as a simple or a complex trust.

3.2.1 Determining domestic trust or foreign trust status

In order to determine the tax liability of a trust, it must be determined if a trust is a domestic trust or a foreign trust for United States tax purposes.

The requirements for a trust to be considered as a domestic trust can be summarised as follows:

- when a United States court can exercise primary supervision over its administration (the court test); and
- when one or more United States persons have authority to control all substantial decisions (the control test).

The court test in terms of section 301.7701-7(c) of the regulations issued by the United States Department of the Treasury (Department of the Treasury, 1999), would be satisfied if the trust is not administered outside the United States as directed by the trust instrument, the trust is administered only in the United States and there is no automatic migration provision stipulated in the trust. The control test would be satisfied if all powers to make substantial decisions lay in the hands of United States persons. These substantial decisions would not be administrative decisions such as bookkeeping, collection of rents and execution of investment decisions (Dumont, Jaffa & Raftery, 2000:150-151).

Substantial decisions could, however, be decisions such as if, when and what amount to distribute, the changing of beneficiaries and making of investment decisions. It could also include the power to terminate a trust, the power to defend or sue on behalf of a trust, the power to add, remove or replace a trustee and the power to allocate a receipt to income or principal (Dumont *et al.*, 2000:151).

Therefore, in order for a trust to qualify as a domestic trust, both the court test and the control test must be met, otherwise the trust will be a foreign trust. A trust, whose majority of trustees are in the United States, will therefore be classified as a domestic trust, irrespective of where it was formed.

For the purposes of this study and in order to make the comparison, the trust under discussion will be considered to be a foreign trust for United States tax purposes in as much as it will not satisfy the court test or the control test for domestic trust status.

3.2.2 **Determining business, investment or ordinary trust status**

The tax liability of a foreign trust can be influenced by its status as a business, investment or ordinary trust.

If a trust is classified as a business or investment trust, the question arises whether the trust remains a trust for tax purposes (Sanborn, 2004:440). Sanborn (2004:445) points out that the answer matters because if a foreign trust qualifies as a business or investment

trust with beneficiaries who have limited liabilities, the trust will fall under the foreign corporation rules for United States income tax purposes.

Three types of foreign corporations and the tax implications for foreign trusts are reviewed. These corporations are a *controlled foreign corporation*, a *foreign personal holding company* and a *passive foreign investment company* (Sanborn, 2004:445-446).

The *controlled foreign corporation* is defined by sections 957(a) and 957(c) of the Internal Revenue Code of 1986 as one or more United States shareholders (each holding a minimum of 10% directly or indirectly) holding more than 50% of either the combined voting power of all stock or the total value of all stock. If the foreign trust is therefore taxable as a corporation and the beneficiaries hold more than 50% of the voting powers or the total value of the beneficial interest, those United States beneficiaries holding at least 10% would include in their income their *pro rata* share of the income, which generally are dividends, interest, royalties, rents and annuities.

The following two tests must be met in order for the foreign trust/corporation to qualify as a *foreign personal holding company*:

- 60% or more of gross income in the applicable tax year is foreign personal holding company income as defined (reduced to 50% for any consecutive year) and 5 or less United States persons owned directly or indirectly either more than 50% of the voting rights or more than 50% of the total value of the stock/beneficiary interest. As is the case with the *controlled foreign corporation*, there is no minimum interest requirement. Sanborn (2004:445) indicates that any undistributed *foreign personal holding company* income must then be included in the income of that United States person; and
- the *passive foreign investment company* is defined by sections 1291(a)(1) and 1291(a)(2) of the Internal Revenue Code as either where 75% or more of income constitutes passive income or 50% or more of assets (by value) held, produce (or are held to produce) passive income. For periods after 31 December 1997, the foreign corporation should also not qualify as a *controlled foreign corporation* with respect to a United States person which is a United States shareholder (i.e. holds at least 10%).

Sanborn (2004:446) reports that the underlying income or gains realised by a *passive foreign investment company* is not attributed or taxed to a United States shareholder until he/she receives (or is deemed to receive) a distribution, or directly or indirectly disposed of his/her interest in the *passive foreign investment company*.

Therefore, if the trust qualifies as a business trust or investment trust under the rules of the Internal Revenue Code, it will be treated either as a *controlled foreign corporation*, *foreign personal holding company* or *passive foreign investment company* and will not be subject to the normal tax rules applicable to a foreign trust.

Hester, Pfeiffer and Henderson (2002:140) point out that under the United States tax classification scheme, determining a trust's status could be complicated. They refer to investment trusts with single classes of ownership and undivided interests in the trust assets, in which case, it would be classified as a trust if there is no power to change the investment of the certificate holders.

However, should this not be the case, this would enable the trustees or someone else to benefit from variations in the market and therefore be beneficial for the beneficiaries. In accordance with the special rules of section 301.7701-4(c) of the regulations issued by the United States Department of the Treasury, such powers would turn the entity's classification into that of a business.

Hester *et al.* (2002:140) conclude that foreign mutual funds such as unit trusts, investment trusts or other similar entities will be classified as business entities for United States withholding tax purposes because in general the trustees have the power to buy and sell investments to maximise profits.

Depending on the types of investments held by the trust and the business activities (or absence of business activities), as well as the trustees' (or someone else's) power to benefit from variations in the market, the trust could be taxed as a business and will be subject to tax on business profits and not as a foreign trust.

3.2.3 **Determining grantor trust or non-grantor trust status**

Furthermore, excluding trusts with a business purpose, ordinary trusts are either classified as a *grantor trust* or a *non-grantor trust*. A *non-grantor trust* is a trust other than a grantor trust (Hester *et al.,* 2002:142). A *grantor trust* is disregarded for most United States tax purposes and would constitute a trust that is owned by its settlor, i.e. the 'grantor' (Hester *et al.*, 2002:141).

There are five circumstances in which a trust would be considered to be a *grantor trust*, namely:

- when a United States person establishes a foreign trust, it would be considered to be a grantor trust;
- if the United States grantor retains certain powers of beneficial interest in the trust;
- if powers are granted over trust income or corpus to a beneficiary and those powers exceed those of the grantor or other beneficiaries, it will also be classified as a grantor trust;
- where a foreign person established the trust before 19 September 1995 and the foreign grantor retained for himself/herself or his/her spouse, an interest in the income or it is a revocable trust; and
- if a foreign person established the trust after 19 September 1995 and it is a revocable trust or distributions may only be made to the grantor or his/her spouse from either income or corpus (Hester *et al.*, 2002:141-142).

When a non-United States person creates a trust within five years prior to becoming a United States person, that non-United States person will also be treated as the owner of the trust. This amendment was made by section 679(a)(4) of the Internal Revenue Code in 1996. The other requirements of section 679 of the Internal Revenue Code must, however, still be met, such as that there must be a transfer of property and the foreign trust must have or could have United States beneficiaries (Williams & Layman, 2004:518).

T.D. 8890 issued by the Department of the Treasury (2000:122), further defines a *grantor* as any person that creates a trust or directly or indirectly makes a gratuitous transfer of

property (including cash) to the trust. If a person funds a trust through an amount that is directly or indirectly reimbursed within a reasonable time, that person will, however, not be treated as the owner of that trust (Department of the Treasury, 2000:122).

Whether a non-grantor trust is a *simple trust* or a *complex trust*, will further influence the United States withholding tax implications. A *simple trust* exists where it is required that all the trust income be distributed to beneficiaries, income or gains may not be accumulated or distributed for charitable purposes and no capital or accumulated income is distributed.

In contrast, a *complex trust* exists where trust income may be accumulated (i.e. distributions are discretionary and not mandatory) or income or gains may be accumulated for charitable purposes.

In the case of a grantor trust, therefore, the grantor (i.e. owner) would be taxable on the trust income, and a non-grantor trust will be taxed depending on whether it is a simple trust or a complex trust.

3.3 **DEFINING THROWBACK TAX**

Another aspect to be considered is the *throwback tax* that arises when a beneficiary of a foreign trust emigrates to the United States and receives distributions from that trust.

In order to reduce the reduction in tax in the case of United States trusts and the deferral of tax in the case of foreign trusts, by accumulating income and not distributing it, throwback tax was introduced (Jetel, 2008:53-54).

Martin and Schimmer (2006:27) explain the pitfalls of the *throwback tax* created by the Small Business Job Protection Act of 1996. They are of the opinion that the income tax consequences are considerable when accumulated income is distributed to a resident alien (or beneficiaries have the right to receive) this income. The income tax consequences are twofold in as much as the throwback tax can apply to the distribution of accumulated income and an accompanying compounded interest charge is imposed on the amount (Martin & Schimmer, 2006:28).

3.3.1 **Calculating throwback tax**

Jetel (2008:61) explains the calculation of the throwback tax and points out that beneficiaries are taxed on their distributions only to the extent of their proportionate share of the trust's *distributable net income* or *undistributable net income*.

The *distributable net income* of a non-grantor (foreign or domestic) trust is calculated as the trust's taxable income, adjusted for any personal exemptions or distributions to beneficiaries, which are not deducted and any tax-exempt income (amounts excluded from gross income) is included. The distributable net income of a foreign non-grantor trust will also include any capital gains realised, income from non-United States sources (reduced by certain tax-exempt income) and amounts excluded by treaty (Jetel, 2008:61-62).

A foreign non-grantor trust's beneficiaries must also include in their gross income any income distributed or required to be distributed from a simple trust, limited to beneficiaries' proportionate share of distributable net income, any income distributed or required to be distributed from a complex trust, limited to beneficiaries' proportionate share of distributable net income, or any other amounts actually paid, credited or required to be distributed from a complex trust, limited to beneficiaries' proportionate share of distributable net income (Jetel, 2008:62).

Jetel (2008:62) points out that those beneficiaries of a purely discretionary trust will have no inclusion in gross income until an actual distribution is made.

When a trust has undistributable net income and the distribution exceeds the distributable net income, that excess distributed from the undistributable net income is referred to as an 'accumulation distribution'. Eleven steps are proposed in order to calculate the throwback tax on that accumulation distribution and are as follows:

- "Step 1 – Determine the accumulation distribution."

  Determine the amount of distribution exceeding the trust's distributable net income.
- "Step 2 – Allocate the accumulation distribution."

Allocate excess calculated in Step 1 to all previous years where the trust had undistributable net income (start with earliest year).

- "Step 3 – Add taxes paid."

  Add to amount calculated in Step 2 the tax paid (United States income tax, foreign tax, war profits and excess profit taxes) by the trust in the years to which the excess was allocated in Step 2.

- "Step 4 – Determine the number of years of deemed distributions."

  "[D]etermine the number of preceding years in which a distribution is deemed to have been made under Step 2." If the undistributable net income deemed to be distributed is less than 25% of the total accumulation distribution (Step 1) divided by the number of preceding years determined (Step 4), that year will be excluded.

- "Step 5 – Identify the computation years."

  Eliminate the years with the highest and lowest income in the immediately preceding five years. The three remaining years will be the beneficiary's 'computation years'.

- "Step 6 – Determine the average annual distribution amount."

  Divide the deemed distribution (Steps 2 & 3) by the number of preceding years (Step 4).

- "Step 7 – Determine the tax increase in the computation years."

  Add the average annual distribution amount (Step 6) to each of the three computation years' income (Step 5) to determine what the beneficiary's taxable income would have been in each of those years. All amounts will be deemed to be ordinary income regardless of their character, such as capital gains.

- "Step 8 – Determine the average tax increase."

  Divide the sum of the three increases (Step 7) by three.

- "Step 9 – Multiply the average tax increase by the number of deemed distribution years."

  Multiply the average tax increase (Step 8) by the number of preceding taxable years of the deemed distribution (Step 4).

- "Step 10 – Determine the throwback tax."

Subtract the United States income tax added in Step 3 from the amount determined in Step 9.

- "Step 11 – Calculate interest."

  The rate applicable to underpayment of tax is equal to the federal short-term rate plus three. Interest is compounded daily over the 'dollar-weighted' number of years. Calculate the 'dollar-weighted' number of years as follows:

  - "Step 11A – Multiply the UNI [(undistributable net income)] for each year by the number of years between that year and the year of the distribution (counting that year, but not the distribution year.[sic])".
  - "Step 11B" – Add all amounts determined in Step 11A.
  - "Step 11C" – Divide amount calculated in Step 11B by the trust's aggregate undistributable net income. Round off to nearest half-year to determine number of years over which interest will be charged (Jetel, 2008:62-63).

3.4 CAPITAL GAINS TAX IMPLICATIONS IN THE UNITED STATES

The capital gains tax consequences are regulated mainly by section 684 of the Internal Revenue Code. This section contains the important exceptions to the general rule that no gain is realised on the gratuitous transfer of property (Williams & Layman, 2004:511).

The general rules of section 684 of the Internal Revenue Code as well as the influence of the change in grantor trust status will be discussed further.

3.4.1 General rules

The transfer of property by a citizen or resident of the United States to a foreign trust is treated as a taxable sale at the fair market value of the property transferred. This, however, does not apply if the foreign trust's grantor/donor is treated as the owner of the trust under the grantor trust rules (Gopman, 2002:307). Gopman (2002:307) also points out that the grantor trust status will cease on date of death of the grantor and that this will be deemed to be a transfer of assets to a foreign trust immediately before death and section 684 of Internal Revenue Code's tax liability will accrue on the deemed sale.

Generally, no gain is realised on the distribution of appreciated property from the trust. There are, however, two exceptions, namely:

- if a distribution is made of property in kind (i.e. other property, income or a fixed amount is substituted for a beneficiary's right to receive a specific distribution), a gain or loss is realised for taxable income (Williams & Layman, 2004:510); and
- the trust may elect to recognise a gain or loss as if it distributed the property or sold it to the beneficiary at market value. This election would normally be made as the United States beneficiary cannot utilise any foreign tax credit unless this election was made (Williams & Layman, 2004:512).

There are some instances where the trust must realise an inherent gain. This would include where a domestic non-grantor trust becomes a foreign non-grantor trust due for instance to the fact that it no longer has any United States trustees (Williams & Layman, 2004:512).

Another instance where a gain will be realised immediately and taxed in the current year would be where a sale was made to a foreign non-grantor trust and the payment was deferred until some later stage. Normally, when a payment is made through an annuity or instalment note, the gain is deferred (Williams & Layman, 2004:512).

3.4.2 **Change in grantor trust status**

A gain must also be realised when a grantor trust converts to a non-grantor trust and if a United States person created a trust for the benefit of United States beneficiaries and those beneficiaries cease to be United States persons (Williams & Layman, 2004:513).

Williams and Layman (2004:509) discuss in more detail the conversions from grantor to non-grantor trusts in terms of section 684 of the Internal Revenue Code and the tax implications thereof, with specific reference to the release of powers such as the power to substitute property for trust assets or adding to the class of beneficiaries, if the trust ceases to have United States beneficiaries, the grantor's death, a foreign irrevocable

insurance trust at the death of the insured and the grantor departs from the United States (Williams & Layman, 2004:513-517).

In all these instances, a change can occur in the status of the trust from a grantor trust to a non-grantor trust and *vice versa*. Williams and Layman (2004:518) express the opinion that section 684 of the Internal Revenue Code could be particularly harsh where, within five years prior to moving to the United States, a non-citizen set up a foreign trust, in which case the non-United States person will be taxed as the grantor/owner of the trust.

No gain will, however, be realised by the trust when a grantor, for example, retains the power to change the beneficiaries or revoke a trust, and in so doing does not make a complete transfer for gift tax purposes. The trust property will be included in the grantor's estate at death at the fair market value (Williams & Layman, 2004:513-514).

As discussed earlier in this chapter, when a non-United States person creates a foreign trust and becomes a United States person within five years thereof, he/she will be treated as the owner of that foreign trust. In terms of section 679(a) of the Internal Revenue Code, that person will be deemed to have made a transfer on his/her residency start date. Williams and Layman (2004:519) are of the opinion that the later termination of grantor trust status in this instance will result in the gain being subject to United States tax.

Williams and Layman (2004:519-520) also point out two instances where section 684 of the Internal Revenue Code might have an effect on pre-immigration trusts. Firstly, where a person creates a trust within five years prior to immigration, but the trust has no United States beneficiaries. Williams and Layman (2004:519) are of the opinion that the person should not be treated as having made a transfer on the residency start date, as this is not a grantor trust and that the grantor trust rules should not create a back door for the application of section 684 of the Internal Revenue Code.

Secondly, when a trust was created more than five years prior to immigration and the trust is considered a grantor trust under provisions other than section 679 of the Internal Revenue Code, Williams and Layman (2004:520) are of the opinion that since no deemed

transfer was made on the residency start date, the provisions of section 684 of the Internal Revenue Code will not apply.

3.4.3 **Strategies to avoid possible application of section 684 of the Internal Revenue Code**

Williams and Layman (2004:520-521) propose strategies in order to avoid the possible taxation on inherent gains. One option is to distribute the appreciated assets to beneficiaries (both United States and foreign beneficiaries) prior to the change in grantor trust status (Williams & Layman, 2004:520). The appreciated assets can also be sold to the grantor for cash as no gain will be realised on the cash asset in the status of the grantor trust changes (Williams & Layman, 2004:520).

Other options, specifically prior to immigration, include distributing the trust assets or realising the inherent gain (Williams & Layman, 2004:521).

3.5 **WITHHOLDING TAX**

The Internal Revenue Code imposes an obligation to withhold tax on United States taxable income paid to foreign persons (including foreign trusts). The person responsible to withhold the tax is referred to as the withholding agent. If the withholding agent fails to withhold the tax, penalties will be imposed (Pharies & Glasser, 2011:175).

The Internal Revenue Service of the United States issued regulations in 1997 in an attempt to ease administrative burdens of withholding agents (Hester *et al.*, 2002:143). These regulations determine that the withholding rules should be applied to the residence status of the trust rather than that of the fiduciary (Hester *et al.*, 2002:144). The regulations also provide rules on how to determine the beneficial owners of the trust.

Who the beneficial owners are would depend on whether the trust is a complex trust or a simple trust as discussed in chapter 3.2. In the case of a complex trust, the foreign complex trust will be treated as the beneficial owner. In contrast, in the case of a simple

trust, the trust's beneficiaries will be treated as the beneficial owners (Hester *et al*., 2002:145).

If the trust is a grantor trust, the trust's owners will be treated as the beneficial owners and if the trust status cannot be determined, it will be treated as a complex trust (Hester *et al*., 2002:145).

The taxable income includes mainly all types of incomes, such as interest, royalties, dividends, rents and wages (Pharies & Glasser, 2011:175).

The amount that should be withheld differs depending on the type of income and would generally be as follows (Pharies & Glasser, 2011:175):

- 10% on the amount realised on the sale of United States real property;
- 33% on United States business or trade taxable income; and
- 30% on income other than United States business or trade taxable income.

3.6 **SUMMARY**

The South African trust as a foreign trust's liability for tax in the United States depends mainly on its status for United States tax purposes. If the court test and control test can be fulfilled, the trust will be classified as a domestic trust in the United States, otherwise it will be classified as a foreign trust.

Furthermore, if the trust has a business purpose, or the trustees have the power to vary the investment of the beneficiaries, the trust will be taxed based on the corporate rules in the United States.

If the trust is not a business trust or investment trust, it will be classified as an ordinary trust. The ordinary trust's liability for tax will further depend on whether it will be classified as a grantor trust, in which case the grantor will be treated as the owner of the trust, or else as a non-grantor trust. The ordinary trust may deduct distributions made in order to determine its tax liability.

Lastly, in the case of a simple non-grantor trust, where no income may be accumulated or distributed for charitable purposes, the beneficiaries will be liable for the tax on the income and gains of the trust. In the case of the complex non-grantor trust, where income may be accumulated (i.e. distributions are discretionary) or distributed for charitable purposes, the trust will be liable for tax on the income and gains.

McNamara (2006:345-348) summarises the main tax accounting issues as follows:

- any trust that does not meet the court or control test to determine United States domestic trust status would constitute a foreign trust;
- deferral or avoidance of United States income tax can be obtained by foreign trusts created by non-resident aliens or United States persons no longer living in the United States; and
- the throwback rule would be applied to undistributed foreign trust income, including capital gains.

CHAPTER 4

DOUBLE TAX RELIEF AND DOUBLE TAX TREATIES

4.1 INTRODUCTION

In South Africa, section 108 of the Income Tax Act makes provision for the government to enter into an agreement with the government of any other country to make arrangements for the prevention, mitigation or discontinuance of taxation imposed on the same income by both countries.

Such an agreement was entered into by South Africa and the United States in 1997 (Department of State, 1997).

4.2 DOUBLE TAX TREATIES

The convention between the Republic of South Africa and the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains (hereafter referred as the double tax agreement), concludes the following:

- The term *person* includes an individual, an estate, a trust, a partnership, a company and any other body of persons (article 1(c) of the double tax agreement).
- A resident of a contracting state means (article 4 of the double tax agreement):
  - in the case of the United States,
    - a person who is liable for tax in the United States due to it being his/her domicile, residence, citizenship, place of incorporation or any similar criteria and excludes persons only liable for tax due to the fact that the source of the income is that of the United States; and
    - a legal person organised under the laws of the United States and which is generally exempt from tax because it is either used for religious,

charitable, educational or similar purposes or provide pensions or other similar benefits to employees; and

- in the case of South Africa, any individual who is ordinarily resident in South Africa and any legal person incorporated or has its place of effective management in South Africa.

In the United States, an aspect that needs to be dealt with in order to determine if the trust will be eligible for tax treaty benefits is the fiscal transparency of the trust. This means that the trust is not taxed, but the beneficiaries or the settlor is taxed. If the trust is treated as a fiscally transparent entity, it will not be liable for tax in the United States and cannot therefore be considered a resident of the United States and therefore will not be eligible for treaty benefits in the United States. The trust may, however, be partially fiscally transparent and will then be treated as a resident for treaty benefit purposes (Honiball & Olivier, 2009:286).

- Income from immovable property (real property) (article 6 of the double tax agreement):

  The contracting state, in which the real property is situated, will have the prior right to tax the income from the use or letting of that real property.
  As the term *may be taxed* is used, this does not preclude the contracting state of the resident to also tax the income.
  The term *real property* will be defined by the laws of the contracting state in which the real property is situated.
  The resident may elect to be taxed on a net basis as if the income were business profits.

- Business profits (article 7 of the double tax agreement):

  Profits are taxed in the source state unless they are derived from a permanent establishment. Only the contracting state in which a permanent establishment is situated, may tax the profits derived from that permanent establishment.

- Dividends (article 10 of the double tax agreement):

  The residence state has the right to tax the dividends.
  The source state also has the right to tax the dividends, but the tax is limited to:

  - 5% of the gross amount where direct shareholding is at least 10%; and

- 15% of the gross amount in all other cases.

The term dividends means "...income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payer is a resident" (article 10(3) of the double tax agreement) (Department of State, 1997:10).

If the dividends are derived from a business which is a permanent establishment, the rules of article 7 will apply.

- Interest (article 11 of the double tax agreement):

The residence state has the only right to tax the interest.
The term *interest* means income from debt claims of every kind.

If the interest is derived from a business which is a permanent establishment, the rules of article 7 will apply.

- Royalties (article 12 of the double tax agreement):

The residence state has the right to tax the interest.

The term *royalties* includes:

- payments for the use of or right to use any copyright, patent, trademark, design or model, plan, secret formula or process; and
- gains from the alienation of property mentioned above.

If the royalties are derived from a business which is a permanent establishment, the rules of article 7 will apply.

- Gains (article 13 of the double tax agreement):

The contracting state in which the real property is situated, will have the prior right to tax the gain from the alienation of that real property.

Gains from the alienation of movable property of a permanent establishment may be taxed in the state in which the permanent establishment is situated.
Gains on all other properties (other than mentioned above and ships, aircraft or containers) are taxed in the residence state.

- Other income (article 21 of the double tax agreement):

All other income not specifically dealt with in the double tax agreement is only taxable in the residence state.

- Relief from double taxation (article 23 of the double tax agreement):

  United States residents and citizens are entitled to a credit against their United States tax (subject to limitations of United States law) as follows:

  - income tax paid or accrued to such resident or citizen; and
  - where dividends are received, with regard to a United States company (with at least 10% voting rights), the income tax paid or accrued to the profits out of which the dividends are paid (Department of State, 1997).

A resident of the treaty state will therefore be eligible for certain treaty benefits in the state in which he/she is a resident.

4.3 FOREIGN TAX CREDIT FOR INDIVIDUALS IN THE UNITED STATES

In accordance with Publication 514 of the Department of the Treasury (2010b:2), a person has the choice between a foreign tax credit or an itemised deduction in relation to any qualifying foreign taxes that have accrued or were paid during the year. This choice can be changed from year to year.

It is suggested that it is generally better to take a credit rather than the deduction, because (Department of the Treasury, 2010b:3):

- the deduction will only reduce the taxable income, whereas the credit will reduce the United States income tax on a dollar-for-dollar basis;
- if one does not itemise one's deductions, one can still choose the credit; and
- one may be able to carry over any excess credit not claimed in the current year.

Beneficiaries may be able to claim the credit based on their proportionate share of the foreign tax paid by the foreign trust (Department of the Treasury, 2010b:6).

Losses (United States and foreign) must be allocated on a proportionate basis among incomes (Department of the Treasury, 2010b:19).

4.4 FOREIGN TAX CREDITS AND DEDUCTIONS IN SOUTH AFRICA

In South Africa, a resident may be eligible for certain foreign tax credits in terms of domestic law. A rebate in terms of section 6*quat* of the Income Tax Act can be claimed where the following income was included in taxable income:

- income received or accrued from any source outside the Republic (section 6*quat*(a) of the Income Tax Act);
- any proportional amount contemplated in section 9D (section 6*quat*(b) of the Income Tax Act);
- any foreign dividend (section 6*quat*(d) of the Income Tax Act); and
- any taxable capital gain from a source outside the Republic (section 6*quat*(e) of the Income Tax Act).

The rebate in terms of section 6*quat* of the Income Tax Act is a rebate against taxation and not income and is calculated as follows:

the sum of all foreign taxes paid or payable, limited to the same ratio as total normal tax attributable to total normal taxable income, i.e.

$$\frac{\text{Taxable foreign income}}{\text{Taxable income}} \times \text{Normal tax payable}$$

4.5 AVOIDING OR MINIMISING THE TAX IMPACT IN THE UNITED STATES

Ways to avoid or minimise the tax impact in the United States are discussed. These include avoiding or minimising the withholding tax on accumulated income, avoiding or minimising the tax on non-grantor trust distributions and avoiding or delaying undistributable net income distributions.

4.5.1 Withholding tax on accumulated income

Due to the withholding tax and interest charge on accumulated income, two plans are suggested to resolve this tainted income (i.e. accumulated income):

- cleansing distributions, where at least the current year's income and all accumulated income are distributed to non-United States taxpaying beneficiaries and the remaining trust funds distributed to United States beneficiaries in the following year; or
- larger future income stream, where income is accrued for several years to increase the asset base and thereafter only current income is distributed (Vetter, 2003:70-72).

4.5.2 **Non-grantor trust distributions**

According to Popovich (2009:30-34), in planning for the tax consequences of a foreign non-grantor trust that accumulated income for a number of years, the following methods to minimise the additional tax (throwback tax) and interest charge may be considered:

- 'domesticate' the trust by making changes to the trust, such as substituting a foreign trustee for a United States trustee, so that the trust will meet the criteria of both the court test and the control test, the trust status will change from a foreign trust to a domestic trust. The trust will then not be subject to the throwback tax on future accumulation income. The throwback tax will, however, still be applicable to the existing accumulated income;
- 'manage' current distributions by only making distributions less than or equal to the trust's accounting income for the year. Remember, however, that capital gains may still create undistributable net income, which is subject to the throwback tax and interest charge (Popovich, 2009:31). This is because capital gains are included in distributable net income but not in accounting income;
- making specific distributions meeting the following three criteria in order for a distribution not to carry out distributable net income:
  - it must be a distribution of a specific property or a specific amount;
  - the amount must actually be paid or credited in three or less instalments; and
  - a clause providing for specific distributions must be included in the terms of the governing instrument;
- making a distribution of the distributable net income and the undistributable net income to United States charities in a particular year. In following years, any

distributions exceeding distributable net income will not be treated as an accumulation distribution;

- making distributions at least equal to the undistributable net income to only non-United States beneficiaries in a specific year. Any distributions to United States beneficiaries in the following year will not be treated as an accumulation distribution. Note, however, that if the non-United States beneficiary transfers the distribution to the United States beneficiary, it will be treated as a deemed distribution;
- distributions after termination of the beneficiary's United States residency status;
- the distributable net income of highly appreciated assets is calculated as the lesser of the fair market value or the basis of the assets, unless otherwise elected. The benefit of distributing assets with a much greater value is that the tax on the sale of the asset is deferred until the asset is sold by the beneficiary;
- purchase of use property because previously, the use of trust property by a beneficiary did not result in a distribution.

  This has, however, been changed by the Hiring Incentives to Restore Employment Act of 2010 (McNamara, 2010:771). This Act stipulates that the use of trust property which is not properly compensated for will result in a taxable distribution. The taxable distribution is calculated as the fair market value of the use of the property;
- loans at a lower 'cost' than would otherwise be available to the beneficiary. The loan must be a written agreement with an interest rate between 100% and 130% of the federal interest rate, should not exceed five years and must be payable in US dollars;
- use flexible termination provisions as the termination of the trust by, for example, a stipulation that at the death of the grantor all trust property must be distributed would result in an accumulation distribution. This could be avoided by providing for the termination over a few years. The trustees could then make distributions of the undistributable net income over a few years and then distribute the rest of the assets in the final year provided.

4.5.3 Avoiding undistributable net income distributions

Jetel (2008:55-56) proposes three primary ways to minimise the accumulation of undistributable net income in the trust:

- by investing trust assets in tax-exempt bonds, the tax-exempt income does not generate distributable net income and will therefore not accumulate as undistributable net income. However, bonds do not always provide desired returns on investments;
- by adopting a buy-and-hold investment strategy, the capital gains will only be included in distributable net income when they are realised. A buy-and-hold strategy will not always provide desired returns on investment. Furthermore, capital gains not distributed, will lose their favourable lower tax rates under the throwback tax rules; and
- when investing trust assets in private placement life insurance, the following are not considered taxable income and therefore not distributable net income:
  - income and investment returns within the policy;
  - death benefit proceeds;
  - withdrawals of premium up to basis; and
  - policy loans.

4.5.4 Delaying undistributable net income distributions

Ways in which to delay the distribution of undistributable net income are:

- lending money against a life insurance policy structured as a non-modified endowment contract in which trust assets were invested and relending the money to the beneficiaries under promissory notes that meet the United States qualified obligation rules;
- distributable net income will only be generated when withdrawals are made from a modified endowment contract in which trust assets were invested as a life insurance policy. Withdrawals can then only be made when needed;

- the trust's distribution scheme should be structured so that the distributions fall within the exceptions of the Internal Revenue Code (Jetel, 2008:56).

4.6 SUMMARY

The treaty relief available under the double tax agreement between South Africa and the United States is only available for the resident in his/her country of residence. Under this treaty, the country that has the right or prior right to tax income is regulated. The residence state has the only right to tax interest, gains other than from the disposal of immovable property and movable property of a permanent establishment and other income not specifically mentioned in the treaty.

In the case of business profits, only the source state has the right to tax income and in the case of royalties, only the residence state has the right to tax the income, unless in both instances, the income is derived from a permanent establishment, then only the country in which the permanent establishment is situated, will have the right to tax the income.

In the following instances, one country has the prior right to tax the income, but this does not exclude the other country from taxing the income or gains. In the case of income from immovable property and gains from the disposal of immovable property, the country where the real property is situated, will have the prior right to tax the income and gains. In the case of dividends, the residence state has the prior right to tax the income, but the source state may also tax the income subject to limitations. Lastly, gains from the disposal of movable property forming a permanent establishment are taxable in the country where the permanent establishment is situated, but this does not preclude the other country to also tax the income.

In South Africa, a South African resident will also receive a rebate for foreign tax paid on foreign source income in terms of section 6*quat* of the Income Tax Act. Furthermore, in South Africa, some income is also exempt from normal tax, such as interest in terms of section 10(1)(i)(xv) of the Income Tax Act available to natural persons only, interest in terms of section 10(1)(h) of the Income Tax Act available to natural and legal persons who are non-residents, South African dividends in terms of section 10(1)(k) of the Income Tax

Act and royalty income on which withholding tax was payable in terms of section 35 of the Income Tax Act.

In South Africa 12% withholding tax is payable on royalty payments to non-residents in terms of section 35 of the Income Tax Act and where a non-resident sells immovable property in South Africa it will either be 5% (for natural persons), 7,5% (for companies) or 10% (for trusts) in terms of section 35A of the Income Tax Act. In contrast to this, in the United States, withholding tax will generally be 30% on all payments to non-residents, unless income consists of United States trade or business income.

In the United States, a United States resident will receive treaty benefits if he/she is the beneficial owner of the income or gains and if he/she is fiscally transparent in his/her owner's jurisdiction. Furthermore, a United States resident will be eligible for a foreign tax credit or deduction on qualifying foreign taxes.

Due to the extensive and complicated tax consequences for a foreign trust in the United States, the uses and benefits of the foreign trust will be explored in the following chapter.

CHAPTER 5

CONTINUING USES AND BENEFITS OF FOREIGN TRUSTS IN THE UNITED STATES

5.1 INTRODUCTION

The tax consequences for the trust in the United States could be quite far-reaching and rather more complicated than the tax consequences of the same trust in South Africa. In this chapter, the continuing uses and benefits of the foreign trust in the United States are discussed and practical examples are given in order to understand that the South African trust as a foreign trust in the United States still has its place.

Vetter (2003:68-72) poses the question whether or not to keep trusts offshore. An offshore trust in this instance refers to a foreign trust for United States income tax purposes that would not be able to claim income tax treaty benefits (generally because it is based in a tax haven). He states that the financial requirements of the beneficiaries and their tax residences along with the trust's lifespan and investment policies are the deciding factors for whether or not to keep the trust offshore. It is pointed out that because the offshore trust falls outside the United States tax net, the beneficiaries are the ones liable for tax to the extent that they receive distributions from a non-grantor trust. He further cautions that should a trust become a United States person and thereafter be moved back offshore, an exit tax will be due on any untaxed appreciation of assets under section 684 the Internal Revenue Code (Vetter, 2003:68-72).

5.2 CONTINUING USES

Bruce, Solomon and Saret (2004:13-17) explore the continuing uses of foreign trusts. They list the following examples of foreign trusts that still serve a purpose:

- created to own a foreign financial account (i.e. bank account) in order to simplify the use of foreign currency;
- created to establish a relationship with a private banker or investment advisor not situated in the United States;

- created by a United States settlor to benefit only non-United States persons, such as relatives or friends not living in the United States If they are not United States taxpayers, the trust is not subject to grantor trust rules (section 679 of the Internal Revenue Code);
- created for the protection of assets. For tax purposes, the grantor will be considered to own all the trust's assets, but for non-tax purposes such as creditors' rights and bankruptcy, the grantor will be not be considered to own these assets;
- created to provide for deferred compensation, retirement benefits and similar compensation, for example, for employees of subsidiaries in other jurisdictions;
- created to move ownership quickly, for example, it could be difficult to move the place of incorporation of a company, but if the shares are owned by a trust, the trust is generally moved more quickly. This would also serve as a means to guard against expropriation;
- created as a means to allocate ownership to one person and the taxable income or losses to another;
- created as foreign grantor trusts under section 672(F)(2) of the Internal Revenue Code by a non-United States person who is not subject to a high level of tax in his/her 'home' country;
- created as a means of creating or operating an international charitable foundation;
- created to operate as a specific purpose vehicle, for example, if there is a need for an entity to operate with more flexibility and which is subject to fiduciary rules;
- created by a non-United States resident before immigrating to the United States;
- created to avoid potential United States exchange control laws;
- created to make completed gifts for transfer tax purposes.

5.3 BENEFITS OF FOREIGN GRANTOR TRUST COMPARED WITH BENEFITS OF DOMESTIC GRANTOR TRUST

The benefits of the foreign grantor trust as a superior wealth preservation planning vehicle preferred to the benefits of the domestic grantor trust are illustrated in Table 5.1 (Gopman, 2002:308).

Table 5.1: Example: Benefits of foreign grantor trust compared with benefits of domestic grantor trust

Example	Wealth transfer results: Foreign trust	Wealth transfer results: Domestic trust
George, a United States citizen and a resident of Florida, establishes a foreign trust in foreign country X for the benefit of his descendants. All of George's descendants live in the United States. George makes a taxable gift to the trust of stock in XYZ Corporation, a publicly traded domestic biotech company in which George is a founding shareholder. The value of this gift for gift tax purposes is $100 000. Prior to making this gift George did not make any other taxable gifts, therefore, no gift tax liability would result from this gift. For income tax purposes, George has no basis in his shares in this company, therefore the shares that he gives to his foreign trust also have no basis. Assume that George dies a resident of the state of Florida five years after his gift to the trust. At the time of George's death, the trust owns all of the original shares that George gave to it and the stock has increased in value to $1 000 000. Assume that George's estate is valued at $10 000 000 for federal estate tax purposes and he is not survived by a spouse.	• $1 000 000 of zero basis stock is owned by foreign grantor trust. • $1 000 000 of XYZ Corporation stock is sold by the trust immediately following George's death and the trust is repatriated to the United States. • The trust retains the full $1 000 000 of proceeds from the sale of the low basis stock undiminished by income tax. • Under section 2053 of the Internal Revenue Code George's estate is permitted to deduct the $200 000 of income tax incurred because of the deemed disposition of the trust assets under section 684 of the Internal Revenue Code. • Assuming George's estate is subject to a marginal estate tax rate of 50%, his estate tax will be calculated as follows: $10 000 000 - $200 000 = $9 800 000. $9 800 000 x 50% = $4 900 000. • The net amount of wealth available to the children: $4 900 000 (net distributable estate) + $1 000 000 (foreign grantor trust) = $5 900 000.	• $1 000 000 of zero basis stock is owned by a domestic grantor trust. • $1 000 000 of stock is sold by the trust immediately following George's death. • The trust retains the full $1 000 000 of proceeds from the sale of the low basis stock less the $200 000 income tax liability for a total of $800 000 of proceeds for the beneficiaries. • If the trust had sold the low basis stock immediately prior to George's death, George would have been legally obliged to pay the income tax liability resulting from the sale. • Assuming George's estate is subject to a marginal estate tax rate of 50%, his estate tax will be calculated as follows: $10 000 000 x 50% = $5 000 000. • The net amount of wealth available to the children: $5 000 000 (net distributable estate) + $800 000 (grantor trust) = $5 800 000. Therefore, using a foreign grantor trust instead of a domestic grantor trust produces a net benefit of $100 000 to George's children.

Source: Gopman (2002:308)

Table 5.1 illustrates that due to the deemed disposition rules of section 684 of the Internal Revenue Code applicable to the foreign trust and the resulting deduction allowed for the income tax payable, the net wealth distributed to the beneficiaries of the foreign trust, exceeds that of the domestic trust.

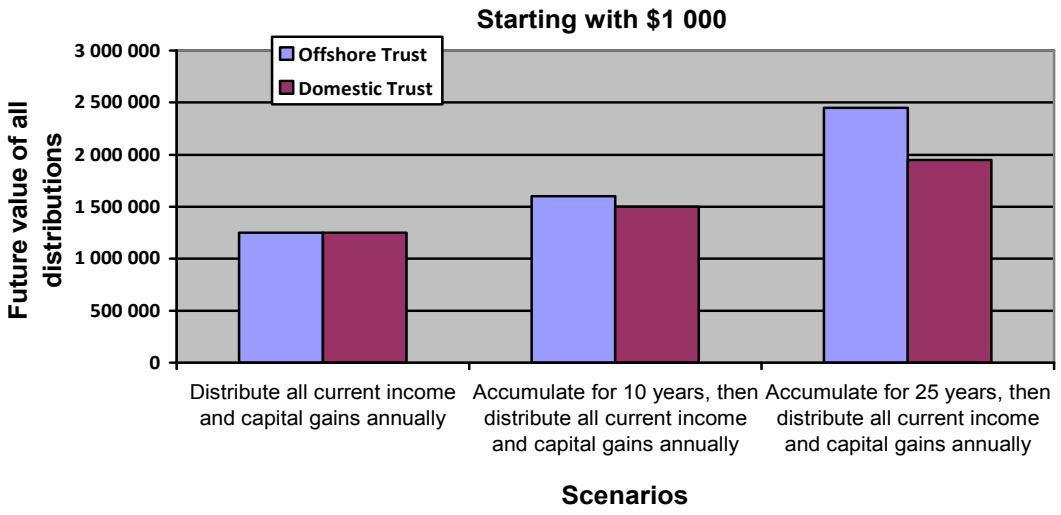
5.4 OFFSHORE TRUST VERSUS DOMESTIC TRUST

Vetter (2003:72) also illustrates the benefits of building an asset base over the long term in an offshore trust instead of in a domestic trust at the hand of the graph shown in Figure 5.1.

Figure 5.1: Offshore trust versus domestic trust

OFFSHORE VS. DOMESTIC

Building assets offshore today produce the largest future income stream



This chart assumes:

- a 100-year trust term;
- no historic gains in the trust;
- 8% interest charge on tax from accumulation distributions;
- 15% tax rate on dividends and capital gains; 35% rate on ordinary income;
- 10% trust investment return (4% current yield, 6% capital growth); 50% turnover rate; 7% after-tax investment return outside the trust;
- current yield is not subject to withholding during accumulation period on offshore scenario;
- current yield is taxed at a 15% rate in domestic scenario, and when distributed currently in offshore scenario.

The chart also includes amounts, if any, distributed at termination.

Source: Vetter (2003:72).

Figure 5.1 illustrates that due to the taxation of the current yield in the domestic trust, whether or not distributed, the growth in the domestic trust is less than in the offshore trust where the yield is not taxed when accumulated (i.e. not distributed currently).

5.5 SUMMARY

Even though the tax consequences in the United States can be far-reaching for a foreign trust, there are some circumstances when having a foreign trust might have tax benefits exceeding those of a domestic trust. For example, the deduction of the tax liability on the deemed disposition of the foreign trust asset in terms of section 684 of the Internal Revenue Code, or the building of an offshore asset base where the current yield is not taxed on the accumulation. The foreign trust may also have other non-tax and economic benefits that serve a purpose exceeding that of paying less tax.

CHAPTER 6

COMPARISON BETWEEN SOUTH AFRICA AND THE UNITED STATES

6.1 INTRODUCTION

The South African normal tax implications and the United States normal tax implications of the South African trust were discussed and will now be compared. The regulation of double taxation that might arise between South Africa and the United States was also investigated, as well as any relief that might be available to residents of each country.

6.2 COMPARISON

The comparisons are shown in more detail in the following tables and figures of comparison.

Tables 6.1 to 6.5 and Figures 6.1 to 6.2 were drawn to make the comparisons based on the general rules in determining the tax liability of all parties to the South African trust both in South Africa and the United States.

Tables 6.1 to 6.3 are a summary of the South African perspective and Figures 6.1 and 6.2 and Tables 6.4 and 6.5 are a summary of the United States perspective.

Determining the tax liability of persons in South Africa would mainly depend on whether or not a donation as defined was made. The main steps to determine who will be liable for tax on the income of a South African trust, is listed in Table 6.1.

Table 6.1: Determining who will be taxed in South Africa on the South African trust's income and distributions in terms of the Income Tax Act

Criteria	If yes, who will be tax liable?	If no, who will be tax liable?
Is the trust formed in South Africa?	YES:	NO:
	Trust is a resident. Trust will be taxed on worldwide income.	Trust is not a resident. Trust will be taxed on South African source and deemed source income.
Did a person make a donation, settlement or other disposition to the trust?	YES:	NO:
	Section 7 must be considered. Donor will be taxed under certain circumstances.	Sections 7(1) and 25B must be considered. Beneficiary or trust will be liable for tax.
Does a beneficiary have a vested right to income?	YES:	NO:
	Beneficiary will be taxed (section 7(1)).	Subject to sections 7(2) – (8), the trust will be taxed.
Was a donation made and:	YES:	NO:
• the recipient is the spouse of the donor?	Donor will be taxed (section 7(2)).	Beneficiary (section 25B) or trust will be taxed.
• the recipient is the minor child of the donor?	Donor will be taxed (sections 7(3) and (4)).	Beneficiary (section 25B) or trust will be taxed.
• is the donation subject to a stipulation?	Donor will be taxed (section 7(5)).	Beneficiary (section 25B) or trust will be taxed.
• the donor retained the right to revoke or confer the right to receive income?	Donor will be taxed (section 7(6)).	Beneficiary (section 25B) or trust will be taxed.
• the donor ceded the income but retained ownership of the asset?	Donor will be taxed (section 7(7)).	Beneficiary (section 25B) or trust will be taxed.
• income accrued to a non-resident beneficiary?	Resident donor will be taxed (section 7(8)).	

Table 6.1 illustrates that the main questions to be answered in determining the South African tax liability for the South African trust's income, are residence status of the trust, donor and beneficiaries, whether the beneficiary has a vested right in income or assets and whether or not a donation was made.

Table 6.2 gives a summary of whether or not a South African or United States resident will be liable for tax in South Africa on the South African source or deemed source income of the South African trust. A summary is also given on the South African tax relief and double tax treaty relief available to the South African resident on specific classes of income.

Table 6.2: Determining who will be taxed in South Africa on the South African trust's income and distributions from South African sources and deemed sources

Person liable for tax:	**Donor (*)**		**Beneficiary (#)**		**Trust (@)**	**South African tax relief**		**Double tax agreement**
Residency status:	**SA resident**	**US resident**	**SA resident**	**US resident**	**SA resident**	**SA resident**	**US resident**	**SA resident**
Distribution from:								
Interest	YES	YES	YES	YES	YES	Exemption section 10(1)(i)(xv) (natural persons only)	Exemption section 10(1)(h)	Only residence state has right to tax
Business profits	YES	YES	YES	YES	YES			Taxed in source state only, unless permanent establish-ment, then only where permanent establish-ment is situated, will have right to tax
Income from immovable property	YES	YES	YES	YES	YES			State where real property is situated will have prior right to tax
Dividends	YES	YES	YES	YES	YES	Exemption section 10(1)(k) on South African dividends	Exemption section 10(1)(k) on South African dividends	Residence state has right to tax, but source state may tax (limitations)
Royalties	YES	YES	YES	YES	YES		Exemption section 10(1)(l) if withholding tax paid in terms of section 35	Residence state has only right to tax, unless permanent establish-ment, then only state where permanent establish-ment is situated, will have right to tax
Gains from disposal of:								
• Immova-ble property	YES	YES	YES	YES	YES			State where real property is situated will have prior right to tax
• Movable	YES	YES, if	YES	YES, if	YES	Deemed		State where

Person liable for tax:	Donor (*)		Beneficiary (#)		Trust (@)	South African tax relief		Double tax agreement
Residency status:	**SA resident**	**US resident**	**SA resident**	**US resident**	**SA resident**	**SA resident**	**US resident**	**SA resident**
Distribution from:								
property from a permanent establishment in South Africa		80% or more of market value of entity is attributable to immovable property		80% or more of market value of entity is attributable to immovable property		South African source, therefore no section 6*quat* rebate on foreign taxes paid		permanent establishment is situated has prior right to tax
• Other gains	YES	YES, if 80% or more of market value of trust is attributable to immovable property	YES	YES, if 80% or more of market value of trust is attributable to immovable property	YES			Taxed in residence state only
Other income	YES	YES	YES	YES	YES			Taxed in residence state only

* Applies to all circumstances where donor will be taxed in terms of section 7 of the Income Tax Act.
\# Applies where a minor child is a South African or United States resident and no donations were made and also where a major child is a United States resident and no donations were made.
@ Applies to all income and gains not distributed and to which no beneficiaries have a vested right.

Table 6.2 illustrates that both South African residents and non-residents will be liable for tax in South Africa on all South African source income. The Income Tax Act provides for certain exemptions on tax relating to specific income depending on the residence status of the person and whether or not the person is a natural or legal person. It further indicates where income of the South African resident will be taxed in accordance with the double tax treaty.

Table 6.3 gives a summary of whether or not a South African or United States resident will be liable for tax in South Africa on the United States source or deemed source income of the South African trust. A summary is also given on the South African tax relief and double tax treaty relief available to the South African resident on specific classes of income.

Table 6.3: Determining who will be taxed in South Africa on the South African trust's income and distributions from United States sources and deemed sources

Person liable for tax:	**Donor (*)**		**Beneficiary (#)**		**Trust (@)**	**South African tax relief**		**Double tax agreement**
Residency status:	**SA resident**	**US resident**	**SA resident**	**US resident**	**SA resident**	**SA resident**	**US resident**	**SA resident**
Distribution from:								
Interest	YES	NO	YES	NO	YES	Exemption section 10(1)(i)(xv) on foreign interest and dividends (R3,700 in 2012) (natural persons only). Section 6*quat* rebate on foreign taxes paid		Only residence state has right to tax
Business profits	YES	NO	YES	NO	YES	Section 6*quat* rebate on foreign taxes paid		Taxed in source state only, unless permanent establish-ment, then only where permanent establish-ment is situated, will have right to tax
Income from immovable property	YES	NO	YES	NO	YES	Section 6*quat* rebate on foreign taxes paid		State where real property is situated will have prior right to tax
Dividends	YES	NO	YES	NO	YES	Exemption section 10(1)(i)(xv) on foreign interest and dividends (R3,700 in 2012) (natural persons only). Section 6*quat* rebate on foreign taxes paid		Residence state has right to tax, but source state may tax (limitations)
Royalties	YES	NO	YES	NO	YES	Section 6*quat* rebate on foreign		Residence state has only right to tax, unless

Person liable for tax:	**Donor (*)**		**Beneficiary (#)**		**Trust (@)**	**South African tax relief**		**Double tax agreement**
Residency status:	**SA resident**	**US resident**	**SA resident**	**US resident**	**SA resident**	**SA resident**	**US resident**	**SA resident**
Distribution from:								
						taxes paid		permanent establish-ment, then only state where permanent establish-ment is situated, will have right to tax
Gains from disposal of:								
• Immova-ble property	YES	NO	YES	NO	YES	Section 6*quat* rebate on foreign taxes paid		State where real property is situated will have prior right to tax.
• Movable property from a perma-nent establish-ment in the United States	YES	NO	YES	NO	YES	Section 6*quat* rebate on foreign taxes paid		State where permanent establish-ment is situated has prior right to tax
• Other gains	YES	NO	YES	NO	YES	Section 6*quat* rebate on foreign taxes paid		Taxed in residence state only
Other income	YES	NO	YES	NO	YES	Section 6*quat* rebate on foreign taxes paid		Taxed in residence state only

* Applies to all circumstances where donor will be taxed in terms of section 7 of the Income Tax Act.
\# Applies where a minor child is a South African or United States resident and no donations were made and also where a major child is a United States resident and no donations were made.
@ Applies to all income and gains not distributed and to which no beneficiaries has a vested right.

Table 6.3 illustrates that only foreign source income of the South African resident will be taxable in South Africa. It indicates the exemptions from normal tax, as well as where the income of the South African resident will be taxed in accordance with the double tax treaty.

Determining the tax liability of the South African trust in the United States would mainly depend on the classification of the trust for United States tax purposes. The trust would mainly be classified as a business, investment or ordinary trust and would further be

classified as a grantor or non-grantor trust. The main steps to determine the classification of the South African trust, is listed in Figures 6.1 and 6.2.

Figure 6.1: Determining whether the foreign trust will be an investment trust, business trust or ordinary trust

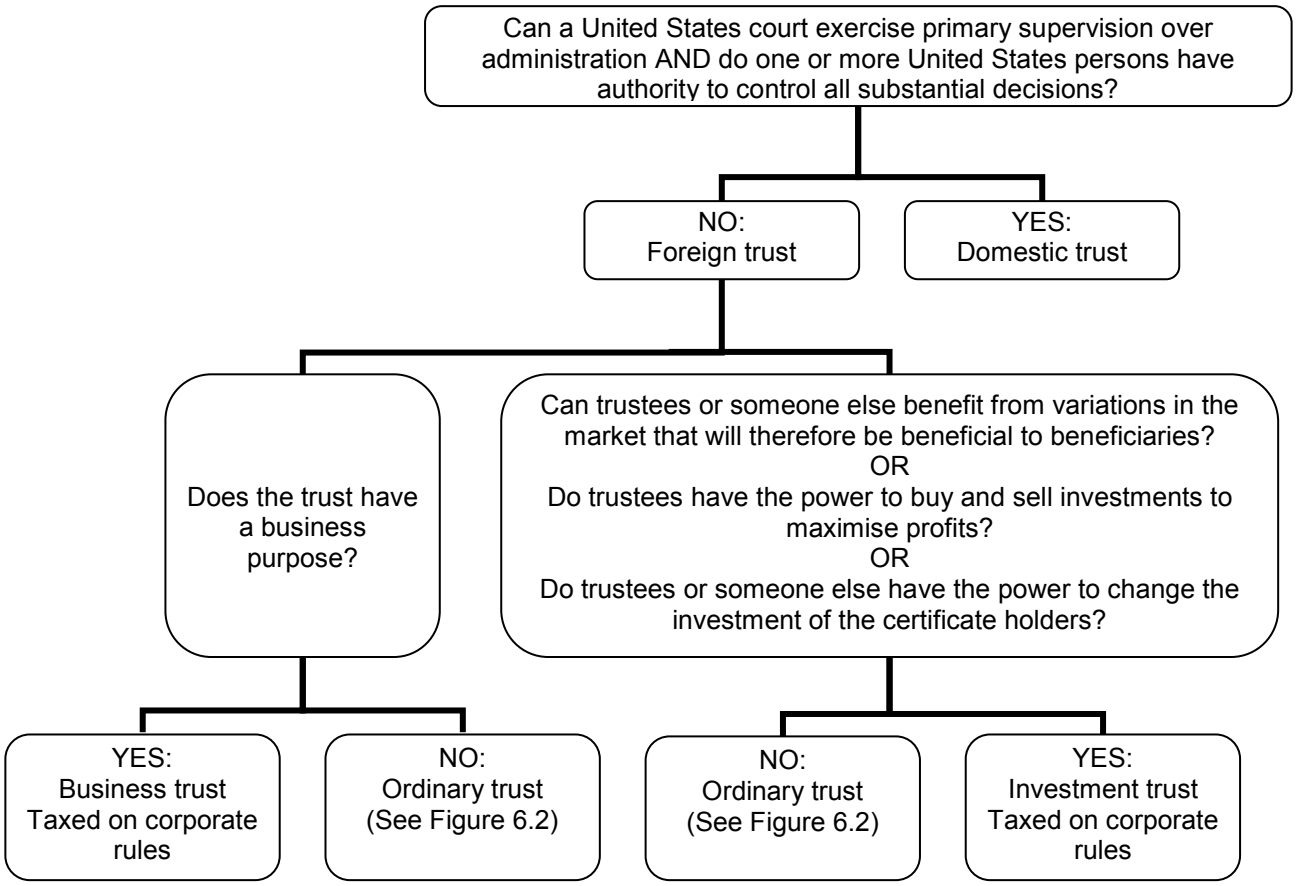


Figure 6.2 illustrates the main questions to be answered in order to determine foreign or domestic trust status and further business, investment or ordinary trust status.

Figure 6.2: Determining whether the ordinary trust will be a grantor trust, simple non-grantor trust or a complex non-grantor trust

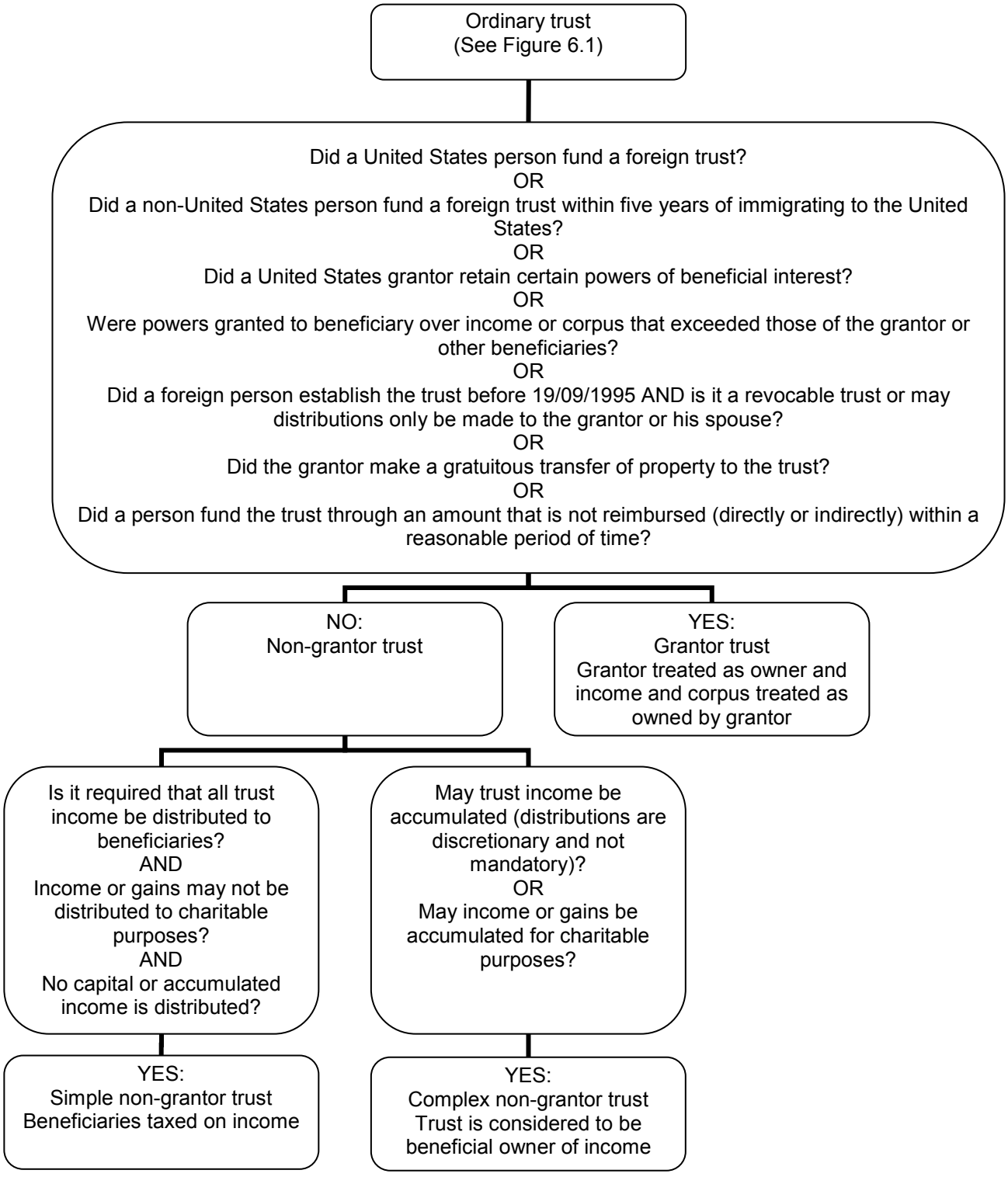


Figure 6.2 illustrates the main questions to be answered in order to determine the grantor or non-grantor trust status of the ordinary trust in the United States.

Table 6.4 summarises who will be liable for tax on the different classes of income of the South African trust in the United States, depending on the trust's status.

Table 6.4: Determining who will be taxed in the United States depending on the trust's status

Foreign trust status:	Business and investment trust	Grantor trust	Simple non-grantor trust	Complex non-grantor trust
Trust income:				
Interest	Trust taxed on corporate rules (#)	Grantor taxed as if owner	Trust beneficiaries taxed on all trust income	Trust taxed on income less distribution to beneficiaries
Business profit	Trust taxed on corporate rules (#)	Grantor taxed as if owner	Trust with business purpose will be taxed on corporate rules	
Income from immovable property	Trust taxed on corporate rules (#)	Grantor taxed as if owner	Trust beneficiaries taxed on all trust income	Trust taxed on income less distribution to beneficiaries
Dividends	Trust taxed on corporate rules (#)	Grantor taxed as if owner	Trust beneficiaries taxed on all trust income	Trust taxed on income less distribution to beneficiaries
Royalties	Trust taxed on corporate rules (#)	Grantor taxed as if owner	Trust beneficiaries taxed on all trust income	Trust taxed on income less distribution to beneficiaries
Gains from disposal of:				
• Immovable property	Generally no gain on appreciated property unless distribution in kind or elect to distribute or sell at market value			
• Movable property from permanent establishment in South Africa	Generally no gain on appreciated property unless distribution in kind or elect to distribute or sell at market value			
• Movable property from permanent establishment in the United States	Generally no gain on appreciated property unless distribution in kind or elect to distribute or sell at market value			
• Other gains	Generally no gain on appreciated property unless distribution in kind or elect to distribute or sell at market value			
Other income	Trust taxed on corporate rules (#)	Grantor taxed as if owner	Trust beneficiaries taxed on all trust income	Trust taxed on income less distribution to beneficiaries

Controlled foreign corporation (shareholders taxed on pro rata share of income and gains) / *foreign personal holding company* (beneficiaries must include undistributed income in taxable income) / *passive foreign investment company* (beneficiaries include income and gains when received or deemed to have received or when a disposition of interest was made.

Table 6.4 illustrates who will be taxable on certain income, for example, in the case of a simple non-grantor trust, the beneficiaries will be liable for tax on all trust income.

Finally, Table 6.5 summarises whether or not the parties to the trust will receive treaty relief and a foreign tax credit in the United States.

Table 6.5: Determining whether the parties to the South African trust will qualify for treaty relief in the United States and/or whether withholding tax will be applicable

South African trust status	**Grantor trust**		**Simple non-grantor trust**		**Complex non-grantor trust**
Person liable for tax:	**United States grantor**	**South African grantor**	**United States beneficiary**	**South African beneficiary**	**South African trust**
Is person liable for tax a 'person' as defined?	YES	YES	YES	YES	YES
Is person a resident in the United States?	YES	NO	YES	NO	NO
Who is beneficial owner?	Grantor	Grantor	Beneficiary	Beneficiary	Trust
Is the person fiscally transparent (in owner's jurisdiction)?	YES	NO	YES	YES	NO
Is the trust specifically listed as resident of South Africa/United States treaty?					YES
Will person receive treaty benefit in the United States?	YES	NO, Because not United States resident	YES	NO, Because not United States resident	NO, Because not United States resident
Is withholding tax due on United States source income (excluding United States trade or business income)?	NO	YES, Generally 30%	NO	YES, Generally 30%	YES, Generally 30%

In Table 6.5 it is determined whether or not the parties to the South African trust will qualify for treaty relief in the United States and whether or not withholding tax will be applicable.

6.3 SUMMARY

The South African and United States tax implications can be summarised as follows:

- in South Africa, if a donation, settlement or other disposition, as defined, was made, then the donor will be liable for tax on the taxable income of the trust. Compared to this, in the United States, the grantor will be liable for the tax on the income of the trust if the trust is considered to be a grantor trust. In contrast, however, in the case of the United States grantor trust, the grantor is treated as the owner of all income

and corpus of the trust, whereas the South African donor will only be liable for tax on the income and gains attributable to the donation, settlement or other disposition;

- the United States non-grantor trust has similar tax implications as section 7(1) and section 25B of the Income Tax Act in South Africa where the beneficiaries or the trust will be liable for tax on the taxable income of the trust; and
- the double tax agreement provides for the relief of double taxation to a person in his/her residence state. Furthermore, a South African resident may be eligible for a foreign tax credit in terms of section 6*quat* of the Income Tax Act.

CHAPTER 7

CONCLUSION

7.1 INTRODUCTION

With an estimated 81 142 South Africans emigrating to the United States in 2010 (The World Bank, 2010), the use of the South African trust as an estate and tax planning tool might have far-reaching tax implications in the United States. If for example, a South African donor is treated as the grantor in the United States, but the trust itself remains a South African resident for tax purposes, it is entirely possible that double taxation might arise. This study aims to compare the tax consequences in South Africa and the United States specifically relating to the South African trust, its donor and beneficiaries.

The following conclusions could be made on the way in which a South African trust may be taxed in South Africa and the United States, based on the literature review.

Differences exist between the definition and tax liability of the donor for South African tax consequences and the grantor for United States tax consequences. The main differences, however, would be that the South African donor will only be taxed on certain income and gains distributed by the trust and would not be treated as the owner of all the income and corpus of the trust. In contrast to the South African trust, the United States grantor will be treated as the owner of all the income and corpus of the trust.

Furthermore, in South Africa, no distinction is made between the tax liability of the trust if a profit was derived from business operations or investments made to benefit from variations in the market. In South Africa, a trust has a fixed rate of tax of 40% (20% on capital gains) on all income and gains retained in the trust, whether these are business profits, investment income or any other income and gains. These income and gains may also be taxed in either the donor or beneficiaries' hands if these were distributed to them, or they had a vested right therein. In contrast to this, in the United States, if a trust was classified as a business or investment trust, the corporate tax rules will be applied to the trust.

In some instances, there were similarities found in the tax consequences between the non-grantor trust of the United States and the South African trust. In the case of the simple non-grantor trust, where all income and gains must be distributed (i.e. no income or gains may be accumulated), it can be compared with the South African trust where beneficiaries have a vested right to income in the trust (excluding those specific exclusions where the donor will be taxed in terms of section 7 of the Income Tax Act). In both these instances, the beneficiary will be taxed on the income and the gains.

Another comparison could be found between the complex non-grantor trust, where trust income may be accumulated, and the discretionary trust in South Africa. In the case of the complex non-grantor trust, the trust is considered to be the beneficial owner of the income or corpus and will be liable for tax thereon in the United States. In the case of the discretionary trust in South Africa, the trust will be liable for tax on income or gains unless a distribution is made to beneficiaries through the discretionary rights of the trustees. Both these trusts may deduct distributions made to beneficiaries.

7.2 RESEARCH PROPOSAL AND OBJECTIVES

The study aimed to achieve the following specific research objectives:

- to investigate the South African normal tax implications of a South African trust before and after the creator, donor and/or beneficiaries emigrate to the United States. This was done in chapter 2;
- to investigate the United States normal tax implications of a South African trust before and after the creator, donor and/or beneficiaries emigrate to the United States. This was done in chapter 3;
- to determine how double taxation is regulated in South Africa and the United States. This was done in chapter 4; and
- to compare the South African and United States tax implications. This was done in chapter 6.

7.3 FINDINGS

In South Africa, one of three persons may be liable for tax:

- the donor, if a donation, settlement or other disposition was made (under the provisions of sections 7(2) to 7(8) of the Income Tax Act);
- the beneficiaries (under the provisions of sections 7(1) and 25B of the Income Tax Act); and
- the trust (under the provisions of sections 7(1) and 25B of the Income Tax Act).

In the United States, there are also three persons that may be liable for tax:

- the grantor, if the trust is a grantor trust;
- the beneficiaries, if the trust is a simple non-grantor trust; and
- the trust, if the trust is a complex non-grantor trust.

7.4 CONCLUSION

The South African and United States tax implications can be summarised as follows:

- in South Africa, if a donation, settlement or other disposition, as defined, was made, then the donor will be liable for tax on the taxable income of the trust. Compared to this, in the United States, the grantor will be liable for the tax on the income of the trust if the trust is considered to be a grantor trust. In contrast, however, in the case of the United States grantor trust, the grantor is treated as the owner of all income and corpus of the trust, whereas the South African donor will only be liable for tax on the income and gains attributable to the donation, settlement or other disposition;
- the United States non-grantor trust has similar tax implications as the provisions of sections 7(1) and 25B of the Income Tax Act in South Africa, where the beneficiaries or the trust will be liable for tax on the taxable income of the trust. The beneficiaries will be liable for tax if the trust is a simple non-grantor trust and the trust will be liable for tax if the trust is a complex non-grantor trust; and

- the double tax agreement provides for the relief of double taxation to a person in his/her residence state. Furthermore, a South African resident may be eligible for a foreign tax credit in terms of section 6*quat* of the Income Tax Act.

Due to the differences in the nature of the tax liabilities of a South African trust in South Africa and the United States, different parties to the trust may be liable for tax in South Africa and the United States if the donor or beneficiaries emigrate to the United States and the trust is considered to be a grantor trust for United States tax purposes. In these circumstances, it may be important to evaluate whether or not to keep the South African trust or to consider if the other uses and benefits of keeping the trust, as discussed in chapter 5, outweigh any additional tax consequences that may arise.

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