

# **A COMPARISON OF THE TAX LEGISLATION OF TRUSTS BETWEEN SOUTH AFRICA AND ISRAEL**

by

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## ABSTRACT

# A COMPARISON OF THE TAX LEGISLATION OF TRUSTS BETWEEN SOUTH AFRICA AND ISRAEL

by

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Trusts are used on a worldwide basis in various financial structures. The residents of both South Africa and Israel also use trusts extensively. The taxation of trusts has developed over the years in South Africa, but the Israeli government only addressed specific tax legislation pertaining to trusts with effect from 2006. No information could be found indicating that any comparative study has been made between these two countries regarding their tax legislation pertaining to trusts.

The aim of this study is to do a comparison of the tax legislation pertaining to trusts by these two countries with a view to identify similarities and differences. The study found that the tax legislation pertaining to trusts of the two countries are very similar. An important difference identified, however, was the fact that the Israeli tax legislation contains some incentives for former Israeli residents returning to Israel and foreigners who become Israeli residents. In terms of these incentives exemption from taxation is enjoyed for periods of five and ten years. This affords the entrants the opportunity to settle properly before they become fully taxable as Israeli residents.

Keywords:

*Trusts*

*Foreign trusts*

*Resident*

*Beneficiaries*

*Donor*

*Trustee*

## OPSOMMING

# ‘N VERGELYKING VAN DIE BELASTINGWETGEWING VAN TRUSTS TUSSEN SUID-AFRIKA EN ISRAEL

deur

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Trusts word wêreldwyd gebruik in finansiële strukture. Die inwoners van Suid Afrika en Israel gebruik trusts ook baie algemeen. Alhoewel die belasting van trusts in Suid Afrika oor verloop van tyd ontwikkel het, het die owerhede van Israel eers sedert 2006 spesifiek die belasting van trusts in die belastingwetgewing aangespreek. Geen inligting kon verkry word oor enige vergelykende studie tussen die belastingwetgewing van die twee lande wat handel oor trusts nie.

Hierdie studie het ten doel om ‘n vergelyking te tref van die belastingwetgewing van trusts tussen die twee lande met die oog daarop om ooreenstemmings en verskille te identifiseer. Die studie het bevind dat die twee lande se wetgewing grootliks ooreenstem. ‘n Belangrike verskil wat geïdentifiseer is, is die feit dat Israel se belastingwetgewing sekere aansporings bevat waardeur Israelis wat terugkeer na Israel en buitelanders wat inwoners van Israel word vir periodes van vyf en tien jaar nie in Israel op sekere inkomste belas word nie. Op daardie wyse word die nuwelinge kans gegee om hulself behoorlik in te burger voordat hulle ten volle belasbaar word as inwoners van Israel.

Sleutelwoorde:

*Trusts*

*Buitelandse trusts*

*Inwoners*

*Begunstigdes*

*Skenker*

*Trustee*

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## CHAPTER 1

### 1 INTRODUCTION AND BACKGROUND

#### 1.1 INTRODUCTION

Trusts are used in a variety of ways around the world, including in South Africa. The Boston Consulting Group estimated in 2007 that there was almost \$6 trillion in offshore banking assets at that stage (Anon, 2007), while the International Monetary Fund (IMF) estimated the figure to be \$7 trillion (Oguttu, 2007:53). It is estimated that a quarter of this amount is held through trusts (Oguttu, 2007:307). There may be various reasons for these offshore investments but it is an indication of the magnitude of funds available for offshore investment.

As a developing country, South Africa requires investments to fund the needed developments for the growth of the economy. One of the ways to obtain funding is by inviting investments from foreign investors into the country. South Africa has to compete with other countries for those funds to be invested in this country. Whilst this study does not focus on foreign investments into South Africa, it is anticipated that a tax system that is seen as effective could be one of the factors that influence the decisions of investors.

South Africa has great potential to attract foreign investments. In the South Africa Business Guide Book 2007/08 (Department of Trade & Industry, 2008:14) the country is labelled as "...one of the world's most promising emerging markets, offering a First World economic infrastructure and a productive economy." A number of other points are mentioned to demonstrate that South Africa has investment potential for foreign investors. It is indicated that in 2005 foreign investments of about \$5,63 billion were made in South Africa. The Reserve Bank put the net inflow of capital at the end of September 2006 at R96,3 billion. For the first quarter of 2007 the inflows for foreign direct investments amounted to R3,8 billion. (Department of Trade & Industry, 2008:14.)

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Countries attract foreign investors through trust structures. Whitaker (2006:36-39) makes the point that, whilst the United States of America (USA) is not the only jurisdiction for foreign trust structures, there are many advantages for foreign trusts in the USA. Recently other countries, such as Canada (Quo Vadis & Sokic, 2008:542) and Israel (Shine-Fried, 2008:567) have also effected specific taxation legislation for foreign trusts. Whilst trusts are fairly commonly used in the world, the tax treatment thereof varies. A number of authorities have introduced specific legislation to regulate trusts.

In South Africa trusts are very often used, be it for investments purposes, business structures or tax planning. Sometimes there is a perception that whenever a solution needs to be found, whether it is for business or legal matters, it can be solved by forming a trust (Olivier & Honiball, 2011:114). In this dissertation the focus will be on trusts, including foreign trusts.

The taxation on trusts in South Africa is mainly impacted by section 7 and that on foreign trusts is covered in terms of the legislation regarding non-residents and the specific anti-avoidance measures in terms of section 25B(2A) of the South African Income Tax Act 58 of 1962 (hereafter referred to as the "Income Tax Act").

It is the responsibility of the South African Revenue Services (SARS) to collect the optimum tax, also on foreign trusts and to ensure that the tax legislation keeps track with international developments in this regard.

South African residents have investments offshore in trusts (SARS 2010:428). Enquiries on 16 May 2011 to Roberts, a senior official in the offices of SARS dealing with high net worth individuals, indicated that South African residents have investments in Israel. Various searches on electronic libraries, such as that of the University of Pretoria, SA ePublications, Google scholar, ProQuest, EBSCOhost and Integritax, did not reveal any research done on the specific aspect of South Africa taxation on foreign trusts in relation to Israel.

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In this research the South Africa tax legislation is compared with that of Israel to determine differences and similarities between the two tax systems.

## 1.2 HISTORY OF TRUSTS

As the focus in this document is on trusts, it is important to briefly look at the history of trusts in general to obtain some understanding of the purpose of trusts and how the trust as a concept has developed. In this part of the chapter a short overview is to be presented on the development of trusts and the general concepts applicable to trusts.

The concept of a trust is used around the world, but where does this concept originate? This is a matter that has been debated often. Some are of the view that it comes from the English law. In the words of Maitland (1903) “[i]f we were asked what is the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence I cannot think that we should have any better answer to give than this, namely, the development from century to century of the trust idea”. Others are of the opinion that trusts originated from the *Salman* or *Treuhand* from German law (Roper, 1999:13). Van Rhee (2001:83) is of the opinion that the law relating to trusts was influenced by the Roman, Canon and Germanic laws. This matter will probably still be debated in future.

The *Treuhand* entails that a person entrusts another (the trustee) in terms of his will with his property. The property is not held by the trustee for his own benefit, but for the benefit of a beneficiary (Roper, 1999:13). This is the same principle as that of the trust.

There are some views that the “English Law trust”, as it is referred to, has its origins in the *Treuhand* principle that was brought to England after the Norman invasion (Roper, 1999:13). In general terms, the concept of the trust is that a person holds assets on behalf of another or for the benefit of another. During mediaeval times the soldiers from England who went on the crusades established a trust to protect their assets (Van Rhee, 2001). These soldiers could be away on a crusade for a very long time. If the soldier for some or other reason did not return from the war there was a risk that his family could lose their land to the king. The practice was adopted whereby the fixed property of the soldier was

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transferred to a trusted person who would then control the assets of the soldier while he was away on a crusade. On the return of the soldier the property would be returned to the soldier. If the soldier did not return the property would be transferred to his family. These early trusts were known as *uses*. (Roper, 1999:13-14.)

Some other early terms used with regard to trusts are:

- “*feoffor*” which we know as settlor, grantor, donor or creator,
- “*feoffee to uses*” today known as trustee, and
- “*cestui que uses*” which we know as beneficiary (Whitman, 2004:842).

Over time the use of trusts have become more complex and the development of laws governing trusts ensued. Many tax authorities have enacted legislation dealing specifically with trusts. Some of the well-known jurisdictions for offshore trusts include the Bahamas, Barbados, Bermuda, Cayman Islands, Guernsey, and Mauritius (Olivier & Honiball, 2011:129).

The trust concept came to South Africa with the British. In 1806 the Cape became a British Colony. Although the Roman-Dutch law was retained as part of the peace treaty at the time, the English legal system was incorporated over time. Although it is not known when English trust law was used in South Africa for the first time, the first reported case referring to a trust was decided in *Twentyman v Hewitt*, 1833 (Van der Westhuizen, 2010:4(1).)

Although trusts have been around for some time, the process of combining the English trust law and the Roman-Dutch law into a proper South Africa law is still in progress. In his doctoral thesis *Die trust in die Romeins-Hollandse Reg*, Coertze reported in 1948 (Van der Westhuizen, 2010:5) that:

“(d)ie wasdom en ontwikkeling van die *Treuhand-idee* in ons reg het plaasgevind onder die invloed van die Engelse reg. Die Engelse terme *trust* en *trustee* is geadopteer maar nie die Engelse trustreg nie. ‘n Eie trustreg is deur ons regspraktyk en deur ons Howe ontwikkel maar dit is nog ver van voltooi”.

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Although some time has passed since that statement by Coertze, the development of trust law in South Africa is still in progress (Van der Westhuizen, 2010:5). Just as the trust law itself is still developing, tax legislation in South Africa is also constantly revisited.

The Israeli legal system has acknowledged the trust as an institution since the 1920's. The Charitable Trusts Ordinance enacted in 1923 sets out the rules for a public trust. (Harris, Kaplan, Linzen & Tamir. Not dated.) Israel became independent in 1948 and has since then developed its own legal system based on the English common law system (Kaplan & Dover, 2010). There was no specific regulation for private trusts until 1979 when the Trust Law was enacted. This does not mean that Israel did not acknowledge the concept of a trust. Before the enactment of the Trust Law the courts had to apply the foreign laws to trusts (Harris *et al.*, Not dated). Because of its common law system it has always acknowledged the trust concept (Kaplan & Dover, 2010).

From the aforementioned it is seen that the South Africa legal system found its base in the English and the Roman-Dutch law and that of Israel is based on English common law. It is therefore expected that there should be similarities between the treatment of trusts by South Africa and Israel. The question is how the tax systems of the two countries address these similarities.

## 1.3 PROBLEM STATEMENT

South Africa re-entered the world economy since the abolition of apartheid in 1994. Whilst this opened up markets and investments from foreign sources, it also requires the country to keep up to date with new developments in the global economy. One of the aspects to be reviewed regularly is taxation legislation. The Income Tax Act is reviewed regularly and there are updates, at least annually, to this Act.

Other countries also regularly revisit their taxation legislation. Canada, for instance, started with its tax legislation of foreign trusts in August 2001 (Quo Vadis & Sokic, 2008:542). In Israel the taxation of trusts has only been legislated since July 2005 to be effective from January 2006 and the reporting requirements for foreign trusts was deferred

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to August 2008 (Shine-Fried, 2008). The authorities realised that the implementation of the changes posed some challenges and the implementation was postponed further so that the first returns to be submitted under the new legislation for the 2006 to 2008 tax years was set for 31 December 2009 (Harris, 2010).

From this it is deduced that the taxation of foreign trusts is continuously developing and countries that do not keep up with the new developments will find that their tax legislation will cause them to suffer losses, either due to the fact that they do not recover their rightful portion of the taxes or, due to the withdrawal of foreign trusts to invest in other countries that better meet their needs.

Countries can always learn from one another and therefore South Africa can learn from the experiences of others. As mentioned before, a search on various electronic libraries has not revealed any comparison of the taxation of trusts with that of Israel.

## 1.4 PURPOSE STATEMENT

The main purpose of this study is to compare the legislation of trusts taxation of South Africa with that of Israel and to identify similarities and differences between the two countries in the taxation of trusts.

## 1.5 RESEARCH OBJECTIVES / RESEARCH QUESTIONS

The study focuses on the following research objectives:

- to review the tax measures South Africa currently employs in the taxation of trusts, including foreign trusts;
- to review the tax measures Israel employs in the taxation of trusts and foreign trusts; and
- to compare the South Africa taxation of trusts with that of Israel to identify similarities and differences.



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## 1.6 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

This study is important from an academic point of view as no such study has been done previously. This study indicates how the taxation of trusts in South Africa compares with that of Israel, a country where South Africa residents hold offshore investments through trust structures.

Through this study a contribution is also made by identifying aspects for further research with regard to the taxation of trusts between South Africa and Israel.

## 1.7 DELIMITATIONS AND ASSUMPTIONS

In a study of this nature it is not possible to address everything. It is subject to some limitations and it is also based on certain assumptions. The main limitations and assumptions of this study are noted in this section of Chapter One.

### 1.7.1 Delimitations

This study focuses on the taxation of foreign trusts with specific reference to the normal income tax covered by the Income Tax Act. This study does not seek to address the complex aspects of capital gains tax or to review the Double Tax Agreement between South Africa and Israel. It does not address the other taxes not governed by the Income Tax Act, such as value-added tax, the securities transfer tax or the taxation of estates.

The study is limited to a comparison between South Africa and Israel. It does not address a comparison with other countries.

The study is focused on taxation of trusts alone and does not seek to address any exchange control matters.

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The study does not address specialist trusts, such as Joint Investment Trusts or Real Estate Investment Trusts applicable in Israel or personal services trusts as found in the Income Tax Act.

The official documentation regarding the Israel Tax Ordinance (hereafter referred to as the “Ordinance”) is published in Hebrew and there is no officially translated version of the Ordinance available. Two freely translated versions of the Ordinance were found on the Internet, the one being directly from the website of the Israeli government and the other from the Society of Trust and Estate Practitioners. Differences have been noted between these two translations. Where these differences impact on this study, the matter is indicated as such.

## 1.7.2 Assumptions

This study is based on a literature review. As such the research is limited to reviewing and interpreting literature on the subject matter. The literature used is assumed to be reliable.

## 1.8 DEFINITION OF KEY TERMS

In this study a number of key concepts are used. These are defined below with cross-references to specific parts in the document where these definitions are used. South Africa and Israel have different definitions for a number of key concepts that they use in their tax legislation. As a result, in a number of instances, more than one definition is presented which demonstrates the differences between the two countries.

**Beneficiaries.** In terms of section 1 of the Income Tax Act a beneficiary is any “... person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust ...”. In South African context the beneficiaries can either be named or be determined based on the definition of who could be beneficiaries of the trust (Van der Westhuizen, 2010:34(3)). Beneficiaries include those with a vested right and those with a discretionary right (Geach, 2007:234).

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Section 75E of the Ordinance defines a beneficiary as “a person entitled to benefit from the trust assets or trust income...”. It provides for some specifics to be included as beneficiaries. These are addressed in chapter 3.2 in more detail.

**Body of persons.** This term is defined in section 1 of the Ordinance as “... any public body, incorporated or amalgamated, and any company, fraternity, fellowship or society, whether incorporated or not ...”. For purposes of this study the term “entity” is used.

**Connected person.** This is a very important concept used in the Income Tax Act and it is defined in section 1 of the Income Tax Act. A trust and a natural person are defined as connected persons. The Income Tax Act also defines a connected person to a trust in section 1 to include any beneficiary and any person connected to that beneficiary. It further includes any person connected to a connected person of a trust. The concept of connected person is very wide.

Although the Ordinance does not deal directly with the definition of connected person, section 75E refers to “an indirect beneficiary through a chain of beneficiaries” and to a beneficiary who controls an entity as a beneficiary. The Ordinance therefore caters for connected persons.

**Discretionary trusts.** The discretionary trust is a trust where the beneficiaries have no vested right in any income or capital of the trust. They only have a contingent right. The beneficiaries have only a vested right in any income and capital when the trustees exercise their discretion to distribute any income or capital. (Olivier & Honiball, 2010:267.) The Ordinance refers to this type of trust as an irrevocable trust (Broide, 2009). For purposes of this study the term “discretionary trust” is used when referring to such trust in South Africa context while the term “irrevocable trust” is used when referring to the Ordinance.

**Foreign trust.** For purposes of this study, a foreign trust will mean a trust that is not encompassed in the trust law of the local country under discussion.

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**Founder, donor, settlor, grantor or creator.** These terms are used interchangeably. In this document the term donor is used. This is the person who wishes to create the trust and transfers property into the trust or by bequeathing property to the trust (Geach, 2007:15). The donor could be one person or more than one person (Van der Westhuizen, 2010:25). The definition in terms of the Israeli Ordinance is similar to this, but includes a number of instances where a person is deemed to be the donor. These specific inclusions can be found in chapter 3.

**Irrevocable trust.** Every trust that is not a revocable trust is defined as an irrevocable trust, “provided that the assessing officer was given a duly certified affidavit by the trust’s settlor and the trustee of the trust regarding the fact that it is an irrevocable trust...” (STEP, 2009:26). An irrevocable trust is also referred to as a discretionary trust (Broide, 2009). In this study the term “irrevocable trust” is used when referring to the Ordinance while the term “discretionary trust” is used in the instances where the term is used in referring to the Income Tax Act.

**Revocable trust.** This is a trust where the donor retains the right to revoke the rights of the beneficiaries to income or assets (STEP, 2009:24). This concept is used very specifically in the Ordinance and it contains a number of conditions that are set out in detail in chapter 3.2 of this study.

**Trust.** The Hague Convention (1985) defines a trust as “the legal relationships created – *inter vivos* or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose”.

In the South Africa context definitions to trusts are found in the Trust Property Control Act 57 of 1988 (hereafter referred to as the “Trust Property Control Act”) and in the Income Tax Act, while the Ordinance defines a trust for Israeli tax purposes. As this study focuses on the taxation aspects of trusts only the definitions from the Income Tax Act and the Ordinance are presented here. For the definition in terms of the Trust Property Control Act see chapter 2.2.

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The Income Tax Act defines a **trust** in section 1 as “...any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person.”

The Israeli definition of a trust as provided in section 75C of the Ordinance is “an arrangement where a trustee holds the trustee’s assets in favour of a beneficiary, which was established either in Israel or outside Israel, whether such is defined under the general law applying to it as a trust or otherwise”. In terms of the Ordinance a trust is also formed where the assets are held by a “trust asset holding company”.

**Trust asset holding company.** This is a term specifically defined in section 75C of the Ordinance and refers to an entity that holds the assets of the trust directly or indirectly. This entity is used to specifically hold the trust assets separate from any other assets that may also be under the control of the trustee or to separate it from the trustee’s personal assets (STEP, 2009:30). This term is not used in the Income Tax Act.

**Trustee.** The Trust Property Control Act defines a trustee in section 1 as “... any person (including the donor of a trust) who acts as trustee by virtue of an authorisation under section 6 ...”. The definition of a trustee in terms of the Israeli Ordinance in section 75C is “a person who is vested with all the assets or revenues from assets, or who holds the assets in trust” (STEP, 2009:26).

**Trusteeship.** The term is used in the Israeli Ordinance for trusts. In this dissertation the term trust is used instead of trusteeship.

**Vest or vesting.** The Investors Dictionary (InvestorsDictionary.com, Not dated) defines vest as “(1) to confer the right of immediate or future possession and use of property or as (2) a designation of ownership or possession of property”. In the Ordinance vesting is defined in section 75C as “... the transfer of an asset to a trustee in trust, without consideration” (STEP, 2009:28). In other words the term in the Ordinance refers to the

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donation of an asset to the trust. In this dissertation the term donation is used for a donation and vest or vesting is used in the normal context as described in the dictionary.

Some names of countries, departments or organisations have abbreviations that are generally known. Table 1 contains the abbreviations that are used in this study and their meanings.

**Table 1: Abbreviations used in this document**

<b>Abbreviation</b>	<b>Meaning</b>
DTI	Department of Trade and Industry
IMF	International Monetary Fund
PBO	Public benefit organisation
SARS	South African Revenue Services
STEP	Society of Trust and Estate Practitioners
USA	United States of America

## 1.9 RESEARCH DESIGN AND METHODS

The study as proposed comprises a literature review. Due to the absence of specific results being reviewed, this comprises a non-empirical study.

In chapter 2, trusts in a South African environment are reviewed and in chapter 3, the trusts of Israel. That is followed in chapter 4 by a comparison between the taxation of trusts in South Africa and Israel that is followed by the conclusion of the study in chapter 5.

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## CHAPTER 2

### 2 TRUSTS IN SOUTH AFRICA

#### 2.1 INTRODUCTION

An understanding of trusts is required before any effort can be made to understand the taxation thereof. In this chapter an overview is presented on trusts in South Africa together with the related taxation. The overview is limited to aspects relating to this study. The definition of a trust from a purely legal perspective differs slightly from the definition of a trust from a tax perspective. Before an assessment may be made regarding the taxation of trusts, the origin and broader definition of a trust within South Africa should be considered.

#### 2.2 BACKGROUND

It may be said that when the Cape became a British colony in 1806, the English trust system found its way to South Africa (Van der Westhuizen, 2010:4(1)). The first reported judgement where reference was made to a trust was in 1833 (Van der Westhuizen, 2010:4(1)). Traditionally the South Africa legal system is based on the Roman-Dutch law. The integration of the English law and the Roman-Dutch law has therefore been taking place, labelled by Van der Westhuizen (2010:5) as the “South Africanising of the trust law”. This process remains on going (Van der Westhuizen, 2010:5).

In South Africa the Trust Property Control Act has been implemented to regulate the control of trusts for property. In terms of section 1 of this Act a trust is established in terms of an agreement in which property is transferred from one person to another. This transfer can either be in terms of an agreement or in terms of a will. The person or persons accepting the assets are the trustees. They do not hold the assets for their own benefit but must act with the assets in terms of the trust deed for the benefit of the beneficiaries. The beneficiaries are defined in the trust deed and may consist of specific people or

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categories of people. The Trust Property Control Act specifically excludes those situations where assets are to be administered in terms of the Administration of Estates Act, 66 of 1965.

The main parties to a trust are the donor, also known as the founder or the settlor, the trustee and the beneficiary (Van der Westhuizen, 2010:25,27,34(2)). There can be more than one donor, trustee or beneficiary. The donor is the person who creates the trust for the benefit of the beneficiaries. The role of the trustee is to manage the trust assets to the best advantage of the beneficiaries. The beneficiaries are the people who should benefit from the trust.

Beneficiaries may have varying rights depending on the terms of the trust deed or how the trustees have exercised their discretion in favour of a beneficiary. The beneficiaries' rights are normally termed as discretionary and vested rights and are also classified between income rights and capital rights (Geach, 2007:19).

Trusts may either be formed by the donor while he or she is still alive, in which case it is referred to as an *inter vivos trust*, or it may be formed in terms of the will of the donor, in which case it is referred to as a trust *mortis causa*. Both these trusts are independent legal concepts, but the legal principles relating to the *inter vivos* trusts are based on the law of contract, while the legal principles relating to the testamentary trusts are still to some extent being developed. (Geach, 2007:18.)

In South Africa there are three main forms of trusts, the general form of a trust, a "bewind trust" and a trust where someone is entrusted with the affairs of another (Olivier & Honiball, 2011:116). The distinction is based on the ownership of the trust assets and the control over such assets.

The first form of a trust is the general form that is the most common form of the trust. This is where the donor transfers ownership of trust property to a trustee to be held for the benefit of the beneficiaries (Olivier & Honiball, 2011:116).



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In the case of the “bewind trust” the donor transfers the ownership of the assets to the beneficiaries but the control of the assets is in the hands of the trustees. The risk in the event of a “bewind trust” is that the trust assets may be exposed to claims by the creditors of the beneficiary (Geach, 2007:19).

The third form of trust is where a person is entrusted with the affairs of someone else. It is normally seen that such person is the agent of the other and is often an office bearer or office holder (Olivier & Honiball, 2011:116).

In this dissertation the focus is on the normal trusts in which ownership has been passed onto the trustees and the agent concept is not included in this study.

As mentioned above, beneficiaries’ rights are either referred to as vested rights or discretionary rights. In this regard trusts are also normally distinguished between as **vested** or **vesting trusts** and **discretionary trusts**.

In vesting trusts the beneficiaries have vested rights to the income or capital of the trust. Ownership of the assets does not vest in the beneficiaries but vests in the trustees. The trustees do not have any discretionary rights with regard to the income or capital distributions of the trust. They have to comply with the prescriptions of the trust deed in distributing any income or capital. Should a beneficiary pass away before a distribution from the trust has been made such beneficiary’s estate is entitled to the income from the trust. (Olivier & Honiball, 2010:267.) One can say that the trustees are merely acting in an administrative capacity, without the right to make decisions to the distribution of profits.

In the discretionary trust the beneficiaries have no vested right with regard to any income or capital of the trust. They only have a contingent right. The beneficiaries receive a vested right in any income and capital when the trustees exercise their discretion to distribute any income or capital (Olivier & Honiball, 2010:267). In this type of trust the donor leaves the discretion of any distributions by the trust in the hands of the trustees who should act in the best interest of the beneficiaries at all times in terms of section 9(1) of the Trust Property Control Act.

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A trust is not a legal entity in terms of South African law and therefore the ownership of the trust's assets and liabilities vests in the trustees. Although the assets of the trust vest in the trustees, it does not mean that they have beneficial ownership of the trusts (Olivier & Honiball, 2011:117). This has been confirmed by the Supreme Court of Appeal in *CIR vs Mac Neillie's Estate*, 1961 24 SATC 282 where it was stated that "... [I]ike a deceased estate, a trust, if it is to be clothed with juristic personality, would be a persona or legal entity consisting of an aggregate of assets and liabilities. Neither our authorities nor our courts have recognized it as such a persona or entity ... It is trite law that the assets and liabilities in a trust vest in the trustee ...".

The courts in South Africa apply South African domestic law to trusts in South Africa even if the case involves a foreign element. In those rare instances where South African courts have to give effect to foreign law they will not do so if the foreign law is contrary to South Africa public policy (Olivier & Honiball, 2011:115). In order to avoid unnecessary disputes it is advisable that the trust deed contains a clear indication under which jurisdiction the trust should be interpreted (Olivier & Honiball, 2011:116).

In this part the legal aspects of trusts were considered. The law relating to trusts has not been fully developed, but is still developing. A trust may be created by a person while still alive or it may be created in terms of his/her will. The main purpose of the trust is for the donor to make provision for the needs of his/her family and thus the trustees appointed by the donor have to be people that are trusted by the donor. The trustees have a fiduciary duty to act in the best interest of the beneficiaries. The Income Tax Act contains specific definitions and sections dealing with trusts that are to be reviewed in the next part of this chapter.

### 2.3 DEFINING TRUSTS FOR TAX PURPOSES IN SOUTH AFRICA

The general definitions and principles relating to trusts were identified as applied for purposes other than for taxation. The Income Tax Act deals with specific aspects of a trust

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for tax purposes in South Africa. These aspects of the Income Tax Act relating to trusts are now to be reviewed.

Since January 2001 South Africa has applied the residence-based tax system which means that residents of South Africa are taxed on their worldwide income while non-residents are taxed on the income derived from a South African source (Stiglingh, M., Koekemoer, A.D., Van Schalkwyk, L., Wilcocks, J.S., De Swardt, R.D., & Jordaan, K., 2010:49). To understand whether a trust is subject to tax in South Africa, some of the principles in determining taxable income should be analysed.

The definition of 'gross income' is set out in section 1 of the Income Tax Act. In terms of this definition the gross income of a resident needs to be determined for a tax year. The definition of 'resident' includes an entity, in other words not a natural person, which is formed in South Africa or which is effectively managed in South Africa. It then goes on to include under the definition of 'person' a trust.

From these definitions it is clear that a trust is specifically included as a person for tax purposes in South Africa. The income of a trust would therefore be subject to tax in South Africa on the same basis as for any person. A resident trust in South Africa is thus taxed on its worldwide income while a non-resident trust or foreign trust is taxed on its income from South African sources.

The definition of a trust in terms of section 1 of the Income Tax Act is similar to that of the Trust Property Control Act. The Income Tax Act defines a trust as "... any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person". This definition specifically includes cash and other assets. It is thus clear that it is not only fixed or movable assets that form the basis of a trust for tax purposes.

The parties to a trust are the donors, the trustees and the beneficiaries. The Income Tax Act does not contain a specific definition of a donor, founder or creator of a trust and the

## **A COMPARISON OF THE TAX LEGISLATION OF TRUSTS BETWEEN SOUTH AFRICA AND ISRAEL**

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general meaning of the word is therefore used. The Income Tax Act defines the terms trustee and beneficiary. The definition of a trustee in the Income Tax Act includes a trustee appointed by the trust.

Another important party to a trust is the beneficiary or beneficiaries. A beneficiary in relation to a trust is defined in terms of the Income Tax Act to mean "... a person who has a vested or contingent interest in all or a portion of the receipts or accruals or the assets of that trust".

As can be seen from the above, the definitions of a trust and its beneficiaries, as described in chapter 2.1 are similar to that of the Income Tax Act. Whilst the Income Tax Act governs the taxation of a trust, the Trust Property Control Act governs the legal aspects of the trust. The Income Tax Act emphasises that property includes cash and cash funds.

In this section of the chapter of the study only the definitions relating to trusts have been considered but the principles of how trusts and the parties related to the trust are taxed still need to be reviewed. This is done in the following section of this chapter of the study.

### **2.4 THE GENERAL PRINCIPLES PERTAINING TO THE TAXATION OF SOUTH AFRICAN TRUSTS**

There are a number of sections in the Income Tax Act that deal with trusts and aspects relating to trusts. These are sections 1, 5, 7, 25B, 26A, paragraphs 68 to 73 of the Eighth Schedule and paragraph 80 of the Eighth Schedule to the Income Tax Act. The definitions as defined in section 1 were considered in the previous part of the study, thus only the other sections mentioned are reviewed in this part of the study.

The tax rate and year end of the trusts are determined in terms of section 5. In terms of this section the Minister determines the rate of tax applicable to a person. It also provides that the tax year-end of the trust is the end of February. The current rate at which a trust is taxed is 40% which rate is the same as the maximum marginal rate of individuals.

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Section 7 is generally seen as an anti-avoidance section. In terms of this section certain amounts are deemed to be income of a person although they did not accrue to that person. If a person divests himself of an asset or income in a gratuitous manner, that income may be taxed in the hands of that person. The application of section 7 is discussed in more detail in chapter 2.3.1 below.

Section 25B should be read with section 7. Effectively the trust is taxed on any income in terms of section 25B(1) that is not taxable in the hands of a donor as determined in section 7 or to which the beneficiaries do not have a vested right or have not obtained a vested right in terms of section 25B(2). Sections 25B(1) and 25B(2) are reviewed in chapter 2.3.2 below with regard to the tax liability of beneficiaries while section 25B(1) relating to the taxation of the trust itself is addressed in chapter 2.3.3.

Section 26A as well as paragraphs 68 to 73 and paragraph 80 of the Eighth Schedule to the Income Tax Act deal with the capital gains aspects relating to trusts. As this study does not cover the capital gains tax aspects of trusts no further review is to be done on these sections and paragraphs.

From the review of these sections above, there are three parties relating to trusts that could incur a tax liability. These are the donor, the beneficiaries or the trust. Section 25B(1) is subject to the provisions of section 7. This means that the provisions of section 7 relating to the taxation in the hands of the donor are first considered. Once this has been considered and there is still income that has not been dealt with, then it needs to be considered whether any beneficiaries have a vested right in terms of section 25B(1) in that income or have obtained a vested right in terms of section 25B(2) in that income, resulting in that income being taxable in the hands of those beneficiaries. If after these considerations have been taken into account and there is still any amount left in the trust that will not be subject to tax by those parties, that amount will be taxable in the trust. In other words, South African tax law considers firstly taxing the donor, thereafter the beneficiary and lastly the trust.

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The various parties are taxed under different sections of the Income Tax Act. The tax consequences for the various parties are now reviewed.

### **2.4.1 Liability of donor for tax on the income of the trust**

As mentioned before the donor to the trust is one of the parties that may be taxed on the income generated by the trust. In the event that there was a “donation, settlement or other disposition” to a trust by a donor the donor is taxed on the income of the trust if sections 7(2) to 7(8) are applicable. These sections are anti-avoidance measures implemented in the Income Tax Act. It has the effect that a person different from the one who is entitled to the income is to be taxed on the income (Stiglingh *et al.*, 2010:750). In South Africa individuals are taxed on a sliding scale depending on their taxable income. If income were redistributed to persons in a lower tax bracket it would reduce the overall tax charge. The main aim of these provisions is to prevent the redistribution of income merely to obtain such a tax advantage. The sub-sections in section 7 seek to tax the donor in specific circumstances.

In section 7(2) the focus is on the income of spouses. This section prevents spouses from splitting their income in order to reduce their tax liability. In the event that a spouse (the donor spouse) makes a donation to a trust and the other spouse (recipient spouse) receives income from the trust earned on the donation by the donor spouse, the donor spouse will be held liable to pay tax on such income if the main purpose in making the donation was to reduce the tax liability of the donor spouse. Therefore, if a spouse receives income from a trust and the real cause of this income was a donation, settlement or other disposition by the donor spouse the donor spouse will be taxed on the income and not the recipient spouse who received the income provided the main purpose in making the donation was to reduce the tax liability of the donor spouse. (Geach, 2007:246-247.)

Section 7(3) seeks to tax the parent of a minor child in the case where the parent makes a donation to the trust with his minor child(ren) being the beneficiary(ies). Where a parent has made a donation to such a trust and as a result of that donation the trust generated

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income that vested in the minor child, the parent of the child is taxed on the income earned by the trust (Stiglingh *et al.*, 2010:751; Geach, 2007:247-248).

Section 7(4) is similar to section 7(3) in that the parent of a minor child is to be taxed on the income that accrued to the child from a donation. This section specifically applies where the parents of one family makes a donation to that of the other family on the condition that the other family also makes a donation to first donor family. These donations are made for the benefit of the minor child(ren) of the families. In terms of this section the income of a minor child or stepchild from such a donation by a third party is taxed in the hands of the parent (Stiglingh *et al.*, 2010:751).

If a donation made to a trust is subject to certain conditions that prevent the trustees from distributing the income from that donation to the beneficiaries until those conditions are met, then that income is to be taxed in the hands of the donor in terms of section 7(5). This is the case where such conditions stipulate that the beneficiaries only receive the income once the conditions have been met and as a result the income is retained in the trust, then the donor is taxable on that income (Geach, 2007:248-249).

Where the donor retains the right to revoke the right of a beneficiary and transfer that right to another then the donor is taxed on that income in terms of section 7(6). In such an instance the income subject to the right to revoke is taxed in the hands of the donor who holds the right to revoke (Geach, 2007:249).

In terms of section 7(7) income is deemed to be that of the person who retains an interest in property, fixed or movable. This section caters for those instances where the taxpayer cedes his right to income from assets to another, in this case a trust, but still retains the ownership of the assets or retains the right to regain the ownership. It covers rental income, dividends, interest, royalties or other similar income received on the basis of the assets. The income so received is to be taxed in the hands of the donor irrespective of the tax position of the beneficiary (Geach, 2007:249).

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Section 7(8) caters for the situation where a resident donor has made a donation to a trust, local or offshore, for the benefit of a non-resident beneficiary who receives an amount that would have been taxed in South Africa if that beneficiary had been a South African resident. In such instance the resident donor has to include the amount that accrued to / received by the non-resident in his taxable income (Geach, 2007:250-251).

From the above it is concluded that the revenue authorities view the taxation of donors in a very serious light. The donor is the first person to be considered for the taxation on the income of the trust. The next person to be considered to incur a tax liability for the income of the trust is the beneficiary.

## **2.4.2 Liability of beneficiary for tax on the income of the trust**

The taxation of the beneficiaries will now be reviewed. The sections of the Income Tax Act that address the taxation of the beneficiaries are sections 25B(1) and 25B(2) read with section 7(1).

The beneficiary is taxed in terms of section 25B(1) on the income to which the beneficiary has a vested right. In terms of section 7(1) where an amount is deemed to have accrued to a person, that person has a vested right. Thus where a beneficiary has a vested right in the income of a trust based on the stipulations of the trust deed, both sections 7(1) and 25B(1) confirm that beneficiary's tax liability on that income. Section 25B(2) provides that a beneficiary obtains a vested right in the income of the trust if the trustees have exercised their discretion and have made a distribution to the beneficiary.

In short, once the beneficiary has a vested right to the income in terms of the trust deed or because the trustees have exercised their discretion, that income is included in the calculation to determine the taxable income of the beneficiary.

The beneficiary is allowed to claim the deductions incurred by the trust in terms of section 25B(3) in determining the taxable income relating to the income received from the trust. Such expenditure cannot create a loss in the hands of the beneficiary. If a loss has



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occurred in the tax year it is retained in the trust but is available to be set off against the income of the beneficiary in future years (sections 25B(4) to 25B(6)).

So far the taxation of the donor and the beneficiary has been reviewed. The trust may also incur a liability to tax, if there is income in the trust that is not subject to taxation in the hands of the donor or the beneficiary.

### **2.4.3 Liability of trust for tax on the income of the trust**

The amounts that are taxable in the hands of the donor and beneficiaries have now been determined. What is left is to determine what is taxable in the hands of the trust.

Section 25B(1) provides that any amount received by or that accrued to a trust during a tax year which is not subject to taxation in the hands of the donor in terms of section 7 or that has not vested in a beneficiary is to be taxed in the trust. The trustee is the representative taxpayer for the trust.

From the above it is clear that within the ambit of South Africa tax law, the donor or the beneficiary is the preferred party to be taxed. One of the parties to the trust should advise the SARS of the registration of the trust and should make a declaration to the SARS on the taxation payable.

### **2.4.4 Reporting requirements for trusts**

The person responsible for the taxation has been established, but the registration of the trust, as a taxpayer needs to be taken care of. Also the declaration of the income needs to be done to the SARS. Various people have responsibilities in this regard.

A trust is to be registered with the Master of the Supreme Court (hereafter referred to as "Master") in terms of section 4 of the Trust Property Control Act. This is done by the donor or an agent appointed on behalf of the donor. The Master then appoints the trustee(s) to

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the trust who is then responsible to see to it that the trust complies with the requirements of the Income Tax Act.

In terms of section 67 of the Income Tax Act, every person who becomes liable for tax in South Africa must register as a taxpayer within 60 days after becoming liable for taxation. The annual notice issued by the SARS in terms of the regulations to the Income Tax Act for taxpayers to furnish tax returns, specifically includes any resident trust or any other trust that derived gross income or any capital gains from a South African source as a person liable to tax. The latest notice issued in this regard is GN531 dated 1 July 2011. The definition of person in the Income Tax Act also specifically includes a trust. Thus, any resident trust should register with SARS as a taxpayer within 60 days of it being registered as a trust with the Master. Similarly a non-South African trust that becomes a South Africa resident should be registered as a taxpayer. The residency of a trust is determined based on its place of effective management or where it is formed unless a double tax treaty agreement between contracting states provides that a person is deemed to be exclusively the resident of either of the contracting states (Olivier & Honiball, 2011:154). If the place of effective management of the trust is in South Africa it is a South Africa resident for tax purposes and should register as a taxpayer as explained (Stiglingh *et al.*, 2010:54-55).

The trustee is the representative taxpayer of the trust and has the obligation to submit the tax returns of the trust with the SARS. In terms of section 66 of the Income Tax Act any person who is liable to tax should submit annual returns to the revenue authorities (Van der Westhuizen, 2010:72-73).

It follows from this that a non-resident trust will not be required to submit a return if it has no South African source income.

The donor and beneficiary have to submit their own tax returns and declare the income from the trust on which they are liable to tax.

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Section 7(10) also provides that any person that made "... any donation, settlement or other disposition as contemplated in this section ..." must declare such transaction in his annual return to SARS.

The normal tax (excluding tax on capital gains) of the trust has now been dealt with. The tax on capital gains has, however, been excluded from the scope of this study.

## 2.5 TAXATION OF THE FOREIGN TRUSTS IN TERMS OF SOUTH AFRICA LEGISLATION

The taxation of South African trusts has been considered. The taxation of foreign trusts will now be considered.

As a trust is a conduit, the income retains its nature and as was explained earlier in this chapter, the beneficiaries or the donor are normally taxed on the income received by the trust (Van der Westhuizen, 2010:74). The residency of the trust does not impact on the income that flows through the conduit of the trust (Stiglingh *et al.*, 2010:761). In those instances where the trust is liable to tax it is important to assess the residency of the trust, because a non-resident trust is only liable to pay tax on its income from a South Africa source.

The income from a non-South African source would thus not be taxed in the hands of the trust in terms of South African tax legislation in the year that it accrues to the trust. If the income vested in a South African resident in the year that it accrued to the non-resident trust the income would be taxable in the hands of the South African resident. To prevent the situation that a South African resident can receive income from a non-South African source via a trust free from taxation in a subsequent year, section 25B(2A) in the Income Tax Act was introduced. This section provides that any resident who acquires a vested right in capital of a foreign trust consisting of income that accrued in a prior year and has not been subject to tax in South Africa yet, should include that amount in his/her income for that year. The reason for this anti-avoidance measure implemented in the Income Tax Act is to prevent the abuse of the tax system and is only applicable to amounts that have

## A COMPARISON OF THE TAX LEGISLATION OF TRUSTS BETWEEN SOUTH AFRICA AND ISRAEL

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not been subject to tax previously. In effect the income previously earned by the trust that has not been taxed in South Africa, that is the income from a non-South African source, is specifically included in the taxable income of the resident who obtains a vested right in such income. (Stiglingh *et al.*, 2010:761.)

### 2.6 CONCLUSION

In this chapter the different aspects of trusts were reviewed. An understanding was obtained of how trusts are formed, who the parties involved with a trust are and what the tax position of each of the parties is. The tax implications pertaining to trusts have been considered in detail as regards the normal tax.

It was confirmed that a trust is a person for tax purposes and that it will be taxed in South Africa on its worldwide income if it is a South African resident, but if it is a non-resident it will be taxed only on its income from a South African source.

The three parties that can be taxed in a trust can result in four different ways of incurring that responsibility based on sections 7 and 25B of the Income Tax Act. These are:

- the trust will be taxed. This will be the case where
  - there is no beneficiary with a vested right;
  - no amounts were distributed to any beneficiaries; and
  - none of the deeming provisions of section 7 is applicable;
- one or more of the beneficiaries will be taxed. This is the case where any amount accrues to the beneficiary or was distributed to the beneficiary and the provisions of section 7 do not apply;
- the trust and the beneficiaries will be taxed. This is the case where none of the provisions of section 7 applies. If any distributions are made the beneficiaries will be taxed on such distribution while the trust is taxed on the income that is retained in the trust; or

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- the donor will be taxed. In terms of section 7 the donor will be taxed on income that arose in the trust from a donation, settlement or other disposition by such donor and one of the specific provisions in sections 7(2) to 7(8) applies.

The Income Tax Act seeks first to tax the donors to the trusts on the income relating to the donations made to the trust and secondly to tax the beneficiaries who have acquired a vested right to the income of the trust. In the last resort the trust will be taxed on income retained in the trust. The income may, however, only be taxed once.

Beneficiaries obtaining a vested right to the capital of non-resident trusts will be taxed on the amount of the right acquired in the tax year in which they acquired the right if the income that accumulated into the capital has not been taxed before in South Africa.

In the next chapter the Israeli trusts will be reviewed to get a better understanding of their handling of trusts to do a comparison between the two countries.

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## CHAPTER 3

### 3 TRUSTS IN ISRAEL

#### 3.1 INTRODUCTION

As was noted in Chapter 1, trusts are used worldwide and different countries apply their own rules and tax regulations to trusts. In Chapter 2 the taxation of trust in South Africa was discussed. Trusts are also a familiar concept in Israel and are also used by their residents. Before a comparison can be made between South Africa and Israel on the taxation of trusts the legislation relating to the taxation of trusts in Israel needs to be reviewed.

#### 3.2 BACKGROUND

As mentioned in Chapter 1, the Israeli legal system has acknowledged the trust as an institution since the 1920's through the Charitable Trusts Ordinance enacted in 1923 which sets out the rules for a public trust (Harris *et al.*, Not dated). In 1948, Israel became independent and has since then developed its own legal system based on the English common law system (Kaplan, 2010). In 1979 the Trust Law was enacted which regulated private trusts for the first time. This does not mean that Israel did not acknowledge the concept of a trust. Before the enactment of the Trust Law the courts had to apply the foreign laws to trusts. Since the enactment of the Trust Law the Israeli courts have had the Israel domestic law to govern trusts. The Trust Law is based on the Anglo-American model (Harris *et al.*, Not dated).

The features of the Israeli trust are similar to that of the trusts known in South Africa. The trustee is entrusted with the control over the assets, but there are no specific prescriptions as to how the control is to be exercised. Normally the assets are transferred to the trustees who then obtain control. It is not necessary to have the assets transferred to the trustees for them to have control. It may be that the trustees are merely empowered to

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manage the assets thereby obtaining control. If the trustees are allowed to determine how to deal with the assets, they have effective control. (Harris *et al.*, Not dated.)

The Israeli tax legislation is contained in the Income Tax Ordinance [New Version] 5721 - 1961 (hereafter referred to as the "Ordinance"). Changes to the Ordinance are made by means of amendments. In 2003 Israel changed its tax law from a source basis to a worldwide basis (Kaplan & Dover, 2010). Chapter Four: B of the Ordinance deals specifically with trusts.

As part of their tax reform, the Rabinowitz Committee Report on Tax Reform recommended that the taxation of trusts be regulated through legislation. This was deemed necessary to close a loophole that arose on the implementation of Amendment 132. The Committee was of the opinion that Amendment 132 afforded tax evasion to taxpayers through the use of trusts. Based on that report a committee was established to investigate the matter. This committee, headed by Frieda Israel, submitted its recommendations in 2003. The matter was investigated further by the Kaputa-Matza Committee, which also recommended that the taxation of trusts be regulated through legislation. Following this, Amendment 147 to the Ordinance was passed by the Knesset (the Israeli parliament) in July 2005 containing the inclusion of sections 75G to 75R that specifically deal with the taxation of trusts. The chapter on trusts was to be effective from 1 January 2006. (STEP 2009:23).

In the following part of this chapter taxation legislation relating to the trust in Israel will be reviewed before focusing on the foreign trusts aspects later on in this chapter.

### 3.3 DEFINING TRUSTS FOR TAX PURPOSES IN ISRAEL

The legislation contained in Chapter Four: B of the Ordinance addresses the matter of trusts fully except for the Land Taxation Law (Betterment, Sale and Purchase) 5723 – 1963 which addresses the sale of fixed property or the right in fixed property (STEP, 2009: 23 & 55). This study only addresses the taxation of trusts as contained in the Ordinance.

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This part provides an overview of trusts in the context of Israeli taxation. This is done by reviewing the definitions and terms generally relating to the taxation of trusts in Israel. As mentioned in chapter 1.7.1, no official translation of the Ordinance could be obtained and therefore the review was done based on freely translated documents. The references in this chapter are based on unofficial translations prepared by Anglo Capital Limited in association with the Society of Trust and Estate Practitioners (“STEP”) and the freely translated copy of the Ordinance obtained from the website of the Israeli government.

Section 75C of the Ordinance, updated by Amendment 147, contains descriptions of definitions used in the chapter on the taxation of trusts. Key definitions were addressed in chapter 1.8 and only the definitions of beneficiary as set out in section 75E, revocable trust as set out in section 75C and trust donor as set out in section 75D, that require further clarity due to all the special provisions pertaining thereto, are addressed in this part. Other definitions that are specific to the Israeli Ordinance are also addressed here.

The definition of beneficiary as contained in section 75E makes provision for certain instances where a person is deemed to be a beneficiary. These deeming provisions clarify the position with regard to beneficiaries where there otherwise could be uncertainty whether the person is a beneficiary or not. The specific references are (STEP, 2009:28):

- in the event that there are certain conditions that need to be fulfilled before the beneficiary may become a beneficiary, that beneficiary is deemed to be a beneficiary, except if the condition is that the donor or another beneficiary must first die before the person can become a beneficiary. In that case the person is not a beneficiary as long as the donor or the other beneficiary is still alive;
- an unborn child can also be a beneficiary;
- where a beneficiary is a beneficiary in another trust that is a beneficiary to the first trust, that beneficiary will be deemed to be a beneficiary of the trust; and
- a person who controls an entity that is a beneficiary, other than a public institution, is deemed to be a beneficiary.



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The definition of a revocable trust is in essence a trust where the donor could retain or regain the assets or the income of the trust. Although this seems to be a simple straightforward matter, section 75C of the Ordinance contains a number of instances, which will cause the trust to be a revocable trust (STEP, 2009:24; Ordinance). These instances can be summarised as follows:

- where the trust may be cancelled or the assets transferred or returned to the donor or his/her spouse or to an entity controlled by them (spouse and entity are hereafter referred to as related parties when used in context with the donor);
- where the income of the trust could be transferred to the donor or related parties;
- where the donor or his/her spouse is one of the beneficiaries or may become a beneficiary;
- where any of the beneficiaries is a minor child (under the age of 18 years) of the donor or it is possible to make any distribution directly or indirectly to such child while the donor or his spouse is still alive;
- where any of the beneficiaries are entities, which are not public institutions, in which 10% or more of the control is held by the donor or related parties or his minor child while the donor or his spouse is still alive;
- where the trustee or the protector of the trust is the donor or an entity;
- where the trustee or the protector of the trust is a relative of the donor. If the Director of the Israeli Tax Authorities is satisfied that there are special circumstances which warrants the appointment of the relative and there will be no interference with the duties of the trustees, it will not result in the trust being a revocable trust;
- where the donor or his relative exercises any control over the trustee's activities the trust is deemed to be a revocable trust;
- where the identity of any of the direct or indirect beneficiaries is not known, unless it is proven to the satisfaction of the Assessing Officer that the beneficiary cannot be the donor or related parties or his minor child;
- where there were any changes to the beneficiaries without the trust documents instructing such changes; and

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- where the necessary documentation registering the trust as an irrevocable trust was not lodged with the authorities in the prescribed time. (STEP, 2009:24-25.)

As mentioned in the definition of “donor” in chapter 1.8, section 75D of the Ordinance provides for specific circumstances in which a person is deemed to be a donor of a trust. Over and above the person who directly or indirectly transferred an asset to a trust as donor, the following people are also deemed to be donors of a trust

- a person who had directly or indirectly a material interest in an entity when that entity donated an asset to the trust;
- where the trustee transfers assets to another trust after the death of the donors of the trust or when the beneficiaries of a trust were changed, without there being a specific instruction to this effect in the trust documents, then the beneficiaries are deemed to be the donor of the other trust or of the trust in which the beneficiaries were changed. If it can be proven to the satisfaction of the assessing officer that the beneficiaries had no influence on these changes or the transfer of the assets, then they are not deemed to be the donor of the trusts in question;
- a beneficiary who can exercise any control over the trust or the trustees is deemed to be a donor of the trust;
- where an Israel resident donates assets to a trust that was created by a foreign resident and the Israel resident or his relative is beneficiaries of the trust, then that Israel resident is a donor of the trust. (STEP, 2009:26-27.)

The aforementioned definitions are generally used in the context of trusts, also in South Africa. The Ordinance contains other terminology which is fairly specific to Israel and which needs to be understood in order to facilitate a comparison between South Africa and Israel. These are terms such as distribution, Israeli resident, foreign resident, trust asset holding company and veteran returning resident.

A distribution is defined as “the transfer of an asset or income by a trustee to a beneficiary, or to his favour, during the existence of the trust or due to its termination; the trustee must

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distribute the assets, rights and funds to the beneficiary, fully or partially, all in accordance with the trust documents” (STEP, 2009:29).

The literature reviewed emphasised that section 75C defines an Israeli resident in the widest possible manner and it includes a trust donor, who at the date of his death was an Israeli resident (STEP, 2009:30). The residency of the donor determines the residency of the trust and therefore this is very important.

A foreign resident is defined in section 1 of the Ordinance as “... anyone who is not an Israeli resident”. With regard to a trust donor, section 75C provides “... that a trust settlor, who at the date of his death, was a foreign resident, will be considered a foreign resident” (STEP, 2009:30).

A veteran returning resident is defined in the Israel Ordinance, section 14, and refers to an Israel resident who has returned to Israel to become a resident again after staying abroad for a minimum of ten consecutive years.

The trust protector is defined in section 75C of the Ordinance as the person who, in terms of the trust documents, has authority over the trustee as he/she can appoint or dismiss the trustee, issue instructions to the trustee, or needs to approve the trustee's actions (STEP, 2009:26).

Section 1 of the Ordinance defines a person as including a company or a body of persons. A body of persons is defined as “any public body, incorporated or amalgamated, and any company, fraternity, fellowship or society, whether incorporated or not”. Nothing in the Ordinance defines a trust as a person but the trust's tax liability is determined in terms of section 75F.

From these definitions it can be seen that there are a number of similarities with the South Africa trusts but there are also some differences. These aspects will be evaluated in detail as part of the comparison between South Africa and Israel to determine how the taxation

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of foreign trusts differs between the two countries. The Israeli Ordinance defines types of trusts with specific tax consequences for each type.

The Ordinance does not only define specific terminology used with regard to trusts, it also defines certain types of trusts that have specific tax implications. In Israel the Ordinance identifies four types of trusts with each having specific tax implications. The four types of trusts are:

- an Israeli resident trust;
- a foreign resident settlor trust;
- foreign resident beneficiary trust; and
- a trust created in terms of a will (STEP, 2009:33).

These trusts and the related tax implications will be reviewed to get a better understanding of how they work.

### **3.3.1 Israel resident trusts**

Section 75G of the Ordinance deals with Israeli resident trusts and defines an Israeli resident trust in section 75G(a) as a trust where at least one of the donors and one of the beneficiaries was a resident at the time of its creation and at least one of the donors and a beneficiary was an Israeli resident during the tax year. If the donor of this type of trust dies after the creation of the trust it will still be an Israeli resident trust irrespective of the residency of the beneficiaries (STEP, 2009:33).

The taxation of the Israeli resident trusts is governed by section 75G of the Ordinance. The beneficiaries, the donor or the trust can incur the tax liability.

In the event that the Israeli resident trust is an irrevocable trust and the income of the trust is distributed to an Israeli beneficiary that beneficiary will be taxed on that income. Any portion of the income that is not distributed will be taxed in the hands of the trust unless that income is taxable in the hands of the donor. The trustee should declare this

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distribution with the annual return submitted for the trust and the beneficiary should include this income in his/her tax return for the year (STEP, 2009:37-38).

The distribution of an asset to a beneficiary will be taxed under the capital gains sections of the Ordinance (STEP, 2009:39). The taxation of capital gains is beyond the scope of this review and thus no further consideration is to be given to the taxation pertaining thereto.

Where the Israeli resident trust is a revocable trust and there is only one donor, who is also an individual Israeli resident, the donor is taxed and not the trust. In this case the donor and the spouse are seen as one person. The donor and the trustee to the trust should file a notice with the tax authorities confirming that the donor will bear the tax. Once this choice has been exercised it will be applicable for future tax years and cannot be reversed. The donor can recover the taxes paid from the trust (STEP, 2009:39).

If there is any income in the trust that was not taxed either in the hands of the beneficiary or the donor as mentioned before, the trust will bear the tax on the same basis as an individual Israeli resident (STEP, 2009:36).

If a trust becomes an Israeli resident due to the fact that the donor became an Israeli resident or the donor is a veteran returning resident who returns to Israel, the trust will qualify for certain tax relief (STEP, 2010:15). Similarly if the trust becomes an Israeli resident trust due to the fact that any of the beneficiaries thereof becomes an Israeli resident, the tax relief is available to that trust also. The relief is found in sections 14(a), 14(c), 16, 97(b) or 97(b)(3) of the Ordinance.

In terms of section 14(a) relief of tax is granted for ten years after the person becomes a resident on income generated from operations or assets acquired outside Israel before such person became an Israeli resident. However, section 14(c) limits the relief of a returning resident to five years after his/her return to Israel on pension, royalties or dividends generated from operations or assets acquired while he/she was abroad and still held outside Israel after he/she became a resident.

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The tax exemption on interest granted to foreign residents in terms of section 16 will be granted for ten years. Section 97 deals with the capital gains aspects in this regard and is beyond the scope of this review.

The income and assets of this type of trust will be treated for tax purposes as if it is that of the donor and the trust will be taxed as an individual Israeli resident. If the trust fails to settle its tax debt the donors of the trust will be held liable for the tax of the trust, even if the donor is no longer an Israel resident, as determined by section 75O(b). Section 75O(e) authorises the trustee to recover any taxes that were paid on behalf of the beneficiaries from the relevant beneficiary.

A foreign resident settlor trust or a foreign resident beneficiary trust may also become an Israeli resident trust due to changes in the circumstances of the trust. This happens in the case where a beneficiary of a foreign resident beneficiary trust becomes an Israeli resident or where the donor of a foreign resident settlor trust becomes an Israeli resident. (STEP, 2009:33).

A trust created in terms of a will is specifically excluded from this definition in terms of section 75G(a)(3). That trust is specifically addressed in section 75L of the Ordinance.

The trust will carry on being treated as an Israeli resident trust and taxed as an Israel resident even after the donor ceases to be an Israeli resident.

The losses of the trust are ring-fenced in terms of section 75F and cannot be utilised by the donor or the beneficiary in determining their taxable income. If there are losses remaining on the termination of the trust, such losses will be available for setoff by the donor or beneficiary in terms of section 75N.

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### 3.3.2 A foreign resident settlor trust

The foreign resident settlor trust is, as the name indicates, a trust in which the donors are non-residents. For this trust to qualify as a foreign resident settlor trust all the donors should have been non-residents at the time of creating the trust and throughout the year should have remained non-residents (STEP, 2009:34).

The foreign resident settlor trust is specifically addressed in section 75I of the Ordinance. The income and assets of the foreign resident settlor trust is dealt with by the trustee in the same way as that of a foreign resident individual. The trust will be taxed on its Israeli source income only.

Where the income of an irrevocable trust is distributed during a year of assessment to an Israeli beneficiary such income will be taxed in terms of section 75G(g) in the hands of that beneficiary.

On the other hand, if the trust is a revocable trust the income of the trust will be deemed to be that of the donor in terms of section 75G(h) irrespective of whether the donor is an Israeli resident or not.

Losses in the trust are ring-fenced and cannot be distributed to beneficiaries or donors other than on termination of the trust. If there remain unutilised losses on the termination of the trust, such losses will be available to the donor for setoff in terms of section 75N against his other Israeli income in determining his taxable income (STEP, 2009:41).

Where assets are distributed to a beneficiary it is considered a direct transfer between the donor and the beneficiary and the tax determined based on the law applicable to the donor (STEP, 2009:40). Thus if the donor is not an Israeli resident there will be no tax implication based on the distribution.

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### 3.3.3 A foreign resident beneficiary trust

Section 75J deals with foreign resident beneficiary trusts and describes it as an irrevocable trust of whom all the beneficiaries throughout the year were non-residents of Israel and at least one of the donors was an Israeli resident. For the trust to obtain this status the trust documents should spell it out that no Israeli resident may become a beneficiary in the trust and that none of the beneficiaries is an Israeli who will become a beneficiary once he/she is no longer an Israeli resident (STEP, 2009:34).

The trust assets and the trust income will be treated as being held by an individual foreign resident. In essence the trust is taxed as a non-resident of Israel and thus is taxed on the income from Israeli sources only (Shine, M).

If the foreign resident beneficiary trust is terminated and there is an unutilised loss available for setoff against Israeli income it may be utilised by the beneficiary in determining his taxable income for that year (STEP, 2009:41-42).

In the year in which the foreign resident beneficiary trust is created the donor of the trust must, in terms of section 75J(a)(4)(b), submit within 90 days of the creation of the trust a notice to the revenue authorities in which it is indicated that the trust has no Israeli resident beneficiary and that no such beneficiary could be added to the trust beneficiaries. Failure to do so may result in the trust being taxed as an Israel resident trust in terms of section 75O(c).

Every year the trustee of the trust should submit a return to the Revenue Authorities indicating all the distributions made during the year and the detail of the beneficiaries to whom the distributions were made (STEP, 2009:50).



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### 3.3.4 A trust created in terms of a will

A trust created in terms of a will is addressed in section 75L of the Ordinance and is defined as a trust where all the donors of the trust were Israeli residents at the time of their death.

The taxation of the trust created in terms of a will is determined in terms of section 75L of the Ordinance. The assets and income will be deemed to be that of the beneficiaries. If at least one of the beneficiaries is an Israeli resident, the trust is deemed to be an Israeli resident, but if there are no Israeli beneficiaries the trust is treated as a foreign resident beneficiary trust and section 75J(c) and (e) will apply to the trust. Any distributions by the trust will be taxed in the hands of the beneficiaries (STEP, 2009: 44).

If the trust has only one beneficiary and that beneficiary is an Israeli resident the beneficiary will be taxable on the income of the trust in terms of section 75L(e) on the condition that the necessary returns have been lodged and approved by the revenue authorities. If the selection is made that the beneficiary will be the representative taxpayer. it will be fixed for the duration of the trust (STEP, 2009:43).

On termination of the trust, any unutilised losses that may be available for setoff against taxable income in Israel are available to the beneficiary for setoff against his/her taxable income in the normal course of completing his tax return (STEP, 2009: 44).

In the aforementioned paragraphs the different types of trusts have been reviewed. Each of these is subject to specific tax implications. In section 3.3 of this chapter the general principles relating to the Israeli trust will be reviewed as well as the instances in which the different parties to the trust incur tax liabilities.

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### 3.4 THE GENERAL PRINCIPLES PERTAINING TO THE TAXATION OF ISRAELI TRUSTS

The various definitions relating to trusts and the types of trust, together with their specific tax implications have been explained in chapter 3.2. In this part the general rules pertaining to the taxation of trusts as applied by Israel are considered. The liability to tax on the part of the donor, the beneficiary and the trust are also reviewed.

Israel's tax is levied on the basis of residence. This means that Israel's residents are taxed on their worldwide income. Non-residents are taxed on the source basis, that is, any income earned from Israel sources will be taxed by the Israel revenue authorities (Kaplan & Dover, 2010).

The trust is not a taxable entity in its own right and therefore the trustee is taxed as the representative taxpayer for the trust (STEP, 2009:30). The taxable income is determined based on the general tax principles applicable to Israeli taxpayers. The losses of the trust are ring-fenced and cannot be distributed to beneficiaries to set it off against the other income of a beneficiary. It can also not be utilised by the donor to set off against his income in the event that the donor is taxable on the income of the trust (STEP, 2009:31).

The tax status of the trust is determined based on the residency of the donor or the beneficiary depending on the type of trust as previously defined. In determining the tax status of the trust the residency of the donor is firstly considered and then the residency of the beneficiary (STEP, 2009:31). This was discussed in chapter 3.3.1.2 and chapter 3.3.1.3. The residency of the trustee has no influence on the tax status of the trust.

The tax rate applicable to the taxable income of the trust is described in section 75F(d) as the maximum rate specified in section 121 of the Ordinance. This section sets the tax rates for individuals. The trusts are therefore taxed at the maximum rate that individuals are taxed. The Ordinance makes provision for special tax rates that can be set by the Israeli Minister of Finance in terms of section 129C. If such a rate has been set, that special tax rate will apply. Although the trusts may qualify for special tax rates where

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these are applicable, they do not enjoy the benefit of exemptions allowed in terms of the Ordinance (STEP, 2009:31).

The income of the trust retains its identity when distributed to the beneficiaries; this is known as the conduit principle. The beneficiary is therefore entitled to claim the normal allowances and deductions afforded in the Ordinance. (STEP, 2009:38.)

The Ordinance makes specific provision for the use of an asset holding company. The asset holding company is used to ring-fence the assets within the trust, or where the trustee is required to formally separate the assets from his personal assets or from the assets of other trusts under his control (STEP, 2009:32). The Ordinance further provides that in the case where the assets are donated to the underlying company this is not deemed to be a sale. The underlying company is seen as “transparent” and all the assets and income relating thereto are deemed to be those of the trust. This underlying company also does not have to submit returns for tax purposes (STEP, 2009:32). The role of this underlying company is thus to have the assets registered in a separate entity from the trustee.

In general the trust’s income will be deemed to be that of the donor or the beneficiary depending on the nature of the trust as determined through the application of sections 75G, 75I, 75J or 75L. The residency of the beneficiary or donor depending on the case determines the type of trust and has the main impact on the tax status of the trust. This does not mean that the income and the assets of the trust are allocated to these parties. It is only used to determine how to tax the trust. The allocation of the income is done in terms of the specific prescriptions of the Ordinance (STEP, 2009: 30-31).

Trusts are taxed in terms of these general principles. The different types of trusts have specific regulations that determine their tax liabilities as was discussed in previous parts of this chapter. Ultimately it is the donor, the beneficiary or the trustee on behalf of the trust who incurs the tax liability.

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## 3.4.1 Liability of donor for tax on the income of the trust

One of the parties that may be held liable for the tax of the trust is the donor. The Ordinance provides for different types of trusts. An analysis of these trusts needs to be made in order to see who is responsible for the taxation of the income of the trust.

The main section of the Ordinance dealing with those aspects where the donor is taxable on the income of the trust is found in section 75G. This section deals with the Israeli resident trust. All the income of an Israeli resident trust will not be taxed in the hands of the donor, but in the event that the trust is a revocable trust, the donor will be taxed on the income of the trust.

The definition of a revocable trust was reviewed in chapter 3.3. Looking at this definition there are a number of instances in section 75G in which a trust can be a revocable trust. This is an indication that the Israeli revenue authorities look seriously at taxing the donor. In view of the importance of the tax liability of the donor the elements that would result in the donor incurring the tax liability are listed in with the definition of a revocable trust in section 75C and are:

- where the assets of the trust can be returned to the donor or related parties due to a transfer, distribution or cancellation of the trust;
- where the income can be transferred to the donor or related parties. This includes that the donor or his spouse is or can become a beneficiary to the trust;
- where any of the beneficiaries of the trust is a minor child of the donor or can become a beneficiary, whether directly or indirectly. Unless the minor child only becomes a beneficiary on the death of the donor;
- where any of the beneficiaries are entities in which 10% or more of the controlling interest is held by the donor or his spouse or their minor child, while the donor or his spouse is still alive;
- where the trustee or the protector is the donor or an entity or a relative of the donor, unless it can be proven to the revenue authorities that there are special circumstances that warrant the relative to be thus appointed;
- where the donor or his relative exercise any control over the trustee

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- where the identity of any of the beneficiaries is not known, unless it can be proven that the unidentified beneficiaries are not the donor or his spouse or their minor child or an entity controlled by them;
- where any changes are made with regard to the beneficiaries without it being required in the trust deed; and
- where the trust was not registered as an irrevocable trust with the revenue authorities.

Over and above the impact of section 75G on the taxation of the trust income in the hands of the donor, there are the conditions of section 75F1 that also confirm that the income from an Israeli resident trust is seen as the income of the donor. If there is no Israeli resident trustee in a trust, the trustee and the donor may elect to have the donor as the representative taxpayer for the trust. In the case of a trust for Israeli residents, the donors may elect to have one of them in terms of section 75F1(b)(3) as the representative taxpayer for the trust.

If the trust fails to settle its tax debt the donors of the trust are held liable for the tax of the trust, even if the donor is no longer an Israeli resident, as determined by section 75O(b).

### **3.4.2 Liability of beneficiary for tax on the income of the trust**

A number of the sections relating to the different types of trusts provide for the beneficiaries to be taxable on the income of the trust. These are sections 75F1, 75G and section 75L.

In terms of sections 75G(g) any distribution to the beneficiaries will be taxed in the hands of the beneficiaries. In the event that there is no Israeli trustee in a trust created in terms of a will and there is more than one beneficiary the beneficiaries may elect in terms of section 75F1(b)(4), read with section 75L(e), to have one of the beneficiaries the representative taxpayer for the trust.

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If there is only one beneficiary in a trust created in terms of a will, then section 75L provides that the beneficiary will be taxable.

Section 75O(e) authorises the trustee to recover any taxes that were paid on behalf of the beneficiaries from the relevant beneficiary.

### **3.4.3 Liability of trust for tax on the income of the trust**

In terms of section 75F(b) the trust income will be considered to be the income of the donor or the beneficiary based on the principles of sections 75G, 75I, 75J or 75L.

The trust will be taxed on the taxable income that was generated or that accrued during the tax year. Although the income of the trust is described as the income of the donor or the beneficiary it does not accrue to them unless specified in the Ordinance that it accrues to them (STEP, 2009:30-31). If the income accrues to the donor or the beneficiaries in terms of the mentioned sections of the Ordinance they will be taxed on that income, else the trust will be liable to tax. In this case the trustee will be the representative taxpayer, unless it was agreed between the trustee and the donors in terms of section 75G(h) or section 75F1 or between the trustee and the beneficiaries in terms of section 75F1 or section 75L that one of them will be the representative taxpayer. In these cases the necessary notices should be filed with the revenue authorities.

### **3.4.4 Reporting requirements for trusts**

The trusts have to submit different reports to the income tax authorities at various stages. The main reporting requirements as contemplated by section 75P will be reviewed. This section places reporting requirements on the donor, the trustee and the beneficiary.

The onus is on the donor to report the creation of a trust for Israeli residents and the conversion of a trust created by foreign residents to an Israeli resident trust or to a foreign resident beneficiary trust to the revenue authorities, in terms of section 75P1.

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Any donor who created a trust in Israel during a tax year should submit a return in terms of section 131(a)(5b)(1) (STEP, 2009: 48). The donor of the foreign trusts should file an annual return with the revenue authorities in the year that the trust is created and in every year that he transfers assets to the trust. That report should identify the trustee, the protector and the beneficiaries together with their residency. If an Israeli resident creates a foreign resident beneficiary trust his/her return should also contain a declaration that there is no Israeli resident beneficiary in the trust and that no such beneficiary may be added to the trust in future (Kaplan & Dover, 2010).

The trustee of a foreign resident beneficiary trust is required to submit an annual return for its Israeli source income and assets. If there is no income or assets from an Israeli source in the trust a special return should be filed to declare that the trust complies with all the conditions to be a foreign resident beneficiary trust. If the trustee fails to submit this return it will be taxed as an Israeli resident trust (Kaplan & Dover, 2010).

The trustee of a foreign settlor trust must submit an annual return only in the tax year that the trust had income or assets from an Israeli source. The return should report on the details of the donor, each of the beneficiaries, any dates of distribution as well as the details of assets distributed. The residency of the trustee has no effect on the filing of the returns (Kaplan & Dover, 2010).

Section 75P2 places the responsibility for the registration of a trust created in terms of a will on the trustee of that trust. Such registration should be done within 90 days from the creation of the trust.

Where an Israeli beneficiary received an asset from any trust as distribution, that beneficiary must declare such distribution with his next tax return irrespective of whether that distribution is taxable in Israel or not, as required by section 75P3.

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## 3.5 TAXATION OF FOREIGN TRUSTS UNDER THE ISRAELI ORDINANCE

The residency of a trust is determined by the residency of the donor or that of the beneficiary, depending on the type of trust.

Foreign trusts are determined based on the type of trust, that is the foreign resident settlor trust or the foreign resident beneficiary trust. The trust will be taxed in the normal way that non-residents are taxed in Israel that is on the source base. As such a foreign trust will be taxed on income generated from Israel sources. Any distributions from the trust to Israeli beneficiaries will be taxed in the hands of the Israel resident irrespective of its source.

## 3.6 CONCLUSION

The Ordinance regulating the taxation of trusts in Israel has been effective since January 2006 but the submission of the first returns was postponed a number of times. The first tax returns for the 2006 to 2008 tax years were only due by the end of December 2009 with the result that enforcement would probably only be effected in 2010. At the time of conducting this study no specific information could be obtained on whether the first returns were filed.

The Ordinance provides for four types of trusts namely an Israeli resident trust, a foreign resident settlor trust, a foreign resident beneficiary trust and a trust created in terms of a will.

The beneficiaries are taxed on any distributions to them from the trusts. The revenue authorities prefer to tax the donor on the income of the trust. This is concluded based on all the conditions prescribing that a trust will be revocable trust in which case the donor will be liable to tax. A foreign resident settlor trust and a foreign resident beneficiary trust will be taxed on the income generated from Israeli sources while an Israeli resident trust will be taxed on the residence basis, in other words on its worldwide income.

The rate at which a trust is taxed is the maximum marginal rate applicable to individuals.



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## CHAPTER 4

### 4 COMPARISON

#### 4.1 INTRODUCTION

As mentioned in the introduction to chapter 1, large portions of the offshore investments in the world are held through trusts. It has been noted that South African residents are also investing more in offshore markets since the relaxation of exchange control (Roper, 1999:3; SARS, 2010:428). Enquiries made to a senior SARS official dealing with high net worth individuals within South Africa, confirmed that South African residents, and especially people from the Jewish community, hold investments in Israel through trusts. Both countries have tax legislation to specifically deal with the taxation of trusts. The Israel Ordinance has been changed with effect from 2006 to cater specifically for trusts. The first returns to have been submitted in terms of this new legislation were due in 2009.

The principles relating to the trusts and the taxation thereof as applied by the two countries have been reviewed in this document. In chapter 2 the legislation of South Africa was reviewed and in chapter 3 that of Israel. In this chapter a comparison will be made between the two countries' legislation and taxation of trusts, including foreign trusts. The comparisons will be done under the sub-headings of defining the trusts, the general tax principles relating to trusts, the tax liability of the donor, the tax liability of the beneficiaries, the tax liability of the trust and lastly the taxation of foreign trusts. In the last instance the reporting requirements of the two countries will be compared and the chapter will be closed off with a summary paragraph.

#### 4.2 COMPARING THE DEFINITIONS OF TRUSTS IN SOUTH AFRICA AND ISRAEL

Firstly a comparison will be made of the basic aspects relating to trusts. The basic legal framework relating to trusts will be compared between the two countries. The comparison will also address the parties to the trust and some of the rights attached to them.

## A COMPARISON OF THE TAX LEGISLATION OF TRUSTS BETWEEN SOUTH AFRICA AND ISRAEL

**Table 2: Defining trusts**

Concept	South Africa	Israel
The basic legislation pertaining to trusts.	<ol style="list-style-type: none"> <li>1. Trust Property Control Act. This Act governs the legal aspects regarding trusts.</li> <li>2. Income Tax Act. Various sections of this Act address trust and the taxation thereof.</li> </ol>	<ol style="list-style-type: none"> <li>1. Land Taxation Law. This Act deals with the transfer of fixed property or the right to fixed property.</li> <li>2. The Ordinance. Chapter Four: B of the Ordinance is the main part in the Ordinance that covers the taxation of trusts.</li> </ol>
The parties to a trust are: <ul style="list-style-type: none"> <li>• The donor.</li> <li>• The trustee.</li> <li>• The beneficiary.</li> </ul> There can be more than one of each of these parties.	Yes. Yes. Yes.	Yes. Yes. Yes.
Specific instances where a person may be deemed to be a beneficiary : <ul style="list-style-type: none"> <li>• Unborn child.</li> <li>• Beneficiary of another trust via linked trusts.</li> <li>• Person who exercises control over a beneficiary.</li> </ul>	Yes, as long as it is part of a category of beneficiaries described in the trust deed.  Yes, in terms of the connected person definition.  Yes, in terms of connected person test.	Yes.  Yes.  Yes.
Rights of beneficiary: <ul style="list-style-type: none"> <li>• Vested right.</li> <li>• Discretionary right.</li> </ul>	Yes.  Yes.	Yes.  Yes.
The rights of the beneficiaries can also be split on the following basis: <ul style="list-style-type: none"> <li>• Income rights.</li> <li>• Capital rights.</li> </ul>	Yes.  Yes.	Yes.  Yes.
Timing of formation of trust: <ul style="list-style-type: none"> <li>• Trust created by the donor while he or she is still alive.</li> <li>• Trust created in terms of a will.</li> </ul>	Yes.  Yes.	Yes.  Yes, section 75L deals specifically with trusts created in terms of a will.

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Concept	South Africa	Israel
Non-resident trust should submit return to declare any changes of parties to the trust or transfer of assets to the trust.	Trustee.	Donor.
A person who had a direct or indirect interest in an entity when that entity made a donation to the trust will be deemed to be a donor of the trust.	May apply on basis of connected person.	Yes.
Where the assets of a trust are transferred to another trust after the death of the donor or the beneficiaries are changed without it being a requirement of the trust, the beneficiary will be deemed to be the donor of the new trust.	No specific provisions but it may happen that in terms of connected person test that this could be the case.	Yes.
A beneficiary who can exercise control over the trust or over the trustees of a trust will be deemed to be the donor of that trust.	Not specifically provided, but the connected person test could result in this being applicable.	Yes.
Where a resident makes a donation to a trust that was created by a non-resident and the resident or his relatives are beneficiaries of the trust, that resident will be deemed to be a donor of the trust.	Not specifically, but the connected persons test may result in this being applicable.	Yes.

This comparison demonstrates that the basic elements regarding a trust and the formation thereof is very similar in both South Africa and Israel. The Israeli Ordinance addresses a number of aspects very specifically such as deemed beneficiaries and a trust created in terms of a will, while the South Africa Income Tax Act addresses the matter of deemed beneficiaries through the definition of connected persons.

### 4.3 PRINCIPLES PERTAINING TO TAXATION OF TRUSTS

The reviews of the tax regulations of the two countries have indicated a large number of similarities but some definite differences were noted. Through the comparison below these similarities and differences are clearly seen.

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**Table 3: Principles pertaining to the taxation of trusts**

Principle	South Africa	Israel
Tax is determined on residence basis. This means that residents are taxed on their worldwide income.	Yes.	Yes.
Non-residents are taxed on source basis.	Yes.	Yes.
The main sections in the Income Tax Act/Ordinance dealing with specific aspects of trusts: <ul style="list-style-type: none"> <li>• Definitions.</li> <li>• Taxation of the donor.</li> <li>• Taxation of the beneficiary.</li> <li>• Taxation of the trust.</li> <li>• The rate of taxation of trusts.</li> </ul>	<p>Section 1.</p> <p>Section 7.</p> <p>Section 25B(1) read with sections 7(1) and 25B(2).</p> <p>Section 25B(1).</p> <p>Section 5.</p>	<p>Section 75C.</p> <p>Section 75D read with section 75G.</p> <p>Section 75E read with section 75G.</p> <p>Section 75F.</p> <p>Section 75F(d).</p>
Capital gains aspects.	Section 26A, as well as paragraphs 68 to 73 and paragraph 80 of the Eighth Schedule of the Income Tax Act.	Part Five of the Ordinance deals with capital gains. Various subsections of sections 75F, 75G, 75H, and 75N refer to capital gains elements. As capital gains tax is not part of this study no further detail is deemed necessary here.
Revocable trusts.	The concept is not specifically defined in the Income Tax Act, but sections 7(6) and 7(7) effectively provide for situations where the donor retains certain rights to revoke income or assets of the trust.	Section 75C specifically defines a revocable trust and cases in which a trust will be deemed to be revocable. If a trust is a revocable trust the donor will be taxed on the income of the trust.
Trust defined as person.	Yes	No.
Can a trust be taxed as a resident?	Yes, residency of a trust is determined based on its effective place of management or the place where it was formed.	Israel resident trust defined in section 75G.
Can a trust be defined as non-resident?	Yes, residency of a trust is determined based on its effective place of management.	Ordinance provides for two types of non-resident trusts. These are a foreign resident settlor trust (section 75I) and a foreign resident beneficiary trust (section 75J).

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Principle	South Africa	Israel
Rates of taxation applicable to trust's income.	Per section 5 maximum rate applicable to individuals.	Per section 75F(d) read with section 121 maximum rates applicable to individuals.
Preferred parties to be taxed.	The order in which the income of trusts are sought to be taxed is firstly in the hands of the donor, secondly in the hands of the beneficiaries and lastly in the hands of the trust.	The trust will be taxed on its income, unless the Ordinance specifically attributes the income to a donor or to the beneficiary.
Trustee is representative taxpayer for the trust.	Yes.	Yes. The parties may also choose to have the donor or the beneficiary as the representative taxpayer in certain instances.
Trusts do not qualify for any special exemptions applicable to individuals.	Except if it is a special trust.	Yes.
Conduit principle applies to the income of trusts.	Yes.	Yes.
Party liable for tax can claim the expenses relating to the income.	Yes.	Yes.
Losses of trust are ring-fenced.	Yes.	Yes, but if losses remain on the termination of the trust such losses may be utilised by the donor or beneficiary as the case may be in terms of section 75N.
Asset holding company can be used to hold the assets of the trust. Such company will not itself be taxable.	No mention.	Yes.
Trusts liable to tax must submit tax returns annually.	Yes.	Yes.

As is evidenced by the above comparison the principles applied by the two countries agree to a large extent. Differences were noted mainly with regard to revocable trusts that are defined clearly in section 75C of the Ordinance, while the Income Tax Act addresses this in terms of the definition of connected person in section.1. The Income Tax Act in section 1 specifically includes a trust in the definition of person while the Ordinance does not contain a similar definition, but it specifically provides that a trust will be subject to tax through its representative taxpayer. It is in this aspect that there is a difference between the South Africa principle and that of Israel, in that in Israel the donor or beneficiary can be appointed as representative taxpayer in place of the trustee. Both countries' tax legislation ring-fence any tax losses in a specific year, but the Ordinance makes provision in section

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75N that if there is an unutilised tax loss on the termination of the trust that such loss may be available to the donor or the beneficiary depending on the type of trust.

## 4.4 LIABILITY OF DONOR FOR PAYING TAX

The donors are the first people on whom the revenue authorities focus to charge with the taxation of the trust. In South Africa section 7 of the Income Tax Act is the main section used for this purpose, while the Ordinance achieves this through defining a trust in section.75C as a revocable trust.

**Table 4: Liability of donor for tax**

Basis on which donor will be liable to tax	South Africa	Israel
Revocable trusts.	The concept is not specifically defined in the Income Tax Act, but sections 7(6) and 7(7) effectively provides for situations where the donor retains certain rights to revoke income or assets of the trust.	Section 75C specifically defines a revocable trust and cases in which a trust will be deemed to be revocable. If a trust is a revocable trust the donor will be taxed on the income of the trust in terms of section 75G(h).
Donation to trust by one spouse where the income based on that donation accrues to the other spouse where the main purpose in making such donation was to reduce the tax liability of the donor spouse.	Section 7(2).	Not directly indicated.
Donation by parent to a trust where the income based on that donation accrues to the minor child.	Section 7(3).	Yes.
An "indirect" donation whereby a minor child of a parent benefits.	Section 7(4).	No, unless the trust is revocable.
Where the donation to the trust is made subject to provisions that prevent the trustees to distribute the income of the trust to the beneficiaries, the donor will be taxed.	Section 7(5).	No, unless the trust is revocable.
Donor retains the right to revoke the rights of a beneficiary or to transfer the rights to another.	Section 7(6).	Yes.

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Basis on which donor will be liable to tax	South Africa	Israel
Donor retains the ownership of the asset or the right to retain the ownership.	Section 7(7).	Yes.
Resident donor donates to a trust for the benefit of non-resident beneficiary or a non-resident trust that would have been taxed if that beneficiary or trust were a resident.	Section 7(8).	No, unless trust is revocable.
Where donor or his/her spouse is one of the beneficiaries or can become a beneficiary.	No.	Yes.
While the donor is still alive and he or his spouse or his minor child holds 10% or more interest in an entity.	Yes, subject to connected person test.	Yes.
Where the trustee or the protector is the donor or an entity.	No.	Yes.
Where the trustee or the protector is a relative of the donor.	No.	Yes.
Where the donor or his relative exercise any control over the trustee's activities.	Yes, subject to connected person test.	Yes, unless there are special circumstances.
Where the identity of any of the beneficiaries cannot be determined.	No.	Yes.
Where any changes are made to the beneficiaries without it being an instruction in terms of the trust deed.	No.	Yes.
Where the necessary documentation was not lodged with the revenue authorities to register the trust as an irrevocable trust.	No.	Yes.
Non-resident donors who become residents or returning veteran residents enjoy tax relief for period of between five and ten years before they become taxable.	No.	Yes.
Failure by trust to settle its tax liability can result in the donor being held liable for tax.	No.	Yes, for Israeli resident trust and also if the donor of foreign resident beneficiary trust failed to submit the declaration to the revenue authorities on creation of the trust.

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The main differences identified in this comparison are that in the case of South Africa trusts the donors will in certain cases be taxable on the income of a trust where such income arose due to the donation made in favour of another while in terms of the Ordinance such arrangements will result in the donor being taxed if the trust is a revocable trust.

A number of instances are noted from this comparison indicating that the Israeli Ordinance is more stringent than that of South Africa with regard to taxing the donors. These occur in cases where the donor, his spouse or minor child is or can become a beneficiary of the trust, or where the donor is a trustee or even where the donor is an entity. Other instances are where the trustee is a relative of the donor, or the identity of a beneficiary cannot be ascertained, or where changes were made to the beneficiaries whilst it is not prescribed by the trust deed. If the trust is a trust for Israeli residents and it was not registered in the prescribed period as such with the revenue authorities of Israel, it will also be a revocable trust with the resulting tax consequences for the donor.

Section 14 of the Ordinance contains a provision for certain tax relief in the case where the founders of a non-resident settlor trust becomes Israeli residents for the first time or are returning veteran residents. These trusts will enjoy exemption from taxation on the income generated by the foreign assets for a period between five and ten years after they became residents. This provision has obvious benefits for immigrants who want to move to Israel but are concerned about the immediate tax implications. The Income Tax Act does not make provision for such tax relief.

The Ordinance also specifically provides for circumstances where the trust cannot settle its tax debt and in this case the donor could be called upon to settle the tax debt, irrespective of whether the donor is still a resident of Israel.



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## 4.5 LIABILITY OF BENEFICIARY FOR PAYING TAX

The beneficiary is also a person that could be liable for tax on the income of the trust. Although the regulations are not as severe as with those pertaining to the donors, there are specific provisions governing the tax liability of beneficiaries.

**Table 5: Liability of beneficiary of tax**

Basis on which beneficiary will be liable to tax	South Africa	Israel
Income on vested rights.	Section 25B(1) read with section 7(1).	Yes, section 75L and 75J. In case of section 75J there will be no tax as the beneficiary is a non-resident.
Income on discretionary right will be taxed on distributions by trustee.	Yes, section 25B(2).	Yes, section 75G(g).
Can deductions be claimed by the beneficiaries on the income that is taxable in their hands?	Yes, section 25B(3).	Yes, section 75F.

It is clear that the two countries treat the tax in the hands of the beneficiaries in the same way.

## 4.6 LIABILITY OF TRUST FOR PAYING TAX

In terms of the tax practices applied by the two countries the trust is effectively the last person of the parties to a trust that will incur a tax liability.

**Table 6: Liability of trust for tax**

Basis on which trust will be liable to tax	South Africa	Israel
Trust will be taxed on income that has not been taxed in the hands of the donor or the beneficiary.	Section 25B(1).	Section 75F.
Representative taxpayer for trust	Trustee.	Trustee. The parties may also choose to have the donor or the beneficiary as the representative taxpayer in certain instances.

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Basis on which trust will be liable to tax	South Africa	Israel
Failure by trust to settle its tax liability can result in the donor being held liable for tax.	No.	Yes, for Israel resident trust and also if the donor of foreign resident beneficiary trust failed to submit the declaration to the revenue authorities on creation of the trust.

In determining the tax liability of the trust itself, the two countries apply the same principles, but the Ordinance provides that if the trust is not able to settle its tax liability then the tax could be recovered from the donor irrespective of whether the donor is still a resident of Israel.

### 4.7 TAXATION OF FOREIGN TRUST

The taxation on foreign trusts in both countries is done on the source basis. There may be differences in the way that the residence of the trust is determined.

**Table 7: Taxation of foreign trusts**

Basis on which foreign trust is taxed	South Africa	Israel
Income is taxable on the source base.	Yes	Yes.
How is residence determined?	The place where the trust was formed or the place of effective management of the trust determines its residence.	The Ordinance provides for types of foreign trusts, namely a foreign resident settlor trust and a foreign resident beneficiary trust.
Beneficiaries will be taxed on distributions in the year in which the income was earned and distributed to them.	Yes.	Yes.
Where beneficiary obtains a vested right in any capital in a non-resident trust will that be taxable in the hands of the beneficiary?	Yes, in the year that they obtain the right they will be taxed thereon in terms of section 25B(2A).	Yes, if foreign resident beneficiary trust becomes Israel resident trust, but certain tax relief may apply.

The above comparison confirms that the trusts are based on the same principles, but the difference is in how the two countries determine whether a trust is a foreign resident trust.

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While the Ordinance identifies two types of foreign trusts in sections 75I and 75J, South Africa bases the residence of the trust in terms of section 1 on the place where the trust carries on its business or where it has a permanent establishment.

## 4.8 REPORTING REQUIREMENTS

For the revenue authorities to tax the trusts they need to know that a trust exists, what the income of the trust is and who is liable to tax on the income. They therefore require certain parties to lodge notices with them and to submit returns.

**Table 8: Reporting requirements**

Reporting requirement	South Africa	Israel
Registration of trust for tax purposes	By trustee	Donor.
Any disposition to a trust made during a tax year by a donor	Yes, section 7(10).	Yes, section 131.
Asset holding company to submit tax returns	Not applicable	No.
Non-resident donor trust becomes resident trust	No such trust in Income Tax Act.	Donor.
Annual tax return where taxable income accrued	Yes.	Yes.

A trust needs to be registered with the revenue authorities in terms of section 75P1 of the Ordinance, while in South Africa the trust is registered in terms of section 4 of the Trust Property Control Act with the Master who appoints the trustee(s). The trustee is then in terms of the Income Tax Act responsible to see to it that the trust complies with the regulatory requirements imposed on it.

## 4.9 CONCLUSION

In this chapter a comparison of the tax legislation of the two countries indicated that the trusts are treated very similarly. The main differences are in how the tax liability of the donor, who in both sets of legislation is the primary target for tax on the income of the trust, is determined and how the two countries go about determining the residence of a

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trust. Another important difference identified is the tax incentive provided in the Israeli Ordinance for immigrants to Israel or former Israeli residents returning to Israel.

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## CHAPTER 5

### 5 CONCLUSION

#### 5.1 INTRODUCTION

This study was conducted on trusts. The main focus was to determine how trusts are taxed by South Africa and Israel respectively and also to identify similarities and differences between the taxation of trusts.

It has been confirmed that the trust is an age-old instrument dating back to the mediaeval times. It is thus no wonder that trusts play an important role in the lives of the residents of both South Africa and Israel.

#### 5.2 OBJECTIVES

The objectives of this study was

- to review the tax measures South Africa currently employs in the taxation of trusts, including foreign trusts. This was done in chapter 2;
- to review the tax measures Israel employs in the taxation of trusts and foreign trusts. This was discussed in chapter 3; and
- to compare the South Africa taxation of trusts with that of Israel to identify similarities and differences. This was discussed in chapter 4.

#### 5.3 TRUSTS IN SOUTH AFRICA

For purposes of taxation in South Africa, a trust is defined as a person and is therefore subject to tax in terms of the Income Tax Act. The main sections of the Income Tax Act governing the taxation of trusts and its related parties are sections 7 and 25B. The Income Tax Act seeks to tax the donor first, secondly the beneficiary and lastly the trust.

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Where a beneficiary obtains a vested right in the capital of non-resident trust and that capital consists of accumulated income that was not previously taxed in South Africa, the beneficiary will be taxed on that capital in the tax year that the vested right was obtained.

Non-resident trusts will be taxed in South Africa on income from South Africa sources.

Trusts are subject to tax at the maximum marginal tax rate applicable to individuals.

### **5.4 TRUSTS IN ISRAEL**

Chapter Four: B of the Ordinance, containing sections 75C to 75R, deals specifically with trusts in Israel. The Ordinance became effective from January 2006 and the first returns to be filed in terms of the Ordinance were for the tax years 2006 to 2008 which returns were to be filed by the end of 2009. The results on how the Ordinance works in practice were not available at the time of this study.

The Ordinance defines four types of trusts each with its own tax implications. These are Israel resident trusts, foreign resident settlor trusts, foreign resident beneficiary trusts and trusts created in terms of a will. The Ordinance also contains a large number of instances that will cause the trust to be deemed to be a revocable trust.

The donor will be taxed on the income of the trust if it is a revocable trust and the beneficiaries will be taxed on any income distributed to them.

A foreign resident settlor trust and a foreign resident beneficiary trust will be taxed in Israel only on income generated from Israeli sources.

The trusts are taxed at the maximum marginal tax rate applicable to individuals.

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## 5.5 COMPARISON BETWEEN SOUTH AFRICA AND ISRAEL

It was established that the trust principles of the two countries both contain an element of English law but that this is not the only legal element used by them to develop their respective laws regarding trusts. It was therefore not strange to find that the basic laws regulating trusts are the same.

Both countries have changed their tax base from the source base to the residence basis in the last decade. South Africa changed its tax base to the residence base with effect from 2001 and Israel changed its base from 2003. Following the change in Israel to the residence basis of taxation, it also introduced specific legislation contained in sections 75C to 75R, dealing with trusts and the taxation thereof with effect from 2006. Despite the fact that the first returns for trusts under the new legislation for the tax years 2006 to 2008 were due by the end of 2009, at the time of this study no information was found on whether those returns were filed in terms of the Ordinance. No information could thus be obtained to determine whether the new requirements of the Ordinance for trusts are working. South Africa though has only done amendments to its tax legislation where deemed necessary to ensure that the taxation of trusts is addressed. The tax legislation of South Africa is reviewed regularly and amendments are made as deemed necessary, but the legislation is updated at least once a year. The study was thus limited to the review and comparison of the legislation and interpretations as no practical experience has been gained on the Israeli application of the new requirements of the Ordinance.

As the Ordinance has a chapter dealing specifically with trusts while the Income Tax Act addresses trusts in various sections, it seems as if the Ordinance addresses some aspects regarding trusts more clearly than does the Income Tax Act. A careful consideration of the two sets of legislation demonstrates that there are more similarities than what was thought at first.

Differences were found, the most notable are the specific types of trusts defined in the Ordinance, each with its own tax consequences, and the extensive definition of what constitutes a revocable trust. The more specifically the trusts are defined the more

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opportunities there may be for taxpayers to arrange affairs to circumvent the tax system. Also by having an extensive definition of a revocable trust it creates the impression that it is a comprehensive definition that excludes other scenarios that are not specifically addressed in the legislation.

Other differences noted were the fact that where foreign resident trusts become resident trusts of Israel there is some tax relief for those trusts and where the trust failed to pay the taxes levied the donor would be held liable for the tax. The tax relief offered to trusts that become Israeli resident trusts is for a period of between five and ten years and relates to the income based on non-Israel source assets as long as those assets are held offshore. This has the benefit of inviting foreigners to become Israel residents or former residents to return to Israel. During the period of the tax relief they can settle properly in Israel before they incur tax liabilities on the income from those offshore assets.

### **5.6 RECOMMENDATIONS FOR FUTURE STUDIES**

This study was limited to the evaluation of tax legislation on normal tax on trusts only. It did not cover the area of capital gains tax nor was the double tax treaty agreement between South Africa and Israel considered.

As no returns have been submitted in terms of the requirements of this Ordinance there is good reason to evaluate the practical aspects of how this Ordinance was implemented and what amendments were required to the initial legislation as contained in the Ordinance.

The double tax treaty agreement between South Africa and Israel would warrant a detailed analysis to determine the implications thereof.

The aspect of capital gains is specifically contained in both the Income Tax Act and the Ordinance. These are specialised aspects that warrant an in-depth study.



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