

**DETERMINING THE RESIDENCE OF A TRUST:
A SOUTH AFRICAN INCOME TAX PERSPECTIVE**

by

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*Thesis presented in fulfilment of the requirements for the degree Master of Laws
(with Specialisation in Tax Law) at the
University of Stellenbosch*



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December 2013

DECLARATION

By submitting this thesis, I declare that the entirety of the work contained herein is my own, original work, that I am the sole author thereof (unless to the extent explicitly otherwise stated), that reproduction and publication thereof by the Stellenbosch University will not infringe any third party rights, and that I have not previously in its entirety or in part submitted it for obtaining any qualification.

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SUMMARY

In the tapestry of history the subjects of trusts and taxes are frequently interwoven. Owing to such frequent interaction, one may assume that all significant aspects regarding the taxation of trusts have long since been resolved. This would be an incorrect assumption as for example, one quite fundamental and important issue, the tax “residence” of a trust, has not been adequately considered. Residence forms the cornerstone of our taxation system in South Africa and is an important pre-requisite for taxes to be imposed upon a trust. Yet as the residence of a trust has received little attention from South Africa's legislature, judiciary, fiscal authorities and legal authors, it remains an area of uncertainty, which potentially undermines our taxation capacity. This thesis therefore seeks to address this lacuna in our law.

In South Africa, the Income Tax Act, 58 of 1962, provides a definition for the term "residence." This statutory definition is critically analysed so as to assess its meaning and practical application in a trust setting. In so doing, certain deficiencies and aspects giving rise to uncertainties are identified and recommendations made for the legislature to intervene. The guidance provided by the South African Revenue Service in its Interpretation Notes, and Discussion Paper, is also assessed. Historical judicial precedent is reviewed and the recent case of the *Oceanic Trust Co Ltd No v Commissioner of SARS* which dealt specifically with this topical issue, considered.

The approach followed in South Africa is further compared to that followed in the international tax treaty setting, and in particular, the Organisation for Economic Co-operation and Development's (OECD) model tax convention and its commentaries, critically analysed. More specifically the approach in two foreign jurisdictions, Canada and the United Kingdom, are also investigated so as to identify suggestions for possible reform and development. Against the underlying justification for a residence-based taxation and the objectives it seeks to achieve, an analysis of the various tests for the residence of a trust is conducted so as to determine the most appropriate and effective test to be applied in the South Africa income tax setting, and recommendations made.

OPSOMMING

Die geskiedenis toon dat die vakgebiede van trusts en belasting al vir eeue nouliks verweef is aan mekaar. Teen so 'n agtergrond, sou 'n aanname gemaak kon word dat alle belangrike aspekte rakende die belasting van trusts, al lank reeds aangespreek is. Dit sou egter nie korrek wees nie aangesien een fundamentele aspek, die inwoner-status van 'n trust, nog nie voldoende oorweeg is in ons reg nie. Die bepaling of 'n persoon 'n inwoner is al dan nie, vorm die hoeksteen van Suid-Afrika se belastingstelsel, en is 'n belangrike voorvereiste vir die heffing van omvattende belasting op die trust. Die bepaling van die inwoner-status van 'n trust het egter nog bitter min aandag geniet van die Suid-Afrikaanse wetgewer, regbank, fiskale owerheid en akademici. Dit bly gevolglik 'n area van onsekerheid wat die moontlikheid inhou om ook ons belastingbasis te beperk. Gevolglik stel hierdie studie ten doel om hierdie lacuna in ons reg te vul.

In Suid-Afrika, word die begrip "inwoner" gedefinieer in die Inkomstebelastingwet, no 58 van 1962. Hierdie statutêre omskrywing word krities ontleed om sodoende die betekenis en praktiese toepassing in 'n trust konteks te bepaal. Sekere tekortkominge en aspekte wat lei tot onsekerheid word geïdentifiseer en voorstelle gemaak vir die wetgewer om in te gryp. Die Suid-Afrikaanse Inkomstediens se Interpretasie Notas, asook Besprekingsdokument, wat hiertoe relevant is, word ook oorweeg. Historiese sake asook die onlangse saak van die *Oceanic Trust Co Ltd v Commissioner of SARS* waarin hierdie aktuele onderwerp, spesifiek hanteer is, word geanaliseer.

Die benadering wat in Suid-Afrika gevolg word, word dan vergelyk met die benadering gevolg in die konteks van internasionale belastingverdrae. Veral die modelbelastingverdrag en gepaardgaande kommentaar van die Organisasie vir Ekonomiese Samewerking en Ontwikkeling, word krities ontleed. Meer spesifiek word die benadering van twee buitelandse jurisdiksies, Kanada en die Verenigde Koninkryk, ook ondersoek om sodoende moontlike voorstelle vir ontwikkeling in ons reg te identifiseer. Teen die onderliggende regverdiging vir 'n inwoner-gebaseerde belastingstelsel en die doelwitte wat dit nastreef, word 'n analise van die verskillende toetse vir die bepaling van die inwoner-status van 'n trust dan uitgevoer om sodoende die mees effektiewe en toepaslike toets vir aanwending in die Suid-Afrikaanse inkomstebelasting konteks, te bepaal en word voorstelle daartoe gemaak.

ACKNOWLEDGEMENTS

Charles Caleb Colton, an eighteenth century English cleric and writer, had said, "Much may be done in those little shreds and patches of time which every day produces, and which most men throw away." This thesis is a culmination of such slivers of time, accumulated - albeit not always as consistently, and not as many as may be wished for - over a period of three and a half years from the few hours left after work's end and before rising for the next day, from snatches of weekends and leave days. Yet, it is also a product of the valuable time so graciously and generously offered by many others, and to whom, I wish to express my heartfelt thanks and appreciation here.

To Professor Annet Wanyana Oguttu of the University of South Africa, who had overseen the initial chapters of this work, thank you for your guidance and motivation at the beginning of this journey. To my promotor, Mr Pieter Oosthuizen of the University of Stellenbosch, thank you for your patience and support through the remainder of this long journey. Thank you for the many hours you have spent reading and re-reading, adding valuable comments and insights, and above all, thank you for your continuous encouragement.

Thank you also to my family, including Wouter, for the many ways you contributed in making this study possible. To my sister, Mari, thank you for the countless hours spent with me at the JS Gericke library, and at work – your camaraderie and unwavering support, is greatly appreciated. To my father, Rev. MG Müller, thank you for every one of your Sunday evening calls over the years, always hoping on progress and constantly encouraging me regardless. Thank you for installing a love of learning in us, and for believing in me.

Lastly, though foremostly, to our heavenly Father, this work stands a testament of Your Grace, without which it would not have been possible.

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CHAPTER ONE: INTRODUCTION

1 1 Background

In the tapestry of history the subjects of trusts and taxes are frequently interwoven. Indeed even the origins of the trust can be traced to medieval times where its ancestral forerunner, termed the “Use,” was developed, inter alia, to limit the potential exposure to harsh and oppressive feudal taxes.¹ One would therefore assume that given the lengthy effluxion of time since then, and the frequent interaction between these two subjects, all issues regarding the taxation of trusts have long since been resolved. Such an assumption would be incorrect.

One quite fundamental and important issue which has not been adequately addressed is the “residence” of a trust. In a tax context, “residence” resorts under the fiscal jurisdiction whereby a state authority levies taxes. Essentially, fiscal jurisdiction refers to the right and power of a state to impose taxes.² To exercise fiscal jurisdiction a 'connecting factor' between the taxing state and the intended taxpayer, or asset, must be established.³ In South Africa, since 2001, fiscal jurisdiction is primarily based on “residence” as the connecting factor.⁴ Thus in relation to trusts, the “residence” of a trust is of particular importance to establish fiscal jurisdiction for South Africa, whereafter it may impose and collect taxes from the trust.

However this aspect, the residence of a trust, is one which has received little attention from the South African legislature, judiciary and legal authors,⁵ with the same unfortunate occurrence in other countries, which also apply residence-based taxation.⁶ Indeed, in South Africa, the relevant

¹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 247; Moffat G *Trusts Law Text and Materials* 4th ed (2005) at 32-33; Haynton DJ *The Law of Trusts* 2nd ed (1993) at 12. See also discussion in Chapter 2 regarding the history of trusts.

² Danzinger E *International Income Tax The South African Perspective* (1991) at 13; Tillinghast DR *Tax Aspects of International Transactions* (1978) at 1.

³ Danzinger E *International Income Tax The South African Perspective* (1991) at 13.

⁴ South Africa applies a “residence minus” system which entails that resident taxpayers are taxed on their worldwide income with certain categories of income and activities undertaken outside South Africa exempted. Non-resident taxpayers are taxed on their South African sourced income. South African Revenue Services “Briefing Note: Residence Basis of Taxation” (2000) available at <http://www.info.gov.za/speeches/2000/000918340p1006.htm> -last accessed on 01/05/2013; Olivier L & Honiball M *International Tax: A South African Perspective* 5th ed (2011) at 19.

⁵ Only a few academic writers have considered this issue in detail – see Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009); Du Plessis I “The Residence of a Trust for South African Income Tax Purposes” 2009 (21) *SA Merc LJ* 332 - 343.

⁶ Baker notes “there is a small number of judicial decisions and rulings around the world relation to trusts and international taxation.” Baker P “The Application of the Convention to Partnerships, Trusts and Other, Non-Corporate Entities” 2002 (2) *GITC Review* at 13.

statutory provisions do not define the term in relation to trusts at all.⁷ The guidance provided by the South African Revenue Service in its Interpretation Notes,⁸ is aimed at individuals and companies, whilst its recently released Discussion Paper, is expressly limited to domestic and foreign companies.⁹ Yet, remarkably, and somewhat ironically then, the first case to be heard by the courts since South Africa's change-over to a residence-based taxation, and which concerned the tax residence of an entity, was not in relation to a company, but in respect of a trust.¹⁰ Unfortunately due to the particular nature of the application and the relief sought in that case, the issue could not be considered in-depth, and thus the scarcity of guidance for trusts, remain.¹¹

The case does however illustrate that the residence of a trust is a crucial aspect, one which deserves greater attention in our legal system. For purposes of providing a background to this important aspect, the focus will firstly be on the abundant use of trusts, secondly on the usefulness of trusts as an economic and social institution, and lastly on the significance of the residence basis for taxation in relation to trusts, before the problem statement is presented. It is also an issue, which is sure to become of greater importance as an increasingly globalised world obviates national borders and traditional norms, and complicates the factors by which "residence" is determined.¹² Consequently it is this issue the thesis will seek to address.

1 1 1 The Trust - a legal institution applied in abundance

As a legal concept, the trust idea can be described as the idea whereby a person or persons (called the trustee or trustees), holds or administers property separately from their own, for the benefit of another person or persons (called the beneficiaries) or in furtherance of a charitable or other purpose.¹³ Fundamental to the trust idea is thus a separation between the control and/or

⁷ Section 1 of the Income Tax Act 58 of 1962 does not expressly define same in relation to trusts.

⁸ The South African Revenue Service (SARS) have issued a Briefing Note and two Interpretation Notes (Interpretation Note 3 issued 4 February 2002 and Interpretation Note 6 issued 26 March 2002).

⁹ In September 2011, a Discussion Paper on Interpretation Note 6 was issued by SARS.

¹⁰ *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127. Gutuza provides confirmation that the matter has yet to come before the courts in the context of companies. – Gutuza, T "Analysis: Has Recent UK Case Law Affected the Interplay Between 'Place of Effective Management' and 'Controlled Foreign Companies?'" (2012) 24 *SA Mercantile Law Journal* 424.

¹¹ As it was an application for declaratory relief, the Western Cape High Court found it had no jurisdiction to decide factual issues, which must be decided by the Tax Court.

¹² See in particular the discussion at paragraph 1 2 2 below.

¹³ Cameron E, De Waal M, Wunsh B, Solomon P & Kahn E *Honoré's South African Law of Trusts* 5th ed (2002) at 1. The distinction between trusts in a "wide sense" and trusts in a narrow sense as well as the legislative and judicial definitions for a trust will be discussed in Chapter 2.

ownership over the assets and the benefit of the assets held under such control.¹⁴ The trust idea is housed in the legal institution referred to as a trust.

It has been said of the trust idea that it is the crowning achievement of the English jurisprudence¹⁵ – an often-quoted statement of Prof Maitland¹⁶ underscores this view,

“If 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.”

If judged by the abundant and extensive use of trusts in various jurisdictions, this statement of Professor Maitland certainly holds true. Both local and foreign statistics reflect the ever-increasing popularity of the trust, and bear testimony to the significant impact the trust idea and hence, the trust has had in the world.

In South Africa, the popularity of the trust is evident from statistics such as the 2012 Tax Statistics issued jointly by the South African Revenue Services and National Treasury which records that currently 301 365 trusts are registered as taxpayers in South Africa.¹⁷ An independent study estimates that approximately 87 new trusts are registered per business day.¹⁸ The Fiduciary Institute of South Africa puts the average figure of new trusts registered for each year over the past three years at 16 500 per annum.¹⁹ Honiball and Olivier²⁰ rightly therefore remark that “there has

¹⁴ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 2; Du Toit F *South African Trust Law Principles and Practice* (2002) at 2.

¹⁵ PriceWaterHouseCoopers “A Dubious Decision on Trusts by the Tax Court” 2008 (February) *Synopsis Tax Today* at 4.

¹⁶ Maitland F “The Unincorporated Body” in *Collected Papers* (1911) 271; Olivier et al *Trust Law and Practice* (November 2011) at 1-10.

¹⁷ The year-on-year growth of this figure has been as high as 12.4% in the 2004/05 tax year but the last positive year-on-year growth was in 2009 at 2% with 392 260 trusts registered as taxpayers. In the 2010 tax year the number declined with 15.4%, for the 2011 tax year a decline of 1.6% was recorded and for the 2012 tax year a decline of 7.7% - SARS and National Treasury *2012 Tax Statistics* - available at <http://www.sars.gov.za/home.asp?pid=64671>, last accessed on 01/05/2013. The author postulates that this decline may partially be attributed to the window of opportunity granted by SARS to allow for primary residences to be transferred from trusts and corporate entities without adverse tax consequences till December 2012, with the termination of the trust/entity a requirement in order to make use of the relief so provided.

¹⁸ Coetzee JP ‘n *Kritiese Ondersoek na die Aard en Inhoud van Trustbegunstigdes se regte ingevolge die Suid-Afrikaanse reg* (Doctoral thesis) (April 2006) at footnote 5 on page 2 where the Coetzee records that between 1995 and 2005 at the Master’s offices of Cape Town, Pretoria, Bloemfontein, Grahamstown, Bisho and Pietermaritz-burg, a total of 249 319 *inter vivos* trusts were registered.

¹⁹ Du Preez, L “Plan to tax capital gains as income will kill discretionary trusts” - Published 3 March 2012 on Personal Finance – available at <http://www.iol.co.za/business/personal-finance/tax/plan-to-tax-capital-gains-as-income-will-kill-discretionary-trusts-1.1479432>. Last accessed on 01/05/2013.

²⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at vii.

been an astonishing proliferation of trusts in South Africa,” or as Kernick explained the phenomenon in more vivid terms, “more and more trusts were formed and the number of trusts grew like asparagus in May, and trustees, if not dukes, were three a penny.”²¹

In other countries, trusts are also a popular investment vehicle. This is especially so in common law countries such as the United Kingdom, the United States of America and countries such as Scotland and Canada(Quebec), Australia and New Zealand.²² In the United Kingdom, as released earlier this year, the number of trusts which completed a Self-Assessment Return for the 2010/2011 tax year, was 164 000 contributing £1,705 million to the revenue collection.²³ Across the Atlantic Ocean, in the USA, the number of domestic trusts which filed returns for tax, doubled since the mid 1970’s with almost 3 million trusts that filed in 2009.²⁴ In New Zealand, the Law Commission has commented on the growth in the utilisation of trusts, by stating that “the impression gained is that the number of trusts has grown steadily over at least the last 20 to 30 years and that New Zealanders, have a predilection for trusts beyond that experienced in similar countries.”²⁵ In its neighbouring country, Australia, a Compliance Programme was released earlier this year, recording that there has been “a significant growth in the use of trusts” with over 700,000 registered trusts in its tax system.²⁶ Such overwhelming numbers lead Professor Haynton to state that “one cannot even hazard a guess at the amount of trust funds world-wide.”²⁷

Even countries which traditionally do not have the trust concept in their domestic laws, such as historically civil law countries, are increasingly prepared to recognise the trust.²⁸ In this regard, the

²¹ Kernick, L “The Future of Trust Law: Declaration of Independence” *De Rebus* (2007) at 27-29.

²² Olivier et al *Trust Law and Practice* (November 2011) at 1-15. Also Haynton DJ *The Law of Trusts* (1993) at 1.

²³ Latest available statistics for the UK. HM Revenue & Customs KAI Personal Tax *Trusts Statistics* (Released 31 January 2013) – Table 13.1. Available at <http://www.hmrc.gov.uk/statistics/trusts/intro.pdf>. Last accessed on 01/05/2013. Trusts are acknowledged as conferring “significant advantages on the British financial system, not least because US investors, the world’s most enthusiastic exporters of portfolio capital, are familiar with the trust concept, but Japan, the world’s biggest creditor country, also uses trust law. Plender, J in the The Haynton Report available at <http://www.trustees.org.uk/word/The%20Haynton%20Report.doc> – last accessed 02/05/2013.

²⁴ Data from the IRS *Statistics of Income* <http://www.irs.gov/pub/irs-soi/10estrustsnap.pdf>. Last accessed on 01/05/2013. The US Internal Revenue Service further estimates that by 2015, \$4.8 trillion in wealth will be transferred from one generation to the next, with much of it through trusts. STEP “Trusts Explained.” Available at [http://www.step.org/PDF/Trusts Explained.pdf](http://www.step.org/PDF/Trusts%20Explained.pdf) - Last accessed on 01/05/2013.

²⁵ New Zealand Law Commission *Review of the Law of Trusts Second Issues Paper* (Dec 2010) at 9.

²⁶ Australian Tax Office “Compliance in Focus 2013/2014” released on 15 July 2013. Available at <http://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/General-statistics/Compliance-in-focus-2013-14/?page=22> – last accessed on 05/09/2013.

²⁷ Haynton DJ *The Law of Trusts* 2nd ed(1993) at 1

²⁸ Haynton DJ *The Law of Trusts* 2nd ed(1993) at 1. If the world’s main common law jurisdictions are

Hague Convention on the Law Applicable to Trusts and on their Recognition²⁹ plays an important role. It is an international multilateral convention which specifically aims to facilitate and promote the recognition of trusts in "non-trust" countries.³⁰ It is hoped of the Convention that as the "influence of the trust in domestic legal systems spreads, there is reason to suppose that the Convention may prove a more widespread success."³¹ Some already attribute it as the cause of an "international evolution," which went beyond the mere adoption of conflict rules for countries on how to deal with trusts and their recognition, to also stimulate fresh attention to trusts and act as catalyst for legal reform, whereby institutions which would qualify as trusts under the Convention, have been introduced and accepted in the domestic laws of countries where the trust was not recognised previously.³² France and the People's Republic of China are examples of countries which have already done so, with other countries such as Italy to shortly follow suit.³³

Thus the trust, already a popular institution in the countries of its origin and historical development, will likely become a more recognised and globally applied institution in the years to come.

1 1 2 The importance of the Trust – its versatility and utility

It is however not only statistics but also the "multitude of diverse purposes to which trusts are put,"³⁴ which serve as affirmation that the trust idea is certainly one of the most distinctive achievements in legal jurisprudence, as contended by Prof Maitland. In this regard, Du Toit³⁵ observes that "the trust, more so than its legal counterparts, lends itself to utilisation in diverse circumstances and towards the achievement of a veritable assortment of purposes." The trust's

excluded, 53 jurisdictions worldwide are said to now provide by way of statute or code expressly or impliedly for a "trust" per Lupoi M (ed) *Trust Laws of the World* (2000) as quoted in Waters D "The Future of the Trust" 2006 (13) 4 *Journal of International Trust and Corporate Planning* at 180.

²⁹ Hague Conference on Private International Law *Convention on the Law Applicable to Trusts and on their Recognition* – concluded 1 July 1985.

³⁰ Duckworth states that "...the primary purpose of the Convention was to require the recognition of trusts by non-trusts states..." in Duckworth A 1999 (13) *Trust Law International* 158 at 162.

³¹ Harris J *The Hague Trusts Convention Scope, Application and Preliminary Issues* (2002) at 427.

³² Smith L *Re-imagining the Trust: Trust in Civil Law* – Chapter 2 Graziadei, M *Recognition of common law trusts in civil law jurisdictions under the Hague Trusts Convention with particular regard to the Italian experience* at 32-33; E-book available at <http://ebooks.cambridge.org.ez.sun.ac.za/pdf>. Last accessed on 01/05/2013.

³³ Smith L *Re-imagining the Trust: Trust in Civil Law* at 33; E-book available at <http://ebooks.cambridge.org.ez.sun.ac.za/pdf>. Last accessed on 01/05/2013.

³⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 1.

³⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 163.

extraordinary versatility and usefulness is perhaps most aptly described by Le Paille³⁶-

“They are like those extraordinary drugs curing at the same time toothache, sprained ankles and baldness, sold by peddlers on the Paris boulevards; they solve equally well family troubles, business, religious and charitable problems. What amazes the sceptical civilian is that they really do solve them.”

Trusts are employed in various contexts. For example, trusts are commonly used in the context of estate planning,³⁷ where according to Davis³⁸ they “play an enormous role” and “are the hallmark of most modern estate plans.”³⁹ Also in the realm of private wealth, trusts are applied for the following purposes: asset holding (to hold assets for the benefit of persons legally incapacitated, or restrained to do so, where a beneficiary is a minor, a prodigal, or suffers from mental or physical deficiencies);⁴⁰ asset protection (a trust exists independently and thus its assets are protected against the creditors and insolvency of the beneficiaries of the trust, as well as its trustees in their personal capacity);⁴¹ continuity and the preservation of assets over generations; facilitating multi-ownership of assets and settling matrimonial and maintenance disputes,⁴² to name but a few. Honiball attributes their popularity to their inherent flexibility and their relative lack of regulation.⁴³ To this may be added that trusts are comparatively easy and inexpensive to establish, and enjoy a longevity that may stretch over several generations.

However it is not only in the context of individuals and private relationships that trusts are applied, but also in the public and social sphere where trusts perform a vital function. Here, trusts for charitable and other impersonal objectives, such as religious, educational or cultural causes are examples. This function of the trust is not new, having emerged as far back as the sixteenth century

³⁶ Le Paille in “Civil Law Substitutes for Trusts” 36 *Yale Law Review* 1147 as quoted by Olivier L & Honiball M in *International Tax: A South African Perspective* (2011) at 114.

³⁷ In estate planning the trust idea and the consequential separation of ownership and enjoyment it allows, is often applied successfully by estate owners to divest themselves from growth and/or income-producing assets - thereby minimizing the payment of potential taxes.

³⁸ Davis DM, Beneke C & Jooste RD *Estate Planning Service Issue 37* (May 2013) at 5-3 and 14-3.

³⁹ Haupt comments that trusts are “the most popular method of overcoming the problems encountered in estate planning.” Haupt P *Notes on South African Income Tax 2013* (32nd ed) at 768.

⁴⁰ King R & Victor B refer to it as “custodianship”- King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 259.

⁴¹ This is subject to application of normal insolvency rules – see King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 260. This feature may offer protection not only in a business context, but also from claims arising from a matrimonial relationship – Geach thus remarks that the trust can protect a beneficiary from the “beneficiary’s own difficulties and indiscretions. Geach WD & Yeats J *Trusts Law and Practice* (2007) at 216.

⁴² King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 260.

⁴³ Honiball, M “Offshore Pour-Over Trusts and the Voluntary Disclosure Programme” Presentation to the Cape Law Society on 22 September 2010 – available at www.capelawsoc.law.za, last accessed 07/05/2013.

during the decline of the Church and feudal control.⁴⁴ Today, such trusts have far exceeded their humble beginnings and the funds under their control are staggering.⁴⁵

A further area where the trust's status as an important role-player is on the rise is in the commercial arena. Du Toit⁴⁶ lists several purposes to which the trust is applied in this context:

“trusts feature in the fiscal strategy of many individuals and corporate entities, businessmen frequently elect to structure business ventures as trusts rather than companies, close corporations or partnerships, companies utilise trusts to secure the interest of share and debenture holders, health and insurance enterprises employ trusts to manage medical aid schemes and pension funds whereas investment enterprises facilitate investment through various trusts schemes. And as any trusts practitioner will attest: the aforementioned applications of the trust represent only the proverbial tip of the iceberg.”

Locally it has been remarked that there has been an upsurge in trusts formed for business purposes,⁴⁷ a tendency which has been judicially noted in the Supreme Court of Appeal.⁴⁸ Recently a new tax dispensation for real estate investment trusts (REITS) have been introduced, which is anticipated to attract both local and foreign investment, and thus grow the property investment market.⁴⁹ The increased use of trusts for commercial purposes is however not a circumstance

⁴⁴ Haynton DJ *The Law of Trusts* 2nd ed (1993) at 102; Moffat G *Trusts Law Text and Materials* 4th ed (2005) at 833.

⁴⁵ For example the Bill and Melinda Gates Foundation Asset Trust forms part of a two tier structure which was established in 2006 by prominent Microsoft cofounder, Bill Gates and his wife. Its objectives include improving health care and education, alleviating poverty and promoting access to information technology. At financial year end 2010 the market value of assets exceeded \$36 billion. Information sourced from <http://money.howstuffworks.com/10-largest-foundations-in-the-world.htm#page=1> and see <http://www.gatesfoundation.org/Who-We-Are/General-Information/Foundation-Factsheet> Last accessed 01/05/2013. Similarly The Wellcome Trust of the UK, ranked third largest in the world has an financial endowment (invested donations) of \$26,4 billion.

⁴⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 1.

⁴⁷ As per a Press Statement released by the Standing Advisory Committee on Company Law of 8 February 1985 quoted in the South African Law Commission *Report on the Review of the Law of Trusts* (June 1987) Project 9 at 92.

⁴⁸ *Land and Agricultural Bank of SA v Parker* 2005 2 SA 77 (SCA) at 87G-H.

⁴⁹ It must be noted that “REITS” do not only denote trusts as it includes both “trust reits” which are the former property unit trusts (PUT) and “company reits” which is to replace property loan stock companies (PLS). The legislative amendments were introduced by the Taxation Laws Amendment Act and came into effect on 1 May 2013. Stated to be a “significant development for SA publically traded real estate ” and to “ring in a new era -Anon “May 1st marks the beginning of SA REIT Structure” published 01/05/2013 by SA Commercial Property News – available at <http://www.sacommercialpropnews.co.za/business-specialties/property-investment-south-africa/5915-may-1st-marks-the-beginning-of-sa-reits-structure.html> It also aligns South Africa with the international community as REITS are a recognisable investment vehicle over the world, with more than 25 countries utilising it. It is already attributed to providing upliftment and growth in the market sector – Anon “ REIT Legislation uplifts Listed Property Sector.” – published 15/04/2013 by SA Commercial Property News, available at <http://www.sacommercialpropnews.co.za/business-specialties/property-investment-south-africa/5869-reit-legislation-uplifts-listed-property-sector.html>. All articles accessed on 07/05/2013.

peculiar to South Africa. It is said that “in several European countries business transaction commonly require the use of trust” and that there is an increase in the frequency of “litigation related to the trust law issues in a business context.”⁵⁰ Prof Hayton estimates that in the UK possibly 90 per cent of trust assets by value, is housed in commercial trusts, whereas fifty years earlier this would have been found in family trusts.⁵¹ These applications of the trust in various contexts do not constitute a closed list. It has been fittingly remarked that trusts can “...be used to serve an almost indefinite variety of objects”, whilst “new uses for the trust are constantly being invented.”⁵²

From the above discussion it is clear that trusts are employed in vast numbers in South Africa, and in other countries around the world. Equally apparent is the conclusion that trusts are an immensely popular institution in the legal and the commercial practice, and are vehicles of extraordinary versatility and practical utility. Yet central to any entity’s attractiveness is its taxation.

1 1 3 The Basis for Taxation of Trusts – a South African Perspective

Taxation is a principal consideration in the utilisation of any entity. It not only impacts on the choice of the entity to be established, but also on the continued application of such entity.⁵³

To establish the taxation structure applicable to an entity, the relevant taxation laws applicable to the entity must first be ascertained. Taxation or the right to tax, forms part of a state’s sovereign powers.⁵⁴ Thus, regard must be had to the domestic laws of a particular state. Although in theory a state’s domestic taxation laws may be unlimited in its application, it is still required to be effective and enforceable.⁵⁵ Danziger⁵⁶ explains that this requirement of effectiveness obligates states to adhere to the principle, that tax laws should only affect tax subjects (taxpayers) and tax objects (assets) to the extent there is a link or connection, which justifies the taxing of the tax subject, or object, in question. This connecting factor is determined by each state independently. In the words

⁵⁰ Graziadei M, Mattei U & Smith L- excerpt from *Commercial trusts in European Private Law: the Interest and Scope of the Enquiry* Cambridge University Press at 3.

⁵¹ Hayton, D & Ward, S in The Haynton Report available at <http://www.trustees.org.uk/word/The%20Hayton%20Report.doc> – last accessed 02/05/2013.

⁵² Cameron et al *Honoré’s South African Law of Trusts* 5th ed (2002) at 15.

⁵³ Moffat G *Trusts Law Text and Materials* (2005) at 69 explains that “whether trusts should be created, what types of trusts should be adopted and where their administration should be located, are all decision taken by property-owners only after careful consideration of the fiscal implications.”

⁵⁴ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 1; Danziger *International Income Tax The South African Perspective* (1991) at 4.

⁵⁵ Danziger E *International Income Tax The South African Perspective* (1991) at 4.

⁵⁶ Danziger E *International Income Tax The South African Perspective* (1991) at 4.

of Tillinghast⁵⁷-

“A nation’s assertion of taxing jurisdiction is a policy decision like any other – a purely mortal determination of the extent to which it is just, or prudent, to subject the income of various persons and entities to the exercise of a primal, and generally onerous, governmental power.”

States predominantly make a selection between “source” or “residence” as the primary connecting factor. By using “residence” as a connecting factor, a link is established between the state and the taxpayer based on the residence of the taxpayer within its jurisdiction, regardless of where the income is earned.⁵⁸ In *Kergeulen Sealing and Whaling Co Ltd v CIR*⁵⁹ a possible justification for the application of this principle is given, “a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him.” On the other hand, by using “source” as a connecting factor, a connection arises when income is earned within the jurisdiction of the relevant state. The underlying premise to this taxation base is also set out in the aforementioned case, in that “a country that produces wealth by reason of its natural resources or the activities of its inhabitants, is entitled to a share of that wealth, wherever the recipient of it may live.”⁶⁰

These connecting factors are not always applied to the exclusion of the other, and often a state will apply aspects of both.⁶¹ South Africa's taxation base serves as an example of the latter. Since 2001, South Africa applies a primarily residence based jurisdiction and taxes residents on their worldwide income, whilst non-residents are taxed on income sourced in South Africa.⁶² This structural change to the South African tax system was deemed necessary to ensure that South Africa keeps pace with globalisation and to facilitate the integration of South Africa with the world economy.⁶³ In relation to trusts, it is thus important to establish where they are tax “resident” and to do so, regard must firstly be had to the legal framework, by which a trust is recognised as a taxpayer.

Due to its particular historical development in South Africa,⁶⁴ a trust is not recognised as a legal

⁵⁷ Tillinghast D *Tax Aspects of International Transactions* (1978) at 4.

⁵⁸ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 19.

⁵⁹ 1939 AD 487 at 507.

⁶⁰ *Kergeulen Sealing and Whaling Co Ltd v CIR* 1939 AD 487 at 507.

⁶¹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 10.

⁶² See footnote 4 above.

⁶³ Trevor Manuel, Minister of Finance in the 2001 Budget Speech delivered on 21 February 2001 – available at <http://www.treasury.gov.za/documents/national%20budget/2001/speech/speech.pdf> - last accessed on 01/05/2013.

⁶⁴ Olivier et al *Trust Law and Practice* (November 2011) – see discussion in Par 1.6 at 1-18.

person, but an institution *sui generis*.⁶⁵ It is perceived to be “an accumulation of assets and liabilities” that, although it forms a separate institution, is not a legal persona.⁶⁶ For tax purposes however, the Income Tax Act (58 of 1962) has specifically been amended in 1991, to also include a trust in the definition of a “person.”⁶⁷ Thus for income tax and capital gains tax purposes, a trust is regarded as a “person” and thus capable of being taxed.

The mere fact that a trust is regarded as a “person” for income tax purposes is not enough for a tax liability to arise. The further components of the definition by which income is taxed⁶⁸ and by which a capital gain⁶⁹ arises, must be met. Specifically one such component is distinctive in the consequences it prescribes, namely that of “residence.” If the trust meets this requirement and is regarded as “resident” in South Africa, it can potentially be taxed on its worldwide income and capital gains.⁷⁰ Conversely, if it is not regarded as being “resident” in South Africa, it may still be taxed should it source income within South Africa, or dispose of its interest in immovable property situate in South Africa, resulting in a capital gains tax liability, and in certain instances, anti-avoidance provisions of the Act may be triggered.⁷¹ “Residence” is therefore an all important term to the application of the income tax framework.

The term “resident” is defined in Section 1 of the Income Tax Act.⁷² Essentially a distinction is made

⁶⁵ *Braun v Blann & Botha NNO* 1984 (2) SA 850 (A) at 859E.

⁶⁶ *Thorpe v Trittenwein* 2007 (2) SA 172 (SCA).

⁶⁷ S (1) (d) of the Taxation Laws Amendment Act 129 of 1991.

⁶⁸ Section 1 of the Income Tax Act 58 of 1962.

⁶⁹ Eighth Schedule to the Income Tax Act 58 of 1962.

⁷⁰ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 234. If it is not regarded as “resident” in South Africa it may still be taxed should it source income from South Africa.

⁷¹ See discussion at Chapter 4; Also Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.8 available electronically on LexisNexis.

⁷² S1 of the Act. The draft Taxation Laws Amendment Bill published on 5 July 2012 for public comment and introduced to Parliament on 25 October 2012 (Taxation Laws Amendment Bill, Bill 34 of 2012) sought to amend the current definition by essentially expanding the exclusions to the definition. These amendments are referred to by the National Treasury as the “Financial Centre of Africa initiatives” and are aimed at providing relief to South African multinationals from double taxation as well as to foreign-owned investment funds managed by South African-based managers, thereby enhancing South Africa as a financial centre and establishing it as the pivotal entry point to Africa. Subsequently the Taxation Laws Amendment Act, no 22 of 2012 was assented to on 30 January 2013. Thus effective from 1 January 2013 in respect of any year of assessment commencing on or after that date, the definition of “resident” now includes these further provisions which aims to exclude foreign companies and foreign investment entities from being regarded as resident under certain circumstances. The Media Statement issued by the National Treasury on 5 July 2012 at www.treasury.gov.za/comm_media/press/2012/2012070501.pdf (last accessed on 01/05/2013) and the Act is available at <http://www.sars.gov.za/AllDocs/LegalDoelib/AmendActs/LAPD-LPrim-AA-2012-03%20-%20Taxation%20Laws%20Amendment%20Act%202012.pdf> (last accessed on

between the meaning of the term in relation to natural persons and the meaning of the term in relation to persons other than natural persons. As a trust is not a natural person, it falls into the category of the second group. In respect of the latter, the term is defined as meaning-

“any person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic...”⁷³

Thus, in respect of persons other than natural persons, such as trusts, there are two criteria for determining residence, namely whether the entity is “incorporated, established or formed in the Republic” or whether the entity has its “place of effective management in the Republic.” These criteria operate in a dissociative manner, in that should either one of the criteria be met, such entity will be regarded as “resident” in the Republic.

There is no definition or explanation of these criteria in the Act itself and consequently their meaning must be determined through interpretation. This then leads to the aim of this study: the challenge, from a South African income tax perspective, to interpret these criteria specifically in the context of trusts.

1 2 Statement of the Problem

This challenge to determine the fiscal residence of a trust, stems from the South African Revenue Services (SARS)' own identified and mandated objective: prior to the changeover from a source-based to a residence-based tax jurisdiction, and to facilitate the conversion, SARS issued a Briefing Note on the Residence Basis of Taxation.⁷⁴ In this Note it succinctly stated that “as a worldwide system is based on residency, it is of crucial importance that there is certainty of what the term means.” Yet in relation to trusts, no effort has been made to establish such certainty.

In the Briefing Note no mention was made of trusts and in the subsequently published Interpretation Note,⁷⁵ the focus was on corporate entities. As Du Plessis⁷⁶ aptly remarks, “plainly,

03/05/2013). These specific exclusions are revisited later in this chapter, and in further detail in chapter 6.

⁷³ The section specifically then excludes from its operation persons who are deemed to be exclusively resident of another country for purposes of any double taxation agreement. Further provisions aimed at excluding certain qualifying entities then follow as referred to in the footnote above and which has for the sake of brevity been omitted here.

⁷⁴ South African Revenue Services “Briefing Note: Residence Basis of Taxation” (2000) available at <http://www.info.gov.za/speeches/2000/000918340p1006.htm> -last accessed on 01/05/2013.

⁷⁵ South African Revenue Services Interpretation Note 6 “Resident: Place of Effective Management (Persons other than Natural Persons)” issued on 26 March 2002.

the drafters of the Note had companies in mind when compiling the note." Even more recently, in September 2011, SARS issued a Discussion Paper, but it expressly limited the scope of its contents, to issues relating to domestic and foreign companies.⁷⁷ Whilst legislative reforms have been proposed in respect of the taxation of trusts, the proposals released to date have not paid any attention to this aspect.⁷⁸ Nor have our courts conclusively addressed this aspect.⁷⁹

It is lamentable that despite trusts being such a popular institution and an important role-player in the economic, social and fiscal environment, little attention has been given to the determination of the meaning of this term in relation to trusts. It is this lacuna that this study aims to fill.

To determine the tax residence of a trust is however not a simple task. Residence is a humanlike concept⁸⁰ and is in the context of trusts, an 'unfamiliar' term. A trust firstly has no physical existence like a human, nor does it display any quintessential human characteristics such as dwelling or living. Without the proverbial "bricks and mortar" to act as indicators, a concrete answer to the residence of a trust is not readily available. Furthermore, a trust is also not recognised as a legal subject, but is instead an "accumulation of assets and liabilities",⁸¹ or a legal relationship between the parties to it. Even though a trust may be recognised for South African domestic tax law purposes as a person, the underlying structure is still intangible and essentially such a search for "residence" necessitates that it first be determined in which legal construction the trust is housed,⁸² and then where the latter is situated, which is an abstract exercise.

A trust further involves several parties; essentially a founder, trustees and beneficiaries,⁸³ but also

⁷⁶ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes " 2009 (21) *SA Merc LJ* at 335.

⁷⁷ South African Revenue Services "Discussion Paper on Interpretation Note 6 Place of Effective Management" issued September 2011. It did however indicate that other entities such as trusts will be addressed in a subsequent project.

⁷⁸ Minister of Finance, Pravin Gordhan announced in the 2013 Budget Speech that legislative measures would be introduced to curtail tax avoidance through trusts. The proposed measures are set out in the Budget Review and are later discussed at 4 2 5 3. The Budget Speech is available at <http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf> and the 2013 Budget Review at <http://www.treasury.gov.za/documents/national%20budget/2013/review/default.aspx>. Last accessed on 01/05/2013.

⁷⁹ *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127. The case is discussed in Chapter 6 below.

⁸⁰ Van der Merwe BA "The Phrase 'Place of Effective Management' Effectively Explained" 2006 (18) *SA Merc LJ* 121 at 121.

⁸¹ *Land and Agricultural Bank of South Africa v Parker* 2005 (2) SA 77 (SCA) at 83.

⁸² Determine the underlying basis for establishment and recognition ie a contract, testamentary disposition etc.

⁸³ These terms are further discussed in Chapter 3.

related parties such as legal and/or tax advisors, fund managers and employees, and in some instances, a protector or enforcer. The residence of a trust may therefore be alluded on the basis of any of their respective locations.⁸⁴ Alternatively, if the parties to the trust are not the decisive factor in determining the residence of the trust, further possible places of residence for the trust may be identified according to different factors. For instance, the country under whose laws the trust was established, the country where the trust is administered or the country where the trust assets are situated.⁸⁵

There are therefore a wide range of factors, that can be viewed as indicators to the "residence" of a trust. South Africa has addressed the question of residence in relation to entities such as trusts, by statutorily identifying two criteria as the threshold for residence within its fiscal jurisdiction, namely whether it is "incorporated, established or formed in the Republic," or whether it has its "place of effective management in the Republic." If either criteria is met, this will establish the residence of the trust as within South Africa's fiscal jurisdiction. Yet, neither criterion has been further defined in the Act, nor have our courts definitively pronounced on it. The aim of this study is to determine the meaning of both these criteria in a trust context, and further to ascertain whether in a trust setting, such criteria are appropriate and can be practically applied.

In relation to the first criterion, "incorporated, established or formed in the Republic", it must therefore be established what each term means in the trust context. Whereas the terms "established" or "formed" are relatively familiar terms in a trust setting, "incorporated" is not.⁸⁶ Yet beyond an identification of which terms are unfamiliar to trust law, it is necessary to determine how and when a trust is created and can thus regarded as "established" or "formed" in South Africa. This will entail that the underlying basis for a trust and the concomitant laws of contract and succession be investigated, as well as the impact such laws have on the time and place of the establishment of the trust be ascertained.⁸⁷ Also, it must be established whether there is a difference between the requirements imposed by the Act to be "resident" in tax law, as opposed to

⁸⁴ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 67.

⁸⁵ Danzinger E *International Income Tax The South African Perspective* (1991) at 50.

⁸⁶ Du Plessis explains that as a trust "is not a legal person... the word 'incorporated' does not apply to trusts" - Du Plessis I "The Residence of a Trust for South African Income Tax Purposes " 2009 (21) *SA Merc LJ* at 329.

⁸⁷ Generally speaking in South Africa, a distinction is made between trusts *mortis causa* (also known as a testamentary trusts) or *inter vivos* trusts. The former denotes a trust that is principally created in terms of a Will which becomes effective upon the testator's death. Thus the laws of succession are relevant. Conversely a trust *inter vivos* becomes effective whilst the founder is still alive and are generally considered to be created by contract. See further discussion in Chapter 2 at 2 7 1, and in particular discussion in Chapter 4 and 5 below.

the requirements for the trust to be officially registered and able to engage in legal and commercial activities in trust law.⁸⁸ The possibility of manipulation of these terms must be considered, and the effect of the advent of the electronic age be examined.⁸⁹

It is however the second criteria, that of "place of effective management," which is more problematic. To alleviate such problems and to provide guidance, SARS' Interpretation Note 6 may prove helpful.⁹⁰ The Interpretation Note outlines a proposed general approach, a practical application and a non-exhaustive list of examples of facts and circumstances that will be relevant in the determination of "the place of effective management." Yet the Interpretation Note was chiefly aimed at companies, indeed there is only one reference which relates to trusts.⁹¹ Following criticisms on the Interpretation Note, SARS has since issued a Discussion Paper on the Interpretation Note, but again devoted its contents to companies.⁹² As trusts differ in form, function and operation from companies,⁹³ to be able to access and utilise the guidance set forth in the Note, its contents and purpose must be brought to the trust level. To this end the following questions must be posed – what does effective management mean in the context of a trust, who manages the trust, who determines its policy and implements its strategic decisions and does the identity of these incumbents differ from those responsible for its day-to-day operations? Furthermore, who can be said to manage the trust when it is passive, and what is the effect of a trust perceived to be a sham trust, where the responsible office holders are but peons under the control of others? The aforesaid questions are but some of the questions that come to mind and necessitates further study to be able to formulate a response.

In addition, the Act⁹⁴ further provides that a person will not be regarded as a resident despite fulfilling either of the aforementioned criteria, should such person be deemed to be exclusively resident of another country for the purposes of any agreement between the government of South Africa and that other country, for the avoidance of double taxation (called double taxation agreements).⁹⁵ The decisive test to be deemed as "resident" in these double taxation agreements

⁸⁸ See discussion in Chapter 5 below.

⁸⁹ See paragraph 1.2.2 below which deals with these terms and examines their effects.

⁹⁰ SARS Interpretation Note 6 "Resident: Place of Effective Management (Persons other than Natural Persons)" issued on 26 March 2002.

⁹¹ Cohen T & Kruger D "Offshore Trusts: Many Dragons wait in Ambush " 2010 (1) (3) *Business Tax & Company Law Quarterly* at 24.

⁹² South African Revenue Services "Discussion Paper on Interpretation Note 6 Place of Effective Management" issued September 2011

⁹³ Geach WD & Yeats J *Trust Law and Practice* (2007) at 161-174.

⁹⁴ Income Tax Act, 58 of 1962.

⁹⁵ Paragraph (b) of the definition of resident in s1 of the Act. The draft Taxation Laws Amendment Bill

(termed a tie-breaker), is most often determined according to the "place of effective management" of the entity in question.⁹⁶ This adds further importance to the task of ascertaining the particular meaning of the phrase "place of effective management".

From 1 January 2013, two further proviso's were also inserted to the definition of "resident" in Section 1,⁹⁷ the first of which pertains to a person who ceases to be a resident and deems such person to be regarded as non-resident from the day the person ceases to be a resident,⁹⁸ whilst the second is relevant to foreign investment entities. A definition for the latter was inserted in the Act,⁹⁹ with a foreign investment entity denoting any person other than a natural person, which has not been incorporated, established or formed in South Africa, whose assets solely comprise a portfolio of qualifying investments¹⁰⁰ and which is held by that person for investment purposes.¹⁰¹ The newly inserted proviso aims to create a specific carve-out for foreign-owned investment funds from the test for residence, by modifying the test for place of effective management, when applied to these qualifying entities. This is evident from the proviso,¹⁰² which mandates that when the place of effective management is determined for a foreign investment entity, no regard may be had to an activity that constitutes a financial service (as defined specifically in the Financial Advisory and Intermediary Services, Act no 37 of 2002)¹⁰³ or is incidental thereto.¹⁰⁴ Thus, it will be important to

as published on 5 July 2012 for public comment (Taxation Laws Amendment Bill, Bill 34 of 2012) was assented to 30 January 2013 by the passing of the Taxation Laws Amendment Act, 22 of 2012. Consequently a further exclusion is now applicable to foreign companies who meet the qualifying criteria as set out in B (AA – DD) of that article.

⁹⁶ Emslie T "The Court of Appeal on Place of Effective Management" March 2011 *The Taxpayer* 42. The concept of double taxation is explained and further discussed at 1 2 1.

⁹⁷ Inserted by s2 (1) (x) and (y) of the Taxation Laws Amendment Act No. 22 of 2012 with effect from 01/01/2013.

⁹⁸ This is perceived to be in response to a Supreme Court of Appeal case, *Commissioner, South African Revenue Service v Tradehold Ltd* 2013 (4) SA 184 (SCA) which had held that the deemed exit charge tax on assets in the statutory provisions relating to capital gains tax is subject to the Double Taxation Agreement between Luxembourg and South Africa. This was seen to have "disturbed the balance" as per Minister of Finance, Mr Pravin Gordhan in his Media Statement released on 9 May 2012. Media statement available at <http://www.info.gov.za/speech/>. Last accessed on 01/05/2013.

⁹⁹ Inserted by s. 2 (1) (h) of the Taxation Laws Amendment Act No. 22 of 2012.

¹⁰⁰ According to the definition of Foreign Investment Entity, such investments must solely consist out of (i) amounts in cash or that constitute cash equivalents and/or (ii) (aa) financial instruments issued by a listed company or by the South African government in the national, provincial or local sphere; (bb) or if not issued by a listed company or by the South African government, are traded by members of the general public and a market for that trade exists, or (iii) are financial instruments, the values of which are determined with reference to the type of financial instruments contemplated in (ii) or are rights to receive any asset contemplated in any of the aforesaid subparagraphs.

¹⁰¹ Furthermore, not more than 10 per cent of the shares, units or participatory interest of that person may be held directly or indirectly by persons that are resident and such person must have no employees, directors or trustees engaged in the management of that person on a full-time basis.

¹⁰² Inserted by s. 2 (1) (y) of the Taxation Laws Amendment, No. 22 of 2012.

¹⁰³ Section 1 of that Act, 37 of 2002.

¹⁰⁴ The term "financial service provider" is defined in Section 1 whilst Section 8 provides for the issuing of

establish whether the trust in question qualifies as a foreign investment entity as defined and if so, whether it is resident or not by having regard to its “place of effective management.” However in reviewing its “place of effective management,” any activities constituting financial services, must be disregarded. This then again emphasizes the importance of the concept of the “place of effective management.”

In conclusion then, the aim of this study is to ascertain and consider the particular meaning of the statutory test set for fiscal residence in South Africa's income taxation laws, and in so doing it is hoped that this study will vitiate the dearth of substantive legal research on this aspect. This is necessary in light of the importance of this aspect, as well as the factors which complicate it, as elaborated upon in the discussions below.

1 2 1 The importance of the test for fiscal "residence" of the trust

The particular importance of the classification of a trust as resident or non-resident becomes apparent when viewed from the vantage of various parties:

- (a) From the perspective of the trust as a potential taxpayer, being classified as a resident or non-resident, has significant consequences in terms of the application of the Income Tax Act. As South Africa follows a residence based system of taxation, the term “resident” attracts worldwide liability and is therefore fundamental to the application of our fiscal legislation.¹⁰⁵ Furthermore, regardless of whether the trust operates in the private, social or commercial sphere, it will require certainty as to where it is taxed and assurance that its governance, activities or other factors do not lead to inadvertent loss or gain of residence within a particular jurisdiction and of the tax regime it is accustomed to.
- (b) Uncertainty as to the term also poses the risk of international double taxation for the trust as taxpayer. Double taxation is generally explained by reference to the two forms it may assume: economic and juridical double taxation. Economic double taxation arises when the

licenses to financial service providers.

¹⁰⁵ Should it be a resident it will be taxed on its worldwide receipts and accruals, alternatively should it be a non-resident it may be taxed on the income sourced from South Africa. Du Plessis also points out that certain tax consequences, specifically in relation to capital gains tax follows when a trust becomes a resident or ceases to be a resident with reference to par12(2)(a) and 12(4) of the Eight Schedule to the Act. Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* 322. These aspects are further discussed in detail in Chapter 5.

same income is taxed in two different taxpayers' hands.¹⁰⁶ In the trust context, economic double taxation may arise if the income is taxed at the level of the trust and again at the level of the beneficiaries of the trust.¹⁰⁷ Juridical double taxation arises when the same income is taxed in the same taxpayer's hands in two different countries.¹⁰⁸ This will be the result when one country taxes its residents on their worldwide income while another country would tax the same income on the basis that it was sourced within its borders.¹⁰⁹ A further example would be if two or more countries tax the income based on their respective claims that it was sourced within their borders. Alternatively, two or more countries could tax the income of a taxpayer based on their individual claims that the taxpayer is resident within its borders.¹¹⁰ It is particularly this last example, which emphasizes that the criteria to determine whether a taxpayer, such as a trust, is resident in a country should be clear.

- (c) The residence of a trust is also important to the underlying parties to the trust. As set out above, individuals and corporate entities frequently utilise trusts in estate or tax planning, where the residence of the trust may be a decisive factor. It is trite that a person is entitled to arrange his affairs in such a way to attract the lowest incidence of tax,¹¹¹ and frequently to do so trusts are used. For example, in this context, trusts are often employed in offshore jurisdictions. Spitz explains that the term "offshore" is applicable to countries or transactions where firstly there are low or no relevant taxes, or, where taxes are levied only on internal taxable events, or thirdly, where special tax privileges are granted to certain types of taxable persons or events.¹¹² By establishing the trust in these jurisdictions it is often achieved that no tax is imposed on the trust capital, income or capital gain.¹¹³ For such benefits to remain applicable, it would thus be necessary to ensure that the trust remains "resident" in such offshore jurisdiction, which requires that the meaning of the term be certain.

¹⁰⁶ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 6.

¹⁰⁷ Arnold B J & McIntyre M J *International Tax Primer 2nd ed* (2002) at 29.

¹⁰⁸ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 6.

¹⁰⁹ Arnold B J & McIntyre M J *International Tax Primer 2nd ed* (2002) at 27. Also Russo R (ed) *Fundamentals of International Tax Planning* (2007) at 8.

¹¹⁰ Arnold B J & McIntyre M J *International Tax Primer* (2002) at 27.

¹¹¹ See Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 3 and in particular the cases cited by her at footnote 8.

¹¹² Spitz B "Offshore Planning Checklists" available at <http://www.barryspitz.com>. Last accessed on 01/05/2013.

¹¹³ Davis et al *Estate Planning* (May 2013) at 17-7.

- (d) For the State as tax collector, the tax residence of the trust is equally important as the taxation of trusts contributes to its tax base. By levying tax on the constituents of its tax base, the State extracts the necessary funding it requires to procure and provide public services such as education, security and administration, to fund the provision and maintenance of infrastructure, and to advance social, economical and political goals.¹¹⁴ It is therefore a primary objective of the State's fiscal authority to protect its tax base against reduction, manipulation and exploitation. To continue with the above example of offshore trusts, for the State as tax collector, such offshore trusts may constitute a tremendous loss of revenue as the trust itself may have its assets situate in the local country, utilise its professionals and resources, yet rely on its offshore registration and persona to prevent taxation of its activities and assets, thus placing itself effectively out of reach of the State's fiscal jurisdiction. It is thus important for the State as tax collector to ensure that the meaning of the term "residence" is not only certain, but is also protected or resistant against manipulation. In relation to offshore trusts, the meaning of the term should be such, that it is capable of capturing these trusts within the local tax net if they are sufficiently connected to it, despite their geographical location elsewhere.

It is particular this latter aspect which has recently been identified by the South African Revenue Services as one of the seven focus areas of the newly launched Compliance Programme, aimed at protecting the state's tax resources by growing the levels of compliance with tax legislation over the next five years.¹¹⁵ At the unveiling of the programme, Minister Pravin Gordhan stated as follows:

"More so than perhaps any other time in history, the current global economic conditions have thrust domestic resource mobilisation into the spotlight, highlighting sustainability built on a foundation of tax compliance... Research by SARS has identified particular areas in our economy and in the tax system that poses significantly higher risks of non-compliance. Over the medium term, SARS will concentrate its attention on....[as one of the seven priority areas] the abuse of trusts by wealthy South Africans."¹¹⁶

¹¹⁴ Morse G & Williams D *Davies: Principles of Tax Law* 5th ed (2004) at 4; Zipfel F Taxation of Income in the Globalization Era – Treading the line between Fairness and Efficiency - Deutsche Bank Reseach. Published 31 October 2008. Available at <http://www.dbresearch.com/servlet/reweb2>. Last accessed on 01/05/2013.

¹¹⁵ Media Statement by Minister Pravin Gordhan on the Preliminary Outcome of Revenue Collection for the 2011/2012 Fiscal Year released at Pretoria, 1 April 2012 – Available at <http://www.sars.gov.za/home.asp?PID=74731&ToolID=2&ItemID=76570>. Last accessed on 01/05/2013. It is stated that SARS based this publication on the example set by tax administrations in countries such as Australia, Brazil, Canada, Denmark, Netherlands, New Zealand, Poland, Spain, Sweden, Turkey, USA, UK.

¹¹⁶ SARS "Compliance Programme 2012/2013 -2016/2017" – Minister Pravin Gordhan in the

Research conducted by SARS had shown that a potentially significant number of wealthy individuals are not registered taxpayers. To identify such individuals for registration SARS intends to make use of third party data including information from financial institutions, credit bureaux and other sources of data. Often too, these individuals are generally linked to trusts and other associated entities.¹¹⁷ It is further reported that a formidable team of experts would be set up to review the trusts systems, for purposes of executing the increased compliance checks and integrated audits on such entities.¹¹⁸ However such focus will not only be locally as SARS is cognisant of the potential tax avoidance through offshore trusts.¹¹⁹ In this respect the former National Commissioner of SARS, Oupa Magashula stated,

"For these wealthy individuals, we are going to start now. We will be collaborating with many tax jurisdictions around the world to get information of all the offshore trusts that wealthy individuals have. We know of certain tax havens that are popular amongst wealthy South Africans. We have already signed lots of double taxation agreements and tax information exchanges that will give us a full view of these individuals."¹²⁰

In the 2013 Budget Speech, this theme was continued with legislative reform proposed to curtail tax avoidance associated with trusts. In particular it was stated that certain aspects of local and offshore trusts have long been a problem for global tax enforcement.¹²¹ Specifically in relation to tax avoidance this was felt to be justified on the basis that "we also owe it to our taxpayers to ensure they are not carrying the burden of those who

Foreword, p1 as well as the Media Statement above.

¹¹⁷ SARS "*Compliance Programme 2012/2013 -2016/2017*" at Foreword at 1 and 9.

¹¹⁸ SAPA "Gordhan issues warning to tax dodgers" appeared 3 April 2012. Available at <http://www.southafrica.info/news/business/1851425.htm> – last accessed on 01/05/2013.

¹¹⁹ SAPA "SARS extends rich tax dodger battle into other countries" appeared 16 April 2012 on Moneywebtax. Last accessed on 01/05/2013. Available at <http://moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page259?oid=67150&sn=Detail&pid=1>. Last accessed on 01/05/2013.

¹²⁰ SAPA "Gordhan issues warning to tax dodgers" appeared 3 April 2012. Available at <http://www.southafrica.info/news/business/1851425.htm> – last accessed on 01/05/2013.

¹²¹ Minister Pravin Gordhan in the 2013 Budget Speech delivered to Parliament on 27 February 2013 stated that the taxation of trusts will be reviewed to address abuse (at 21 of the printed speech) as was further elaborated in the Budget Review 2013 issued by National Treasury in Chapter 4 dealing with "Revenue Trends and Tax Proposals" at 54. The Budget Speech is available at <http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf> and the 2013 Budget Review at <http://www.treasury.gov.za/documents/national%20budget/2013/review/default.aspx>. Last accessed on 01/05/2013.

benefit from our country's infrastructure and resources without paying their fair share of the costs."¹²²

The abuse of such offshore trusts thus refers to the problem of trusts that may be housed offshore, having no real ties in respect of its funding and income, or its management and administration to such offshore jurisdiction, yet due to its offshore status, seemingly out of reach of the local tax collector. This dramatically brings to the fore the importance of the residence of the trusts, which if shown to be South African, would create the necessary connection to bring such trusts as taxpayers and their taxable income and activities within the reach of the South African tax authorities.

1 2 2 Factors that complicate the "residence" of the trust

The task of establishing the "residence" of a trust is complicated by the fact that trusts are "able to cross borders," in that they are not necessarily confined in terms of their activities, assets or involved parties to a particular state.¹²³ Trusts are also subject to developments and changes that affect the world, such as an increasingly globalised and technological world.¹²⁴ Specifically, several factors can be identified as contributing to the internationalisation of the trust, which in turn complicates the determination of the test for the residence of a trust. These factors are set out below. The factors so listed are based on the factors identified by Schoenblum as causative factors in the internationalisation of the trust:¹²⁵

- a) The increased mobility of capital is the first factor considered.¹²⁶ This term refers to the ability of investors to utilise technology to obtain instantaneous information about markets, to then identify the most efficient location for their capital and to invest, withdraw and reinvest such capital swiftly, thus causing a continuous flow of capital all over the world. In the particular context of trusts, Schoenblum gives the example of a founder in State A who transfers assets to a trustee in State B. The Trustee in State B immediately has access to information about markets in State C and D on which to base his investment decisions and

¹²² The 2013 Budget Speech is available at <http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf>. Last accessed on 01/05/2013.

¹²³ Harris J *The Hague Trust Convention Scope, Application and Preliminary Issues* (2002) at 1.

¹²⁴ As to the meaning and effect of the term see paragraph (b) below.

¹²⁵ Schoenblum JA "The Rise of the International Trust." 1999 (32) *Vanderbilt Journal of Transnational Law* at 520 -523.

¹²⁶ Schoenblum JA (1999) *Vanderbilt Journal of Transnational Law* at 520.

to effect them without delay.¹²⁷ The Trustee, whilst located in any state, can effect future investments of the trust capital and such capital can effortlessly be relocated to further states. Thus the assets of a trust, and the "effective management" of such assets can be located, transferred and controlled in and from various locations, any of which can be deemed to be the place of residence of the trust. Whilst in South Africa, exchange controls are still applied, which curbs this factor to a certain extent, many other countries do not/no longer have such controls,¹²⁸ and with the gradual relaxation of our controls locally, greater investments in international markets are being made.¹²⁹

b) Technological developments and the advance of globalisation¹³⁰ have together led to the introduction of an era, which is characterized by the vastly enhanced speed and ease by which information can be transferred as well as the mobility of persons across jurisdictions. The effect of these factors are profound. It allows for the establishment and economic activity of an entity or a person without having a physical presence¹³¹ The lack of a physical presence plays havoc with the traditional criteria for the determination of "residence," which is underpinned by the notion that an entity benefits from the use of the country's economic infrastructure and would thus to a certain extent, be physically present.¹³² So for example in context of trusts, through the application of the internet¹³³ and other technological devices, a trust can be "formed" or "established" in places, where neither its assets nor the parties to it are situated. So too, in respect of the "effective management" of the trust and its assets, the residence of the parties to the trust become irrelevant, as the parties can meet/act whilst each is individually located in different places.

c) The rise of the geographically extended family. The development of technology and the

¹²⁷ Schoenblum JA (1999) *Vanderbilt Journal of Transnational Law* at 520.

¹²⁸ For example the UK abolished their exchange controls in 1979. See http://www.bankofengland.co.uk/markets/Pages/sterlingoperations/timeline/timeline_no_flash.aspx – last accessed 05/05/2013.

¹²⁹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 234 where they record that the gradual relaxation of exchange control since 1 July 1997, has led South Africans to invest in the international investment market in greater numbers.

¹³⁰ The latter term denotes "the growth of economic interconnectedness and interdependence among people." – Benshalom I "The New Poor at our Gates: Global Justice implications for International Trade and Tax Law (2010) 85 N.Y.U. L. Rev.1.

¹³¹ Wesson N "Die Effek van die Internet op die Inwonerbeginsel, soos gedefinieer in Inkomstebelastingwet Nr. 58 van 1962." 2002 (10) *Meditari Accountancy Research* at 244.

¹³² Collette M "Developing a New Test for Fiscal Residence for Companies (2003) *UNSW Law JI* 42.

¹³³ The term "internet" refers to a loose network of computers and computer networks that spans the globe and facilitates communication between computers - Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 150.

decline of investment barriers, have led humans to be increasingly mobile and to seek better employment and/or educational opportunities across territorial barriers.¹³⁴ If such persons play a management role in the trust, their movement could affect the "residence" of the trust. This is especially true in the South African context where emigration is prevalent.¹³⁵ In South Africa, several factors contribute to the high emigration figure of skilled workers from South Africa. To mention some: a high incidence of crime, political instability, labour unrest, unsatisfactory public service delivery, which, coupled with better economic prospects and employment opportunities in the country of intended immigration, give rise to a continuous exodus,¹³⁶ often termed in the media as "the brain drain."¹³⁷ On the positive side, it must also be remembered that with the re-entry of South Africa to the global marketplace after years of isolation, increased interaction within the international arena become possible, leading to new opportunities, which contribute to the emigration numbers.¹³⁸ It is therefore not unusual to find in a typical family trust setting, that the *diaspora* of the parties to the trust results in the founder resident in one country, the trustees in another and its beneficiaries in various other countries. This in turn, may cause several places of "effective management" to be identified for the trust.

- d) A further factor is the rise of the universalist culture, which Schoenblum uses to describe the growing attitude within society, that in light of the distribution of capital and family members worldwide, loyalty to only one jurisdiction is questionable and is costly to the maximisation of wealth.¹³⁹ This can be coupled with an increasing attitude that the tax

¹³⁴ Schoenblum JA (1999) *Vanderbilt Journal of Transnational Law* at 520.

¹³⁵ Boyle B & Shevel A "Emigration trickle turns into tidal wave." Published March 30, 2008 – Available at <http://www.timeslive.co.za>; Last accessed on 01/05/2013. See Statistics South Africa Report 03-51-03 (2003) entitled "Documented migration, 2003" – Available at http://www.statsa.gov.za/publications/Report-03-05-03_2003.pdf Last accessed 01/05/2013.

¹³⁶ Temkin S "Crime Still driving Business Emigration." Published 4 March 2010 online at <http://allafrica.com/stories/201003040254.html>; Also Bornman E "Afrikaners in Suid-Afrika vandag: identiteit, kultuur en emigrasie." Available at <http://www.unisa.ac.za/contents/faculties/humanities/comm/docs/Emigrasie%20Onder%20Afrikaners%20vandag.doc>. Last accessed on 01/05/2013.

¹³⁷ Skills migration and the brain drain in South Africa – Media brief factsheet issued 25 February 2004 by the Human Sciences Research Council – Available online at <http://dev.worldwidecreative.co.za/en/media-briefs/fact-sheets/factsheet-5-skills-migration-and-the-brain-drain-in-south-africa>. Last accessed on 01/05/2013. Prof K Asmal "South Africa's brain drain dilemma. Available online at <http://news.bbc.co.uk/2/hi/africa/3629657.stm>. Last accessed on 01/05/2013.

¹³⁸ Bailey T "Skills migration" (2003) HRD Review at 247. Available online at <http://www.queensu.ca/samp/migrationresources/braindrain/documents/bailey.pdf>. Last accessed on 01/05/2013. Afriforum "Problem-Solving in South Africa" – Available at <http://www.komhuistoe.co.za/probleemoplossing.htm>. Last accessed on 01/05/2013.

¹³⁹ Schoenblum JA (1999) *Vanderbilt Journal of Transnational Law* at 521.

jurisdiction can be chosen by the taxpayer.¹⁴⁰ The first attitude undermines the establishment and affirmation of ties with a particular country by a taxpayer. These ties or connections are important factors in the determination of "residence." The second attitude leads to manipulation and an artificial presence of factors, evincing "residence" within a particular jurisdiction.

- e) The rise of the offshore jurisdiction. The latter term has been described above as denoting a jurisdiction, which essentially provides tax and regulatory privileges or advantages to taxpayers resident outside its borders.¹⁴¹ Their function is aptly summarized as follows¹⁴² –

“Beyond the formal facade of sovereignty and the enforcement of a stable system of autonomous nation-states, there thrives an unregulated bazaar for free capital. Mini-states, with little else to sustain them, function as filters in the worldwide free flow of capital. They are way-stations in the passage of capital from one sovereign country to its redeployment in another sovereign’s territory...Once offshore, the capital becomes essentially untraceable by the source country for purposes of taxation...”

Essentially this factor may have the effect, that when trusts are set up in such jurisdictions, indicators to the "residence" of a trust, such as the location of the trust’s assets and who exercises the actual control over them, are plunged into obscurity. This is because a lack of transparency and secrecy of information, is often associated with such jurisdictions. It is often difficult to obtain information about the trust, as the legislation of these offshore centres do not require a register of trusts to be kept, imposes strict confidentiality obligations upon trust company administrators and bank officials, and these jurisdictions are generally not willing to exchange information with other countries.¹⁴³ A trust set up in such a jurisdiction may itself be a highly secretive vehicle.¹⁴⁴ As trusts have been perceived, to be the “most effective tools for holding assets outside of a taxpayer’s country of residence,”¹⁴⁵ and South Africans have been encouraged to have at least 20-30% of their

¹⁴⁰ Taylor G “The Fight Against Globalisation.” Available online at <http://searchwarp.comswa32432.htm>. Last accessed on 01/05/2013.

¹⁴¹ Oguttu AW *Curbing Offshore Tax Avoidance* (November 2007) at 9 read with Murphy R *The Missing Billions – The UK Tax Gap Touchstone Pamphlets* Available at <http://www.tuc.org.uk/touchstone/missingbillions/1missingbillions.pdf>. Last accessed on 01/05/2013.

¹⁴² Schoenblum JA (1999) *Vanderbilt Journal of Transnational Law* at 521.

¹⁴³ Anonymous “Time to tackle the offshore trust” Published 7 May 2009 – Available online at <http://taxjustice.blogspot.com/2009/05/time-to-tackle-offshore-trusts.html>. Last accessed on 01/05/2013.

¹⁴⁴ For example a “blind trust” (also known as a “limping trust” or “black hole”), where within the trust structure itself, it is near impossible to identify the true founder and beneficiaries of the trust. Jones S “The Right Trust for you.” Published 10 January 2008 – Available online at <http://www.moneywebtax.co.za/moneywebtax/view>. Last accessed on 01/05/2013.

¹⁴⁵ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (2007) at 320.

investment portfolio offshore,¹⁴⁶ it is anticipated that trusts will continue to be employed in this context. The problems these trusts pose for the South African fiscus has been outlined above.

These factors severely impact on the test for the residence of a trust and substantiate the submission, that the determination of the trust's residence is not a simple task but is instead fraught with complexities and difficulties. It is therefore necessary that the issue of the residence of a trust be addressed comprehensively whilst taking into account the challenges posed by these factors.

1 3 Purpose of the study

The purpose of this study is to establish from a South African income tax perspective, how the residence of a trust is determined. Thus an analysis of the definition of "residence" as set forth in the Income Tax Act, will be conducted. Such an exercise will aim to achieve the following:

- (a) To ascertain the meaning of the phrase "incorporated, established or formed" in relation to trusts. A separate examination of each term will be conducted and the practical implications thereof in a trust setting determined.
- (b) To ascertain the meaning of the concept "place of effective management", in relation to a trust. In respect of this latter criterion, the aforementioned Interpretation Note¹⁴⁷ and Discussion Paper¹⁴⁸ of SARS, seeks to address this concept. The focus of these aids fall on corporate entities. As best summarised by Du Plessis "the drafters... paid little attention to other entities such as trusts. It therefore remains for taxpayers to translate SARS' view to trusts."¹⁴⁹ It is the aim of this study to determine and offer such a translation. Consequently the structure, functional form and administration of a trust will be reviewed, and the role and responsibilities of its parties examined herein. The Interpretation Note provides guidance in such an endeavour, in that it encourages that the ordinary meaning of the words must be determined, and that in this regard international precedent and

¹⁴⁶ Roper PEW "Investing in the offshore marketplace." (2000) Insurance and Tax 15 (1) at 7.

¹⁴⁷ SARS Interpretation Note 6 "Resident: Place of Effective Management (Persons other than Natural Persons)" issued on 26 March 2002. A Discussion Paper on the Interpretation Note has now also been issued.

¹⁴⁸ SARS "Discussion Paper on Interpretation Note 6 Place of Effective Management" issued September 2011.

¹⁴⁹ Du Plessis 2009 SA Merc LJ at 335.

interpretation, will assist in the assigning of a meaning. In particular it must be noted that the term “place of effective management”, is used by various countries throughout the world¹⁵⁰ and is often found in double taxation agreements. The term emanates from an Organisation for Economic Co-operation and Development's (OECD) model tax convention¹⁵¹ and thus the OECD's interpretation must also be considered.

- (c) This then leads to the further object of this study, namely to study the meanings of the above concepts in selected foreign jurisdictions and for this purpose Canada and the United Kingdom have been chosen. The reasons for selecting these countries are twofold: firstly these countries recognise the trust as a legal institution and secondly, they have in recent times given particular attention to this issue in judicial pronouncements. It is hoped that their insight and conclusions to this issue will improve and advance our own structures and understanding.
- (d) Regard will also be had to international model tax conventions dealing with this particular topic, as expounded by international organizations such as the OECD, and the United Nations Model Double Taxation Convention between Developed and Developing Countries. It must be borne in mind, that although South Africa is not a member of the OECD and therefore is not bound by its recommendations, it was awarded observer status in 2004.¹⁵² This international comparison is done in line with the Interpretation Note which encourages the review of international precedent and interpretation in order to assign a meaning to these terms, as well as the underlying constitutional obligation to develop the South African common law in line with international law.¹⁵³ It is the aim of this study to identify any similarities and inconsistencies between the South African approach and other countries, and the approach advocated by the model conventions.
- (e) Lastly an analysis of the various tests for residence will be conducted, to determine the most appropriate and effective test for the determination of residence of a trust to be applied in the South Africa income tax setting.

¹⁵⁰ SARS Interpretation Note 6 “Resident: Place of Effective Management (Persons other than Natural Persons)” issued by the South African Revenue Services on 26 March 2002.

¹⁵¹ Meyerowitz D Meyerowitz *on Income Tax (2007-2008)* at par 5-6.

¹⁵² Oguttu AW "The Challenges that E-Commerce Poses to International Tax Laws: 'Controlled Foreign Company Legislation' from a South African Perspective (Part 1) 2008 (20) *SA Merc LJ* 355.

¹⁵³ Section 233 of the Constitution of the Republic of South Africa Act 108 of 1996. See Chapter 8 1 where this section is elaborated upon.

1 4 Scope of the study and limitations on the scope

To lay a foundation for the study, the trust as a unique legal institution will be investigated, and a discussion of the definition of a trust, the historical development of the trust, the formation and establishment of a trust, the essential elements of the trust, the role-players to it and the different types of trusts will be given. Although it will be necessary to discuss the theory and principles underlying trusts, a detailed exposition on such topics will not be undertaken. Also, the study will focus on certain types of trust, as will be identified and recorded later,¹⁵⁴ which exhibit the core elements of trusts.

The study is aimed at reviewing the fiscal jurisdiction to tax the trust, as based on the definition furnished in the Income Tax Act. Whilst a general overview discussion will be provided, it will not focus in-depth on the actual taxation of trusts, the rules and principles whereby taxes are levied and calculated. Nor will issues regarding the compliance, tax administration and collection of taxes be deliberated.

The South African meaning of the term “residence” in an income tax setting and the interpretation thereof in legislation, case law and legal writings are analysed. A comparative analysis with selected foreign jurisdictions follows. As stated above, the study will be limited to two jurisdictions that have been selected for this comparative study, namely the United Kingdom and Canada. To set out the differing viewpoints and approaches internationally, in particular to the meaning of the latter part of the definition of the residence, namely the “place of effective management,” the model tax conventions, such as the OECD Model Tax Convention and the United Nations Model Double Taxation Convention between Developed and Developing Countries will be considered. The viewpoint of international legal writers will also be considered.

Throughout the study the effect of the factors listed at paragraph 1 2 2 will be kept in mind and considered, as they cut across the issues addressed in the respective chapters. It is therefore not necessary to devote a particular chapter to same.

¹⁵⁴ The study will be limited to trusts in the narrow sense. As to the distinction between trusts in the narrow and wide sense, and the reasons for the focus on trusts in the narrow sense, see the discussion at paragraph 2.3. Furthermore the focus will be on trusts formed by Will (*mortis causa*) and/or contract (*inter vivos*) and not on trusts formed by statute, treaty, judicial order or oral trusts.

The study is based on the law as is stated as at 5 September 2013 and does not take into account developments thereafter.

1 5 Methodology

Research involves the consideration of relevant legislation, case law, tax conventions and treaties, journal articles, books and other legal writings, of both a local and foreign origin.

The study is conducted in analytical and interpretational manner. The outcomes of the research are also applied to practical situations where appropriate.

Lastly the study is comparative in nature, so as to ensure a critical reflection of the structures and understanding that is currently applied in South Africa, and to identify solutions and guidance from other jurisdictions, for the improvement of determining the residence of a trust for tax purposes locally.

1 6 Structure of the study

The study consists of ten chapters:

- Chapter 1 sets out the background to the study and provides a definition of the term “trust.” It reflects on the importance of the trust as legal institution by reviewing the trust’s vast and widespread application, as well as its extraordinary usefulness in the private, commercial and public sphere. The Chapter further sets out the problem statement, the importance thereof and discusses the factors that influence it. It also outlines the particular objectives of the study, as well as the scope and the methodology that will be applied herein.
- Chapter 2 lays a theoretical foundation of trusts and provides an overview of the legal principles in South African trust law. In so doing, the origin of the trust concept and its particular reception in South Africa is set out, the various definitions for a trust examined, the requirements for a valid trust and the legal nature of the trust explained, as well as the different types of trusts that can be identified, based on different criteria discussed. As trusts formed outside South Africa may also fall into our tax net, the features relevant to such trusts are discussed and several examples given. This chapter aims to provide a thorough

understanding of trusts and the legal principles applicable to this entity in South Africa.

- Chapter 3 continues the theoretical discussion, but shifts the focus to the role-players of the trust. It considers the specific role and function of the various parties to the trust structure, their duties and powers, and more importantly to the study at hand, their possible impact on the components of the test for fiscal residence.
- Chapter 4 provides an introduction to the South African taxation framework in relation to trusts. It describes and explains the most important features of the local fiscal legislation applicable to trusts, subject to the limitations expressed above in discussing the Scope of the Study. It also discusses the proposed legislative reforms announced in the 2013 Budget Speech.¹⁵⁵ The aim of the chapter is to lay a foundation for the discussion of the residence of the trust under the South African tax framework in the subsequent chapters.
- Chapters 5 and 6 builds on the preceding chapter by considering the basis on which South Africa exercises fiscal jurisdiction, specifically in relation to trusts. These chapters form the crux of the Study. It aims to meet paragraph (a) and (b) of the Purposes of the Study set out above at paragraph 1.3 and for the sake of brevity, is not reiterated here. It sets out the approach followed in South Africa, by reviewing each component of the test for fiscal residence and analysing it through domestic statutory law, judicial precedent and legal writings.
- Chapter 7 then reviews the meaning of the term “residence” under tax treaties and international model tax conventions, particularly with the focus on ascertaining the meaning of “place of effective management” and thus inform the local interpretation of this concept.
- Chapter 8 present an overview of the approach followed in the foreign jurisdictions of Canada and the United Kingdom, including a discussion of recent case law in these jurisdictions. This then establishes various alternative approaches, to which the South African approach may be compared and assessed.
- Consequently it sets the foundation for Chapter 9, wherein the various approaches are critically analyzed. This is done against the backdrop of the rationale of residence-based taxation and the objectives it seeks to achieve. A practical example is also given in this chapter.

¹⁵⁵ The 2013 Budget Speech is available at <http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf>. Last accessed on 01/05/2013.

- Chapter 10 then concludes the study, summarizes the findings of the study and presents recommendations.

1 7 Conclusion

More than a century ago, in the case of *Naef v Mutter*¹⁵⁶, it was said that

“Residence has a variety of meanings according to the statute in which it is used.”

This then forms the crux of this study, to determine the meaning of “residence” in relation to trusts: thus, in the context of the Income Tax Act of South Africa, whilst taking cognizance of the characteristics and peculiarities of the trust contextual setting. This is an important task, as “residence” forms the basis for taxation in South Africa. It is the necessary prerequisite to allow South African fiscal authorities to levy taxes on trusts so essential to its domestic resources and public spending. To commence this task, we now turn to the next chapter, wherein the theory and principles underlying trust law in South Africa is considered.

¹⁵⁶ (1862) 31 LJCP 359.

CHAPTER TWO

THEORETICAL FOUNDATIONS OF THE TRUST IN SOUTH AFRICAN TRUST LAW

2 1 Introduction

Before embarking upon any discussion relating to the taxation of trusts, it is prudent to first consider the theoretical foundation underlying trusts and to broadly understand the structure and legal nature of trusts, as well as the terminology particular to this field of law. This chapter aims to achieve this by giving an overview of the origin of trusts, discussing the various definitions for the trust, the requirements for a valid trust, the parties to a trust, the different types of trusts and the legal principles that are important to the study at hand. However, in such an endeavour, the words of Hahlo¹ are worth noting, “When it comes to trusts in our law, even the most elementary propositions cannot be regarded as settled.”

2 2 Origin of the Trust Concept

In this section a brief overview of the history of trusts is given with the specific aim to present and reaffirm the basic idea of the trust concept.² It is trusted that this will accordingly assist in the identification of the trust's legal structure and promote an understanding of its form and function. Moreover, a discussion of the evolution of the trust concept, also illustrates how the trust has become a legally accepted institution – one capable of being "resident" in a particular country and taxed.

2 2 1 History and Development of the Trust Concept

The learned authors, Pace and Van der Westhuizen³ write, that the trust found its way to South Africa more than two centuries ago, when the Cape became a British colony in 1806. Indeed it has

¹ Hahlo “Revocation of Trust” 1952 *SALJ* at 349.

² It is emphasized that the discussion here is not intended to be a detailed treatise on the history of trusts and instead focuses on the principal events and developments in relation to the trust concept. The discussion here has mainly been compiled from Du Toit F *South African Trust Law Principles and Practice* (2002) at 15-18, Olivier et al *Trust Law and Practice Service Issue 3* (November 2011) at 1-1-10 – 1-25; MJ De Waal “The Core Elements of the Trust: Aspects of the English, Scottish and South African Trusts compared “ 2002 *SALJ* at 548-571& Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 21-25. For a detailed discussion on the development of the trust in historical context, including the Roman law, see JP Coetzee ‘*n Kritiese Ondersoek na die Aard en Inhoud van Trustbegunstigdes se regte ingevolge die Suid-Afrikaanse reg* (Doktorale Proefskrif) (April 2006) (LLD thesis) at 13-34.

³ Pace RP & Van der Westhuizen WM *Wills and Trusts Service Issue 16* (October 2012) – B2 at 6.

been remarked, that the British brought the trust with them “as part and parcel of their legal and intellectual baggage.”⁴ Consequently regard must be had to the development of the trust in England. Firstly however, the *Treuhand* as an institution will be discussed as it is widely considered to be the ancestor of the English Trust.⁵ It is believed of the *Treuhand*, that it was one of the “great number of continental ideas, customs and institutions,” that crossed the English channel in the aftermath of the Battle of Hastings in 1066 when the Norman, William the Conqueror defeated the English and was subsequently crowned as the King of England.⁶ The *Treuhand* had originally been practised by various Germanic tribes. The most important tribe was the Salian Franks, who had under their power the present areas of France, Belgium and the southern part of Netherlands.⁷

Olivier⁸ encapsulates the basic idea of the *Treuhand* as follows, “that one person holds property as owner, in terms of the will of another, not for his own benefit but for the benefit of nominated beneficiaries.” This is in essence thus also the trust idea. Olivier⁹ however remarks, that the ownership of such an idea cannot solely be assigned to a particular nation, as the basic idea underlying it, is a “universal human phenomenon,” and can be found amongst the ancient peoples of the Egyptians, Greeks, Japanese, Indian, Burmese, Arabs, Romans and the Germanic tribes.

The *Treuhand* is believed to have developed in the context of the transfer of property on death and is primarily attributed to the fact that the Germanic Tribes did not acknowledge the Will as a valid mode of disposition.¹⁰ Their unwillingness to do so stemmed predominantly from two factors. Firstly the idea of individual ownership was foreign to them. Ownership of property vested in families and not in individuals. Consequently upon death, the succession of property was

⁴ Honore T, “Trust” in Zimmermann & Visser ‘Introduction: South African law as a mixed legal system’ as quoted by De Waal 2000 *SALJ* at 555.

⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 15. There are also suggestions that the trust originated from the Islamic waqf whereby “property is reserved, and its usufruct appropriated, for the benefit of specific individuals, or for a general charitable purpose” – which the crusaders may have encountered during the Holy Wars. See Gaudiosi, Monica M. (April 1988), “The Influence of the Islamic Law of Waqf on the Development of the Trust in England: The Case of Merton College”, *University of Pennsylvania Law Review* 136 (4): 1231–1261 available at <http://www.jstor.org/discover/10.2307/3312162?uid=2129&uid=2&uid=70&uid=4&sid=21102240963837> as well as Stibbard, P, Russell D & Bromley B “Understanding the Waqf in the World of Trust” (2012) *Trust and Trustees* Vol 18 (8) at 785-810 available at <http://beneficgroup.com/blog/wp-content/uploads/2012/09/Understanding-the-Waqf-in-the-World-of-the-Trust.pdf> - last accessed on 02/05/2013.

⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 15.

⁷ Olivier et al *Trust Law and Practice* (November 2011) at 1-11.

⁸ Olivier et al *Trust Law and Practice* (November 2011) at 1-11. Du Toit F *South African Trust Law Principles and Practice* (2002) at 15

⁹ Olivier et al *Trust Law and Practice* (November 2011) at 1-11.

¹⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 15.

determined according to their intestate succession rules, which adhered to this notion and protected the proprietary rights of families over the property.¹¹ Secondly the idea of a disposition by a Will, was in conflict with their belief that the particular identity of an heir, was established by God and that a human testator could not interfere with such a divine predetermined order.¹²

The *Lex Salica*, a document setting out the legal principles or rules of the Salian Franks dating back to the sixth century, however allowed an exception to the accepted customs regarding the transfer of property on death, which led to development of the *Treuhand*. In particular Title 46 of the *Lex Salica* permitted a person to transfer property to an intermediary, with instructions that after the transferor's death, the property be transferred to the nominated beneficiaries.¹³ A characteristic of the *Treuhand* worth noting is that the intermediary, although the property was transferred to him and he was recognised as owner thereof, enjoyed no beneficial interest. He was bound by his oath at all times to honour his undertaking, namely, to transfer the property to the nominated beneficiaries.¹⁴ Yet the *Treuhand* did not endure to the present day, as Du Toit concludes¹⁵ -

“As an alternative to intestate succession the *Treuhand* however contained within itself the seeds of its own destruction: the emergence of particularly testate succession in the legal systems of continental Europe caused the *Treuhand* to fall into disuse and in due course to disappear altogether.”

Certain of the attributes of the *Treuhand* did however survive and can be recognised in the institution of the “Use” which is considered to be the forerunner of the modern English trust.¹⁶

The “Use”, whereby property was transferred to a *feoffee* (transferee), for uses (for the benefit of some person or object), can be traced to the eleventh century in England. By the thirteenth century it was a very popular institution.¹⁷ A number of reasons have been advanced to explain the prevalent use of this institution during this time period. One such reason was the protection of landowners who participated in the Crusades. The latter term refers to the “military expeditions undertaken in the 11th, 12th and 13th centuries, by the Christian powers of Europe to recapture the

¹¹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 16. Agnatic succession was applied in that property would be passed to the closest male relative in the blood line <http://lexsalica.com/lexsalica/> and <http://spiritus-temporis.com/salic-law/agnatic-succession.html> - last visited on 02/05/2013.

¹² Olivier et al *Trust Law and Practice* (November 2011) at 1-11

¹³ Olivier et al *Trust Law and Practice* (November 2011) at 1-12.

¹⁴ Olivier et al *Trust Law and Practice* (November 2011) at 1-12.

¹⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 16.

¹⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 16 and Olivier et al *Trust Law and Practice* (November 2011) at 1-12.

¹⁷ Cameron et al *Honoré's South African Law of Trusts* 5th ed (2002) at 24.

Holy Land from the Muslims.”¹⁸ Oguttu¹⁹ explains that in order to finance these campaigns the King levied a military tax and also made other demands on landowners, in return for the land grants. This made land quite a valuable article to possess and important to retain.²⁰ Should a crusader not return from the Holy wars, his family would be dispossessed of the land in the King’s interest.²¹ Consequently to protect such landownership, a crusader would employ a practice, whereby the land would be placed in the name of a trusted friend (the *feoffee*). The latter would upon the crusader’s return, transfer the property back to him, or should he not return, then usually, in accordance with instructions, transfer the property to the nominated beneficiary.²² This practice thus offered protection during the lengthy time periods the crusader would be away and also enabled the landowner to escape some of the feudal dues.²³

In the thirteenth century the Franciscan friars came to England, an event that would further advance the application of the Use. Hanbury²⁴ explains the predicament of the friars and the practical solution the Use presented-

“They were bound by vows of poverty to hold no property, and yet, they must have somewhere to live. A simple solution was provided by conveying land to a borough community to the use of the friars. Thus was forged an engine that was to prove a dynamic force in the power-house of the legal system.”

Honoré²⁵ notes a further reason for the application of the Use, namely the civil wars of the fifteenth century. During such times most great landowners participated in enterprises, which could be regarded as apposite to the ruling order, or worse, as treacherous, and if confirmed as such, would lead to the loss of their lands.

¹⁸ Butterfield et al (eds) *Collins English Dictionary Complete and Unabridged* (2003) .

¹⁹ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (2007) at 309.

²⁰ Hayton & Ward explain that the King granted land to his foremost supporters either for life or for so long as the recipient had heirs to inherit the land. Burdensome incidents were however imposed e.g. the adult heir of a supporter had to pay a year’s profits to the King on inheriting the land and if still a minor, the King would be entitled to all profits until the heir attained majority . In the case of an heiress, she would be married off to the highest offeror. See The Haynton Report available at <http://www.trustees.org.uk/word/The%20Hayton%20Report.doc> – last accessed 02/05/2013.

²¹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 247.

²² De Waal MJ 2000 *SALJ* at 553.

²³ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (2007) at 309; King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 247. See also The Haynton Report available at <http://www.trustees.org.uk/word/The%20Hayton%20Report.doc> – last accessed 02/05/2013 where it is explained that the feudal dues were only levied at the death of a sole owner and thus it was advantageous to make the property over to more than one friend.

²⁴ Hanbury *The English Courts of Law* at 131 quoted in Olivier et al *Trust Law and Practice* at 1-13.

²⁵ Cameron et al *Honoré’s South African Law of Trusts* 5th ed (2002) at 25.

What is apparent from a discussion on the Use is its remarkable likeness to the *Treuhand*. It bears the common attributes of the trust principle. Ownership of the property is transferred by a person (here called the *feoffor*), to another (termed the *feoffee*), to the use of another (called the *cestui que use*.) Yet its development must be placed in the particular context of the English legal system and the two systems of court that influenced its development – the “common law” courts and the “chancery” courts. A brief discussion follows as it is submitted that it will provide a sound contextual setting for the comparative discussion of English case law in Chapter 8.

The “common” law in this context, refers to the law that became common to the whole of England after the Norman conquests.²⁶ By the end of the thirteenth century, the common law had developed into a strict body of rules, structures and procedures. Should a party’s cause of action or application fall outside the boundaries of the demarcated remedies, it would be dismissed as the court lacked jurisdiction to address the matter.²⁷ The application of such a rigid common law system often led to hardship or inequity. This caused the King to offer relief to aggrieved parties via his Chancellor.²⁸ The latter filled the office as chief adviser to the King.²⁹ Olivier³⁰ explains the interchange between the King and the Chancellor as follows –

“Traditionally, the King was regarded as the source of all justice, and the Chancellor acted as the keeper of the King’s conscience. It was the Chancellor’s duty to ensure that justice should triumph in those cases which could not be accommodated within the strict and unbending rules of the common law.... The King was the source of all power and as the image had to be maintained that he was a just ruler, it became customary for the Chancellor to give rulings on issues submitted to him in accordance with his views of right and wrong.”

The central purpose of the introduction of ‘equity’ was thus to alleviate the harshness and rigidity of the common law. Albeit the original intention was that equity would be complementary to the rules of the common law (“equity follows the law”), it developed into an independent system which was later presided over by separate courts: the Common Law Courts and the Chancery Courts (Courts of Equity).³¹ Yet even after courts were given the power to apply both common law and equity, this distinction prevailed and it is still perceptible today.³²

²⁶ De Waal 2000 *SALJ* at 553.

²⁷ Olivier et al *Trust Law and Practice* (November 2011) at 1-14.

²⁸ Du Plessis LM *Introduction to the South African law* 3ed (1999) at 73.

²⁹ Hayton DJ & Ward describe the Chancellor as the King’s “right hand man in administrative matters.” See The Haynton Report available at <http://www.trustees.org.uk/word/The%20Haynton%20Report.doc> – last accessed 02/05/2013.

³⁰ Olivier et al *Trust Law and Practice* (November 2011) at 1-14.

³¹ Du Plessis LM *Introduction to the South African law* at 73; See also Cameron, et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at at 25.

³² This was allowed by the promulgation of The Judicature Acts of 1873 and 1875.

At common law, the *feoffee* (the person to whom the property was transferred), was recognised as the legal owner of the property and his interest in the property was termed a “legal estate.”³³ Disputes relating hereto would form the subject matter of the Common Law courts. However the *feoffee’s* undertaking towards the *cestui que use*, was not enforceable at Common Law and the latter was thus without a remedy. Yet in Equity the caveat to the *feoffee’s* legal ownership, namely that he held the land for the benefit of the *cestui que use*, was recognised by the Chancellor.³⁴ Thus the *feoffee* could in this court be held to his promise and be forced to perform in accordance with it. These rights of the *cestui que use*, were later recognised as a form of ownership (“equitable estate”) and thus the concept of a divided ownership originated. A concept that is distinctive to the English law.³⁵

However, it was precisely the benefits of the Use that also lead to its downfall. The widespread exploitation of the Use, often for purposes of disrepute such as the avoidance of feudal dues and liability towards creditors, led to the introduction of the Statute of Uses in 1535, which had as its aim the curtailing of this abuse.³⁶ By application of this Statute, the legal and equitable estates now vested in the *cestui qui use*, which rendered the Use ineffective and its application consequently dwindled. It would however re-emerge during the 17 and 18th centuries under the name of the Trust.³⁷ It was to be this institution, which similar to its early ancestors, would cross continents, in order to plant itself on African soil.³⁸

2 2 2 Reception in South African law and development

The rooting of the trust in South African soil and its consequent reception and development

³³ Du Toit F *South African Trust Law Principles and Practice* (2002) at 17 and Olivier et al *Trust Law and Practice* (November 2011) at 1-14.

³⁴ Sheridan as quoted in Coetzee ‘n *Kritiese ondersoek na die aard en inhoud van trustbegunstigdes se regte* (LLD thesis) at 55, “ their loss was the Chancellor’s gain...the ecclesiastical Chancellor of the Middle Ages was the proper person to prevent a serious breach of breach of an obligation of faith such as was involved in the undertaking of a use.”

³⁵ Olivier et al *Trust Law and Practice* (November 2011) at 1-14. This concept is explained by the authors Williams & Mazansky in Williams B & Mazansky E *Silke on International Tax* (Last updated November 2010) Chapter 6 at 6.2 available electronically on LexisNexis. They explain that in English law, property can be subjected to two different types of ownership vested in different persons simultaneously, ie one person may have legal ownership under the common law whilst another has equitable ownership – beneficial ownership in terms of the principles of equity. This dual concurrent ownership however is not be equated to joint ownership.

³⁶ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 248; Olivier et al *Trust Law and Practice* (November 2011) at 1-15.

³⁷ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (2007) at 309.

³⁸ De Waal MJ 2000 *SALJ* at 555; Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B2 at 6.

demonstrate the powerful influence historical events can have on the law. Turning back the pages of South African history to the 17th century, in the year 1652, Jan van Riebeeck arrived at the Cape of Good Hope, mandated by the *Verenigde Geocroyeerde Oost-Indishche Compagne* (the "VOC" – translated as the Dutch East Indian company) to establish a trading post.³⁹ The law originally practised by Van Riebeeck and the further Dutch settlers was the Roman-Dutch law (Roman law as interpreted by the Dutch writers of the 17th and 18th centuries).⁴⁰ This law was to become the foundation of the South African common law. Yet the concept of a trust was not known in Roman-Dutch law.⁴¹

The trust that appeared in South Africa was the trust that accompanied the British settlers and officials to South Africa.⁴² This was in consequence of the occupation of the Cape by the British and the eventual colonization of the Cape as British territory in 1806.⁴³ The trust became entrenched here by usage and custom, as opposed to legislative intervention.⁴⁴ De Waal explains this unique set of circumstances⁴⁵-

"The introduction of the trust institution into South African practice happened by way of incorporation of trusts (as the notion was then conceived) and the use of the word 'trust' and 'trustee' in wills, deeds of gift, antenuptial contracts and land transfers."

Du Toit⁴⁶ however wryly remarks that "South African law readily received the trust as an institution, but proved less receptive to English law pertaining to trusts." South African courts have similarly endorsed this sentiment, emphasizing that although the words "trust" and "trustee" may have been adopted in legal parlance, the English trust law has not been adopted.⁴⁷ This is a fine distinction that is echoed by Honiball & Olivier, "it is important to remember that although the English trust as an institution was incorporated into South African law, the English law of trusts was never

³⁹ Du Plessis LM *Introduction to South African Law* 3ed (1999) at 49.

⁴⁰ Barrat A & Snyman P "Researching South African Law" (update by R E Kapindu) – Article available at http://www.nyulawglobal.org/globalex/South_Africa1.htm. Last accessed on 02/05/2013.

⁴¹ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (2007) at 310.

⁴² According to Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 21 the appearance of the trust as institution was recorded as early as 1817, only two years after British occupation commenced in 1815 and the first reported case in which a trust was the central issue in dispute was in 1833 in the case of *Twentyman v Hewitt* (1833) 1Menz 156. See also Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B2 at 6. Barrat A & Snyman P "Researching South African Law" (update by R E Kapindu) – Article available at http://www.nyulawglobal.org/globalex/South_Africa1.htm. Last accessed on 02/05/2013.

⁴³ De Waal MJ 2000 *SALJ* at 555.

⁴⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 18.

⁴⁵ De Waal MJ 2000 *SALJ* at 555.

⁴⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 1.

⁴⁷ *Crookes NO and Another v Watson and Others* 1956 (1) SA 277 (A) at 297; *Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (A) at 859.

incorporated.”⁴⁸

The question that begs to be asked is therefore that if the English law of trusts was not incorporated in South African law, what then formed the basis upon which the trust was recognised as a valid legal institution, and upon what basis was it reconciled with the Roman-Dutch common law? Coertze⁴⁹ explains the dilemma as follows –

“The trust, however, had Roman Dutch lawyers baffled – perhaps even horrified or amused. They were confronted with a legal philosophy which demanded from them, if not an impossibility, then certainly something most incongruous. Here was a figure of law obviously conceived to create separate rights of ownership – not jointly- over an object, all equally valid, and at the same time, each in the separate hands of at least two different persons... All this to a lawyer trained in English law, quite feasible, “why not?” To the South African lawyer, trained in Roman Dutch law, “patent nonsense, what else?”

For more than a century the aforesaid question as to the basis of the trust’s recognition in our law remained unanswered and the trust continued to be employed in practice, without the courts deciding authoritatively on the legitimacy of the institution. But in 1915, in the case of *Estate Kemp v MacDonald’s Trustee*,⁵⁰ the Appellate Division was faced with this question. The court stated firmly and from the outset that the English law of trusts was not received in South African law and English trust law thus forms no part of the South African law.⁵¹

However as the trust had become so firmly embedded in practice, it would in the words of Judge Solomon be “impossible to eradicate it or seek to abolish the use of the expression ‘trustee’.” It was further recognized, that there is also nothing in South African law which is inconsistent with the institution. The court then went on to accommodate the trust within a recognised Roman-Dutch concept. This methodology - to accept the trust as an institution by finding a Roman-Dutch foundation - was also applied in subsequent cases.⁵² A methodology that was later overridden (at least in part), by the clear recognition that the South African trust is a legal institution *sui generis*, an unique institution of which the law pertaining to it is developed by our courts and which is still in the process of evolving, through the continuous adaption of the trust idea to the principles of our

⁴⁸ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 2. Also Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.1 available electronically on LexisNexis – “There has been no general reception of English law in South Africa, although particular aspects of English law have found their way in South African law.”

⁴⁹ Coertze in the Foreword to Olivier *Trust Law and Practice* (1990).

⁵⁰ 1915 AD 491.

⁵¹ *Estate Kemp v MacDonald’s Trustee* 1915 AD 491 at 499.

⁵² See in particular *Crookes v Watson* 1956 1 SA 277(A) where a trust *inter vivos* was found to also have a Roman-Dutch basis – namely that of a *stipulatio alteri* (a contract for the benefit of a third party.)

own law.⁵³

The rules and principles of South African trust law are thus described as “a mixture of English, Roman-Dutch and distinctively South African rules, with the latter continually growing in relative importance.”⁵⁴ An example of the latter is the Trust Property Control Act,⁵⁵ which was promulgated after a thorough study of the South African law of trusts by the South African Law Commission, which took into account public comment and the viewpoint of writers and practitioners in the field.⁵⁶ This Act however did not codify South African trust law, and thus our trust law has fortunately not “been confined to a statutory strait jacket”, but is “in a state of incremental development and refinement.”⁵⁷ As Olivier⁵⁸ therefore rightly remarks, “it [the trust] is a welcome import and although the original window dressing to grant it citizenship was rather questionable, this is no longer important.” Indeed the South African trust law is “all the stronger for being able to draw so widely” from its history.⁵⁹

The only drawback from the unique history of our trust law, appears to be a potential difficulty that may be experienced in encountering trust law of other countries, such as for example in the context of international tax treaties. Williams & Mazansky⁶⁰ explain that the inclusion of technical terms of the English law of trust, such as trust, trustee, beneficiary and beneficial ownership in South African trust law jargon, sometimes obscure the fact that these terms do not necessarily have the same meaning in South Africa, as in English law or in other jurisdictions based on English law. This is consequently an important aspect to remember and a familiarity with the distinctive history of the trust in South Africa as discussed above, will aid such understanding and interpretation.

This historical background has aimed to introduce the trust concept and its underlying structure, so to facilitate the discussions following in the chapters hereafter. It also showcased the various

⁵³ *Braun v Blann and Botha* 1984 2 SA 850 (A) at 859E where it was held that the trust is a legal institution *sui generis* - it must be noted that the judgment only related to testamentary trusts.

⁵⁴ Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 21.

⁵⁵ 57 of 1988.

⁵⁶ Olivier et al *Trust Law and Practice* (November 2011) at 1-23; Davis et al *Estate Planning* (May 2013) at 5-3 remark that the Act is not intended to be a codification of the trust law and that the trust unlike other entities such as companies and close corporations “are not subject to rigorous and extensive legislative regulation.”

⁵⁷ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.1 available electronically on LexisNexis.

⁵⁸ Olivier et al *Trust Law and Practice* (November 2011) at 1-25.

⁵⁹ Cameron et al *Honoré's South African Law of Trusts* 5th ed (2002) at 23.

⁶⁰ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.1 available electronically on LexisNexis.

sources pertinent to trust law in South Africa, which may accordingly be consulted for guidance in this study. It must however be agreed with De Waal,⁶¹ who remarked that “one can hardly write on the law of trusts without first defining “trust.” It is this task that is embarked upon in the next section. However, a warning can be found in his further words that such a task “...is surprisingly difficult. As Hayton has wisely remarked: “Like an elephant, a trust is difficult to describe but easy to recognize.”⁶²

2 3 Defining the trust

The definition of “trusts” in Stroud’s Judicial Dictionary of Words and Phrases commences with the statement that “no definition of trust seems to have been accepted as comprehensive and exact.”⁶³ Similarly Honoré⁶⁴ begins his monumental work on the law of trust, by stating that “an author is rightly expected to define the subject-matter of his book. So far as trusts are concerned this is not as straightforward as it seems.” De Waal⁶⁵ explains that

“A definition of the true nature of the trust in South African law is not easy to give. It is in a certain sense, easier to approach this task in a negative way by saying, for example, that the trust in South African law cannot be equated with the English trust or by stating that the trust should not be treated as a form of *fideicommissum*.”

To assist in the compilation of such a definition, Honoré⁶⁶ made a distinction between “trusts in the wide sense” and “trusts in the narrow sense,” a distinction which is made not only in South Africa, but according to him in all countries where English is spoken.

A trust in the wide sense is present “whenever a person is bound to hold or administer property on behalf of another or for some impersonal object and not for his own benefit.” Examples of such trusts, would normally exist in the situation of tutors who administer the property of their pupils, curators of mental patients or prodigals, and agents who hold money or property for their principals.⁶⁷ The dominant characteristics of the trust concept can however be identified in all such relationships, somebody holds or administers property on behalf of another, or others or for some

⁶¹ De Waal MJ 2000 *SALJ* at 548. See also See also Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B4 at 11 as well as 20(4).

⁶² De Waal MJ 2000 *SALJ* also at 548.

⁶³ *Stroud’s Judicial Dictionary of Words and Phrases* 7th edition(2006) Sweet & Maxwell Ltd, London.

⁶⁴ Honoré & Cameron *Honoré’s South African Law of Trust* (4th ed) at 1.

⁶⁵ De Waal, MJ “Anomalieë in die Suid-Afrikaanse trustreg” (1993) 56 *THRHR* 1.

⁶⁶ Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 3 as well as Honoré & Cameron *Honoré’s South African Law of Trust* (4th ed) at 2.

⁶⁷ Cameron et al *Honoré’s South African Law of Trusts* 5th ed (2002) at at 3.

object, in accordance with the fiduciary relationship⁶⁸ between them. Another important feature of trusts in this sense, is the fact that control and benefit is separated and assigned to different parties. Yet as Du Toit⁶⁹ points out, “in general legal parlance the aforementioned instances are however rarely labelled as trusts – more often than not reference is simply made to tutorship, curatorship, executorship, or trusteeship in an insolvent estate or agency.” If trusts are defined in this manner, De Waal⁷⁰ states that, then all jurisdictions would have the trust, which is evidently not the case and as he furthermore notes “there is a difference between a law of entrusting and a law of trusts.”

A stricter definition is however available in Honoré’s identification of trusts in the narrow sense. A trust in the narrow sense comes into being, “when the creator of the trust, whom we call the founder, has handed over or is bound to hand over to another the control of property which, or the proceeds of which, is to be administered or disposed of by the other (the trustee or administrator) for the benefit of some person other than the trustee as beneficiary, or for some impersonal object.”⁷¹ Again the distinction between control and benefit is present and thus it can be said that the trust in the narrow sense is therefore not so much an opposite to the trust in the wide sense, but instead a more distinguished form or a specie of the trust, in the wide sense.⁷² Trusts in the wide sense should be regarded, “as a broad umbrella – type of concept embracing all relationships in which the concept of a trust is to be found.”⁷³

The distinctive feature between the trusts in the narrow and trusts in the wide sense relate to the trustee: the trustee in the narrow sense occupies an office and is accordingly subject to the Master of the High Court (the state authority tasked with the supervision of trusts),⁷⁴ whereas the trustee in the wide sense, do not necessarily occupy an office at all (eg agency) and where they do hold office (eg tutors, curators etc), they are subject to different legislation, as they “have historically

⁶⁸ A fiduciary relationship denotes a relationship where the highest degree of trust is prevalent amongst the parties to it. See Olivier et al *Trust Law and Practice* (November 2011) at 1-9.

⁶⁹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 2.

⁷⁰ De Waal MJ 2000 *SALJ* at 548.

⁷¹ Cameron et al *Honoré’s South African Law of Trusts* 5th ed (2002) at 5.

⁷² Du Toit F *South African Trust Law Principles and Practice* at 2.

⁷³ Olivier et al *Trust Law and Practice* (November 2011) at 1-6.

⁷⁴ The Master of the High Court is the public authority tasked with overseeing the registration of trusts and authorising of trustees in such office. It also acts as a custodian of trust documents but does not validate or legitimize such documents. The Master is also given powers in terms of the Trust Property Act to oversee the trustees – for example, to call trustees to account for their administration and disposal of trust assets, to call for records and documents of the trust, instruct investigations to be carried out in respect of the trust administration. The Master may also in appropriate circumstance remove a trustee from office. See Geach WD & Yeats J *Trust Law and Practice* (2007) at 7.

grown up in different compartments".⁷⁵ Specifically these cases are excluded from the definition of the trust in Trust Property Control Act and the Act is thus not applicable to them. It is widely accepted⁷⁶ and judicially supported,⁷⁷ that only trusts in the narrow sense fall within the definition of the Trust Property Control Act.

This Act defines a Trust as -

"the arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed –

- (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of a person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or
- (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument,

but does not include the case where the property of another is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965 (Act No 66 of 1965)".

Important to note here, is that this definition thus requires a "making over or bequest" of ownership of the trust property to another. The latter can either be the trustee/s or the beneficiaries. It also requires a "trust instrument", which is defined in the Act to mean a "written agreement or a testamentary writing or a court order according to which a trust was created."⁷⁸ Trusts created orally are therefore excluded from the ambit of the Trust Property Control Act, unless they have been reduced to writing, in which event Section 2 of the Act provides for such a document to be deemed as a trust instrument.⁷⁹

It must be noted that the various acts by which taxes are levied,⁸⁰ and particularly important for this study, the Income Tax Act also contains a definition for trust, which is discussed in Chapter 4.

For purposes of the study, the principal focus will however be on trusts in the narrow sense. The reasons for doing so are threefold. Firstly, most of the rules of trust law only pertain to trusts in the

⁷⁵ Cameron et al *Honoré's South African Law of Trusts* 5th ed (2002) at 5.

⁷⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 2; Cameron, et al *Honoré's South African Law of Trusts* 5th ed (2002) at 5.

⁷⁷ *Conze v Masterbond Participation Trust Managers* 1996 3 SA 786 (C).

⁷⁸ S 1 of the Trust Property Control Act, 57 of 1988

⁷⁹ S 2 of the Trust Property Control Act, 57 of 1988.

⁸⁰ It must be borne in mind that the other taxation legislation such as the VAT Act (89 of 1991) and the Transfer Duty Act (40 of 1949) also have definitions relating to trusts.

narrow sense.⁸¹ Secondly, trusts in the “wide sense,” such as tutelage, curatorships or insolvent estate, have particular characteristics and principles relevant to them, with different legislation applicable so that a study on such topics would become too broad and divergent. Thirdly the specific types of trusts, with which this study is concerned (as identified later), can be classified as trusts in the narrow sense.⁸²

From a worldwide perspective, regard may be had to the Hague Convention on the Law Applicable to Trusts and on their Recognition. The objective of the Convention is, *inter alia*, to harmonise the various trust definitions.⁸³ According to Section 2 of the Convention, the term "trust" refers to the legal relationship 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.” The Convention then lists the following characteristics for a trust –

- “a) the assets constitute a separate fund and are not a part of the trustee’s own estate;
- b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
- c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.”

At the end of the section it is stated that –

“The reservation by the settlor of certain rights and powers, and the fact that the trustee may himself have rights as a beneficiary, are not necessarily inconsistent with the existence of a trust.”

Although South Africa is not a party to the Convention, the definition does bear similarity to the definition of trusts as expounded in South African law.⁸⁴

In conclusion of this section, it is evident from the above definitions that the core idea of the trust is the administration of property, by a party not for his own benefit, but for the benefit of another. For purposes of the study at hand, this is then an integral part to a trust being regarded as "established" or "formed", as required by the first criteria of the test for fiscal residence. The definitions also emphasize the administration aspect of a trust, which aspect is important to the concept of "effective management", as required by the second criteria of the test for fiscal

⁸¹ Cameron et al *Honoré’s South African Law of Trusts* 5th ed (2002) at 4.

⁸² See discussion at 2.7.

⁸³ Hague Convention on the Law on the Law Applicable to Trusts and on their Recognition) Available at www.hcch.net/index_en.php?act=conventions.text&cid=59. Last accessed on 02/05/2013. Signed on 1 July 1985 and came into operation on 1 January 1992.

⁸⁴ De Waal MJ 2000 *SALJ* at 549.

residence. The various parties to whom reference is made in the definitions above, have in legal terminology been assigned the names of founder, beneficiary and trustee, and it is to them that we now turn.

2 4 The Role-players (*dramatis personae*) of the Trust

The concept of the founder, trustees and the beneficiaries is explained here so to ensure a familiarity with the meanings of the terms, when they are utilised in the discussions which follow below. However, as these terms form the subject matter of Chapter 3 and are in detailed discussed there, such explanation is presented in synopsis form.

The first of these role-players is the founder. As the name indicates, the founder (also referred to as the “donor” or “settlor”, is the person who “founds” (creates) the trust by conveying his or her property to another and who must exhibit the intention of creating a trust.⁸⁵ The trustee is the recipient of such property and will control and administers the trust property in furtherance of the trust object, or for the benefit of the beneficiaries.⁸⁶ Thus, the beneficiaries, are in turn, those who stand to benefit from the creation and administration of the trust. These concepts are revisited in Chapter 3 and elaborated there.

2 5 Essentialia of the Trust

In terms of South African law, certain essential requirements (referred to as the *essentialia*) must be met for a valid trust to exist. A distinction is made between the *essentialia* for the creation of a valid trust and the *essentialia* at the commencement of the administration of the trust.

2 5 1 The *essentialia* for the creation of a valid trust

The *essentialia* that must be present at the creation of the trust, has in case law, been identified to refer to five requirements.⁸⁷ Firstly the founder must have the requisite intention to create a trust. This entails that he must clearly and unambiguously express his intention to create a trust and not some other legal institution. It also denotes that his intention must be to hand over the control of

⁸⁵ Olivier et al *Trust Law and Practice* (November 2011) at 1-10.

⁸⁶ Olivier et al *Trust Law and Practice* (November 2011) at 1-10.

⁸⁷ *Administrators, Estate Richards v Nichol* 1996 (4) SA 253 (C) at 258 E-F; Du Toit F *South African Trust Law Principles and Practice* (2002) at 27.

the trust property to another to be administered for the benefit of a third party. Secondly the founder must express his intention in a manner capable of creating an obligation. This requirement relates to the manner in which the trust is formed and will be discussed when the formation of a trust is analysed.⁸⁸ The "obligation" to which this second requirement refers is the obligation to enable the trustees to administer the trust property, or where the trust property has already been transferred to the trustees, to the obligation resting upon the trustees to administer the property in accordance with the trust object.⁸⁹ Thirdly the subject matter of the trust must be defined with reasonable certainty. This requirement refers to the trust property and as was evident from the discussion regarding the basic idea of the trust concept, there must be "property". The Act defines "trust property" as follows-

"trust property" or **"property"** means movable or immovable property, and includes contingent interests in property, which in accordance with the provisions of a trust instrument are to be administered or disposed of by a trustee.⁹⁰

Du Toit⁹¹ states that often the purpose for which a particular trust is created, will determine the nature of the property subject to such trust. Similar to the third requirement, the fourth requirement expresses the need for the trust object, personal or impersonal, to be defined with reasonable certainty. This entails that where trusts are set up to benefit certain persons or classes of persons they must be determined or at least be ascertainable.⁹² And lastly, the trust object must be lawful. The latter thus denotes that the object identified for the trust should not be illegal or against public policy (*contra bonos mores*).⁹³ It may be noted at this juncture, that there is no requirement in the Income Tax Act, that a trust as defined there, should have a legal object.

2 5 2 The *essentialia* at the commencement of the administration of the trust

The *essentialia* required at the commencement of the administration of the trust is stated to be a continuance of the *essentialia* stated above, save for the addition of the following two requirements: firstly the presence of a duly appointed trustee who has accepted the appointment

⁸⁸ This obligation can be housed in various forms eg Will, contract, court order, statute etc and the formalities applicable to such form must therefore be complied with to create an effective obligation. See discussion at Chapter 5.

⁸⁹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 30.

⁹⁰ S 1.

⁹¹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 7.

⁹² Du Toit F *South African Trust Law Principles and Practice* (2002) at 31.

⁹³ Du Toit F *South African Trust Law Principles and Practice* (2002) at 32. Of these two criteria, the latter is more difficult to determine as public policy is based on the norms and values of the society which is in constant flux.

as trustee and secondly the transfer of the trust property to the intended party. The first requirement must not be taken to mean that a trust cannot be formed nor exist further due to the absence of a trustee – for it has often been said "a trust will not fail for want of a trustee."⁹⁴ However the trustee fulfils such an important role in the administration of the trust, that the functioning will be hampered should there not be a trustee. The second requirement is self-explanatory and ties up with the obligation of the trustee to administer the property for the benefit of the trust beneficiaries, or for such impersonal trust object as may have been stated in the trust deed. The trustee will not be able to fulfil such objects should the property not be transferred.⁹⁵

Thus for an entity to be legally recognised as a trust in South African trust law, it is not sufficient to merely display the trust idea (explained in paragraph 2) in its structure, nor to meet the statutory definition set in paragraph 3, or have the various parties in office as set out in the various paragraph 4. Instead it must comply and exhibit these *essentialia* for it to be regarded as a valid trust. Du Toit states that "in the absence of any one or more of these elements, no valid trust comes into existence."⁹⁶ It is submitted however that an invalid trust in terms of the *essentialia* as discussed, may however still be regarded as a "trust" in terms of the Income Tax Act, and be regarded as "resident."⁹⁷

2 6 The Legal Nature of the Trust

In the context of persons other than natural persons, a distinction is usually made between entities who are recognised in law as legal persons (also referred to as juristic persons) and those who are not regarded as such, with specific consequences following such categorization. An entity that is regarded as a juristic person, is recognised as having an independent legal identity from its underlying members.⁹⁸ As such it is allowed to acquire its own rights, own assets in its own name and enter into contracts. It can also incur its own duties and obligations and is responsible for same. A juristic person essentially has no physical presence but is recognised as having an existence for

⁹⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 34. Should a vacancy occurs, the Master or High Court may appoint a trustee.

⁹⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 35. See Coetzee 'n *Kritiese ondersoek na die aard en inhoud van trustbegunstigdes se regte* (LLD thesis) at 136 -138 where the *essentialia* as identified by various authors are listed.

⁹⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 27.

⁹⁷ For example it may still be regarded as "effectively managed" in South Africa and thus resident for tax purposes.

⁹⁸ Honey M "Legal structures commonly used by Non-Profit Organisations" – Available at <http://www.etu.org.za/toolbox/docs/building/lrc.html>. Last accessed on 02/05/2013.

legal purposes.⁹⁹ One of the most important consequences of an entity being recognised as a legal person is that it enjoys continuity and does not cease upon the death of its members.

It is therefore important to ascertain the precise legal status of a trust. That such an endeavour is not unproblematic, is recognised by Honiball & Olivier,¹⁰⁰ who remark that “the legal nature of a trust in South Africa remains one of the most difficult aspects to grasp.” Also Pace & Van der Westhuizen state, that “the true legal nature of the trust has for many years been the terrain for some intense legal debate.”¹⁰¹

At common law, the trust is not clothed with juristic personality. Instead the assets and liabilities vests in the trustees who administer same. It is the trustees who, for example, enter into contractual agreements on behalf of the trust and who will be sued or joined in suing in litigation matters.¹⁰² South African courts have on more than one occasion confirmed the common law position and had held that the trust is not a legal person.¹⁰³ Our Supreme Court of Appeal in the case of *CIR v MacNeillie’s Estate* also endorsed this stance¹⁰⁴ -

“Like a deceased estate, a trust, if clothed with juristic personality, would be like a persona or legal entity consisting of an aggregate of assets and liabilities. Neither our authorities nor our Courts have recognised it as such a persona or entity. It is trite law that the assets and liabilities in a trust vest in the trustee.”¹⁰⁵

The South African Law Commission was also not in favour of awarding legal personality to trusts.¹⁰⁶ Yet an “anomalous” situation often results in practice, where a trust is treated as having legal personality.¹⁰⁷ In other words an inconsistency arises, in that trust theory consisting out of the principles and case law on trust, which would prescribe that a trust is not a legal person and consequently does not have a separate personality, whereas trust practice, which relates to how trusts function in practice, will accord it same.¹⁰⁸ For example, a trust does not have a separate identity according to trust theory and is thus not possible to sequestrate it, however in trust

⁹⁹ Van Dorsten JL *South African Business Entities – A Practical Guide* 3rd Ed (1993) at 4.

¹⁰⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 9.

¹⁰¹ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B5 at 20(6).

¹⁰² Geach WD & Yeats J *Trusts Law and Practice* (2007) at 14.

¹⁰³ See various cases listed at Du Toit F *South African Trust Law Principles and Practice* (2002) at 9.

¹⁰⁴ 1961 (3) SA 833 (A) at 840 F-G.

¹⁰⁵ *Braun v Blann and Botha* at 860A. A recent decision, *Knoop NO V Birkenstock Properties (Pty) (Ltd) and Others* [2009] ZAFSHC 67 is controversial as it states that a trust is a ‘corporate entity’ and similarly has a ‘corporate veil’ that can be pierced.

¹⁰⁶ South African Law Commission *Report on the Review of Law of Trusts* (Project 9)(June 1987) par 23.8.

¹⁰⁷ De Waal MJ “Anomalieë in die Suid-Afrikaanse trustreg” (1993) THRHR 1.

¹⁰⁸ Olivier et al *Trust Law and Practice* (November 2011) at 2-30(9) to 2-31.

practice this is effected.¹⁰⁹

Often out of practical considerations, legislation is passed to award legal personality to an entity.¹¹⁰ A case in point being the Income Tax Act, which was specifically amended to include a trust in the definition of a “person.”¹¹¹ This was done to counter case law, which had held that a trust is not a person for purposes of the Income Tax Act and consequently does not constitute a taxable entity and can thus not be taxed.¹¹² Through the amendment of the Act¹¹³, the trust is now recognised as a “person” for purposes of the Income Tax Act. Consequently as a separate taxable entity, it can be taxed in its own right provided the further requirements for such taxation are met, including the requirement of “residence.”

To overcome the perceived anomalies and to clarify the precise nature of the trust, it has been called for legal personality to be awarded to trusts.¹¹⁴ It is argued that such a step will promote the integrity of the trust idea and lead to legal theoretical purity in respect of the trust.¹¹⁵ It is further believed that this would resolve the tension between trust practice and trust theory, which give rise to these anomalies, and would also put an end to the piecemeal approach presently followed, namely to only address issues by legislative intervention when the schism between theory and practice becomes too big. However, in the words of Du Toit¹¹⁶-

“The reluctance to bestow legal personality on trusts and the resultant practical and theoretical difficulties, have fortunately not detracted from the usefulness of the trust as a legal and commercial tool... most of the discrepancies which result from the trust’s lack of legal personality, do not translate into insurmountable practical obstacles.”

It is further remarked by De Waal, that the positive side of the uncertainty surrounding the legal nature of the trust, translates into the fact that the trust is seen as a highly flexible and adaptable institution.¹¹⁷ The latter characteristic forms the subject matter of the next section.

¹⁰⁹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 256.

¹¹⁰ Recently this was done in the Consumer Protection Act, 68 of 2011 and the Companies Act, 71 of 2008.

¹¹¹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 10. The relevant legislation being S 2(1)(d) of Act 129 of 1991.

¹¹² Du Toit F *South African Trust Law Principles and Practice* (2002) at 10. See *Friedman v CIR : In re Phillip Frame Will Trust v CIR* 1991 2 SA 340 (W).

¹¹³ The relevant legislation being S2(1)(d) of Act 129 of 1991.

¹¹⁴ Olivier et al *Trust Law and Practice* (November 2011) at 2-32; Du Toit F *South African Trust Law Principles and Practice* (2002) at 9 & 25.

¹¹⁵ De Waal MJ “Anomalieë in die Suid-Afrikaanse trustreg” (1993) *THRHR* 9.

¹¹⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 13 &-14.

¹¹⁷ De Waal MJ “Anomalieë in die Suid-Afrikaanse trustreg” (1993) *THRHR* 1.

2 7 Classification of trusts

Trusts can be classified in a variety of ways and the name attributed to a trust often depends on the specific angle from which the trust is viewed. So for example trusts can be classified from the viewpoint of its origin (source or place), the rights of the beneficiaries, the powers of the trustees, the purpose for which the trust was created, or from a tax perspective.¹¹⁸ In this section the various types of trusts as generally classified will be traversed, as reference will be made to certain of the trusts in the further chapters. More importantly the discussion will aim to highlight the features unique to such trusts, which features in turn have relevance to and impact on the fiscal test for "residence."

2 7 1 Classification according to when a trust becomes effective/mode of creation

Generally a distinction is made as to whether a particular trust is a *mortis causa* trust (also known as a testamentary trust or will trust), or an *inter vivos* trust. The former denotes a trust that is principally created in terms of a will.¹¹⁹ The key feature of such a trust is that it only becomes effective upon the testator's death.¹²⁰ Conversely a trust *inter vivos* becomes effective whilst the founder is still alive.¹²¹ Such trusts are generally deemed to be created by contract and although the subject of much controversy and opposition, has been characterized as a specific type of contract, namely a contract for the benefit of a third party – a *stipulatio alteri* by our Appellate Division.¹²² Yet even though its underlying basis may be depicted as a contract (unlike English law), it must be noted that the trust itself is more than simply a contract. In the words of Williams & Mazansky "it is a public law institution which a contract, is not, and the trustee holds an office and does not act in a purely private capacity."¹²³

In addition to being formed in a Will and/or contract, a trust may be formed by statute, treaty,

¹¹⁸ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 252; Olivier et al *Trust Law and Practice* (November 2011) at 5-3 to 5-42 and Geach WD & Yeats J *Trusts Law and Practice* (2007) at 17-33.

¹¹⁹ As Olivier observes despite the prevalence of such trusts created by wills, it is in theory possible for such trusts to be created by other instruments such as antenuptial contracts. Olivier et al *Trust Law and Practice* (November 2011) at 5-3.

¹²⁰ Olivier et al *Trust Law and Practice* (November 2011) at 5-5.

¹²¹ It must be noted that the death of the founder will not transform an *inter vivos* trust into a *mortis causa* trust as the original source for the trust will still remain the agreement of trust.

¹²² Olivier et al *Trust Law and Practice* (November 2011) at 5-5.

¹²³ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.2 available electronically on LexisNexis. The authors further note that in contrast, in English law, a trust is not created by contract.

judicial order or transfer.¹²⁴ A trust can also be formed by oral agreement, but the Trust Property Control Act will not govern such a trust.¹²⁵ However should the oral agreement be reduced to writing, such document is according to section 2 of the Act deemed to be a trust instrument and would then fall within the ambit of the Act's governance.¹²⁶

In general, the distinction between trusts *mortis causa* and trust *inter vivos* is relevant in the tax framework to the extent, that it may be a requirement for a specific type of trust which has particular taxation rules applicable to it¹²⁷ and it also identifies the parties which may be taxed.¹²⁸ For the purposes of the study at hand, the importance of a trust being classified as either being a *mortis causa* trust or an *inter vivos* trust, primarily affects its formation and impacts on the effective moment at which the trust will be deemed to come into existence. It also sets the specific criteria for its validity. This will consequently be discussed in Chapter 5 dealing with the "incorporated, established or formed"-criterion of the test for residence.

2 7 2 Classification according to the ownership of the trust property

A further distinction is often made based on the ownership of the trust property.¹²⁹ A trust may be classified as either an ownership trust or a *bewind* trust. In an ownership trust, ownership of the trust property vests in the trustee/s, who also exercise the powers of control over it for the benefit of the trust beneficiaries, or in furtherance of the trust object.¹³⁰ This type of trust can be recognised in the definition of a "trust" in the Trust Property Control Act– paragraph (a). By contrast, the beneficiaries are the owners of the trust property in a *bewind* trust and the trustees only exercise control over it.¹³¹ Paragraph (b) of the definition of a "trust in the Trust Property Control Act is a summation thereof. Such trusts are usually formed for a beneficiary who suffers

¹²⁴ Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 138. Honore gives as example of trusts formed by statute, the National Parks Boards of Trustees formed under Act 57 of 1976, and in relation to court order trusts, remark upon the increased tendency to establish trusts to administer damages for personal injuries.

¹²⁵ Sec 1 of the Act defines a trust instrument as a written agreement or a testamentary writing or a court order- thus all bear the essential characteristic of appearing in text.

¹²⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 7.

¹²⁷ One of the types of special trusts recognized by the Act is a testamentary trust that has been ceated solely for the relatives of the testator where the youngest beneficiary is younger than 18.

¹²⁸ Haupt P *Notes on South African Income Tax 2013* at 795. In an *inter vivos* trust the founder, beneficiaries and the trust can possibly be taxed. With a *mortis causa* trust, the founder is not alive during the existence of the trust and thus only the trust and/or beneficiaries may potentially be liable for tax.

¹²⁹ Olivier et al *Trust Law and Practice* (November 2011) at 5-13

¹³⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 3 and Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 315.

¹³¹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 253.

from some sort of limitation, or where the need for “custodianship” over the assets is predominant. Geach¹³² mentions the following example of where such a “bewind” trust may be appropriate: a lack of contractual capacity as is the case with minors or those sufferings from a mental or physical incapacities. The ownership trust can be further classified in two types of trusts based on the rights of the beneficiaries, which classification is discussed next.¹³³

2 7 3 Classification according to the rights of the beneficiaries

The rights of the beneficiaries can either be described as vested or discretionary rights, and a beneficiary may have a combination of such rights. A vested right refers to the right of a beneficiary to claim delivery of the benefit, that is the subject matter of the right from the trustee upon the happening of a certain event.¹³⁴ The subject matter of the right could for example be a right to the income of the trust, or to a specific portion of the income of the trust, or the right to a specific amount or to use a specific asset, or to a portion or all of the capital.¹³⁵ Such a right is a personal right.¹³⁶ A discretionary right is described as a contingent right or a *spes* (hope). The benefit such a beneficiary will enjoy and the extent thereof is contingent upon the exercise of the trustees’ discretion in favour of him or her. This distinction was explained in *ITC 76*¹³⁷ as follows-

“A vested right is something substantial, something which can be measured in money, something which had a present value and could be attached. A contingent right is a mere *spes*- an expectation that might never be realised. Due to its nature it can not have a definite current value. For tax purposes a vested right is an accrued right.”

Should the rights of the beneficiaries be such that they have vested rights, a “vested or vesting” trust would be present.¹³⁸ Should the distribution of income or capital to the beneficiaries be dependent upon the exercise of the trustees’ discretion, a discretionary trust would be present.¹³⁹ The extent to which the trustees have a discretion is determined by the terms of the trust deed and in this regard Davis list the following examples: the trustees may be given the discretion whether to make a distribution or not; to make a distribution in equal shares to the beneficiaries or in unequal

¹³² Geach WD & Yeats J *Trusts Law and Practice* (2007) at 19.

¹³³ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 19.

¹³⁴ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 253.

¹³⁵ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 21.

¹³⁶ This must be contrasted to ownership which is a real right. This distinction is important so as to avoid a confusion with a bewind trust where ownership of the trust assets vest in the beneficiaries. Here the ownership of the assets still vest in the trustees, but is subject to the personal rights of the beneficiaries. See also Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 5.

¹³⁷ 1927 3 SATC 68-69.

¹³⁸ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 5.

¹³⁹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 6.

shares, or to exclude one or more of the beneficiaries.¹⁴⁰

This second and third classification of trust based on the ownership of trust property and the rights of the beneficiaries is important for tax purposes in determining the appropriate taxpayer.¹⁴¹ This issue will be revisited in Chapter 4 and dealt with in further detail.

2 7 4 Classification according to the purpose for which the trust was created

An American trait whereby trusts are given names primarily based on their underlying purpose¹⁴² can also be observed in South Africa. One frequently encounters in daily practice terms such as family trusts, business trusts, charitable trusts, property trusts and BEE (Black Economic Empowerment) trusts. Such a classification, based on the purpose for which the trust is created, will be briefly discussed to ensure a familiarity with such terminology. The various purposes for which a trust can be created is most comprehensively describe by Honoré:

“The Founder may want to prevent the dissipation of his property after death, or to support a political, religious or social cause in a way which calls for continuous management rather than a single disposition... A paternalist may wish to protect his relatives against themselves, a parent to provide for a child’s education and start in life. A person may want to put some or all of his assets out of the reach of creditors or family, or to conceal his ownership of them. Estate planners make much use of trusts in order to minimize tax liability. A businesswoman may prefer to do business under the aegis of a trust rather than a company, close corporation or partnership. She may resort to a trust to ensure that her business is well run after her death, to promote a company, to make an investment or to realise an estate in an orderly way(realisation trust). Businesses employ trust to protect the interest of debenture holders, to manage pension funds and to run share purchase or management incentive schemes. Industry attracts small investors through unit trusts which are subject to special statutory controls. Trade unions and community organizations have employed the trust to protect their assets from the danger of seizure by the state. The legislator itself uses trusts for the management of national parks and for the control and management of public spaces...The courts too employ trusts, for instance in the settlement of matrimonial disputes or to protect awards of damages made to minors...¹⁴³”

Consequently, the name of trust will be dependent on the object for which it was created.

¹⁴⁰ Davis et al *Estate Planning* (May 2013) at 5-13.

¹⁴¹ Geach explains that when income is received/accrues to the trust four possibilities arise: firstly the trust may be taxed, secondly, one or more of the beneficiaries may be taxed, thirdly, the trust and one or more of the beneficiaries may be taxed or fourthly, a person who made a gratuitous disposition to the trust will be taxed. Thus for example the trust will be taxed if there is no beneficiary with a vested rights or no amounts were distributed or allocated to discretionary beneficiaries. On the other hand a beneficiary in a bebind trust, or a beneficiary with a vested right will be taxed. See Geach WD & Yeats J *Trusts Law and Practice* (2007) at 242.

¹⁴² Olivier et al *Trust Law and Practice* (November 2011) at 5-3.

¹⁴³ Cameron et al *Honoré’s South African Law of Trusts* 5th ed (2002) at 16; See King R, Victor B et al *Estate Planning & Fiduciary Services Guide* 2013 (2013) at 2for the miscellaneous uses of trusts.

Impersonal objects

Should the object of the trust be framed altruistically and be for the benefit of the general public or a defined section of the community it will be termed a charitable trust.¹⁴⁴ Specifically such trusts are created for an impersonal object and although there is at the end of the line, persons who benefit, there is no requirement that they be named upfront, the declaration of the object of the trust is sufficient.¹⁴⁵ A further difference between such trusts and other trusts are the “benevolent attitude of the courts”¹⁴⁶ they enjoy, as well as favourable tax laws, which in essence allow them to operate and receive funding without being taxed.¹⁴⁷ Particularly due to the latter reason, the fact that a special dispensation of taxation laws normally apply to such charitable trusts, such trusts do not form the principal focus of the study at hand.

Private trusts

Where trusts are formed for named or ascertainable beneficiaries, such trusts are usually refer to as a private trusts. The latter mostly operates in the context of families where it is then known as a “family trust.”¹⁴⁸ Such a trust can be said to have as its purpose, the protection of the interest and property of a family circle.¹⁴⁹ Yet it is often within this close-knit group that the core idea of the trust, namely the separation between control and enjoyment is abused.¹⁵⁰ Geach¹⁵¹ explains-

“With this sort of trust, the founder, planner and/or the beneficiaries usually treat the trust assets as their own assets, and freely use, consume, sell or otherwise deal with these so-called trust assets without any discussion, knowledge or consent of the trustees of the trust. In such a case the trust form is in reality, a sham, and the trust assets are practically controlled by the founder, beneficiaries, planner and/or by their agents for personal benefit.”

The focus of the study will be on this type of trust as a form of the ownership trust and in particular as they denote the majority of private trusts.¹⁵² Also important is the need to take cognisance of this potential misuse by the trust functionaries in these trusts especially in the context of the

¹⁴⁴ Olivier et al *Trust Law and Practice* (November 2011) at 5-37.

¹⁴⁵ Du Toit F *South African Trust Law Principles and Practice* (2007) at 185.

¹⁴⁶ Olivier et al *Trust Law and Practice* (November 2011) at 5-38. Such an approach refers to the court’s willingness to rather find in favour of their validity as opposed to their invalidity.

¹⁴⁷ Olivier et al *Trust Law and Practice* (November 2011) at 5-38, Du Toit F *South African Trust Law Principles and Practice* (2007) at chapter 7.

¹⁴⁸ Olivier et al *Trust Law and Practice* (November 2011) at 5-16 (2).

¹⁴⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 13.

¹⁵⁰ *Land and Agricultural Bank of South Africa v Parker* 2005 (2) SA 77 (SCA); *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA)

¹⁵¹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 13.

¹⁵² Olivier et al *Trust Law and Practice* (November 2011) at 5-16(2).

“effective management” of the test for residence.

Business trusts

Another type of trust that is increasingly employed in practice is the trust created with the main objective to trade. Such a trust is often referred to as a business trust or trading trust.¹⁵³ This trust has been judicially recognised and described as a “newer type of trust.”¹⁵⁴ Its popularity derives from the fact that it offers the principal advantages corporate entities¹⁵⁵ possesses, namely limited liability and perpetual succession. Yet these trusts also have the added benefit that certain expensive and onerous administrative requirements of the legislation¹⁵⁶ which govern corporate entities do not apply to it, for instance an annual audit is not required.¹⁵⁷ Another feature that is particularly attractive, is its flexibility.¹⁵⁸

In terms of South African law, a trustee has no power to carry on business with the assets of a trust, as the trustee would by doing so expose the trust assets to business and risk.¹⁵⁹ A trust deed however may empower a trustee to this effect and most standard trust deeds do authorise the trustees to engage in business activities. Should the trustees thus act in accordance with these powers, such trusts would in Olivier’s view be a private trusts engaging in business activities.¹⁶⁰ A trust may for example be created to house the operation of a garage or block of flats, for example where the specific property has been placed under the ownership and control of the trust's trustees so as to generate revenue with it, in the interest of the stated beneficiaries, and yet will still not strictly be a business trust.¹⁶¹

¹⁵³ Davis et al *Estate Planning* (May 2013) at 5-14(4). Also Olivier et al *Trust Law and Practice* (November 2011) at 5-17 and Du Toit F *South African Trust Law Principles and Practice* at 179. See Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002) 91-95 – in particular at 91 “Over the past three decades business trusts have become increasingly popular in South Africa.”

¹⁵⁴ *Nieuwoudt v Vrystaat Mielies (Edms) Bpk* 2004 3 SA 468 (SCA) 493E.

¹⁵⁵ Previously companies and close corporations. Since the promulgation of the new Companies Act, effective 1 May 2011 no new close corporations may be registered. The Act makes provision smaller business to instead be formed as companies but without the stringent financial reporting and auditing requirements usually applicable to companies.

¹⁵⁶ Previously the Companies Act, 61 of 1973 and the Close Corporations Act, 69 of 1984; now the Companies Act, 71 of 2008.

¹⁵⁷ Davis et al *Estate Planning* (May 2013) at 5-14(4).

¹⁵⁸ Statement published on 8 February 1985, the Standing Advisory Committee on Company Law. For a further comparison of the advantage of a business trust as opposed to a close corporations, company or partnership see Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 92-93.

¹⁵⁹ Geach WD & Yeats *JTrusts Law and Practice* (2007) at 295; *Sackville-West v Nourse* 1925 AD 516.

¹⁶⁰ Olivier et al *Trust Law and Practice* (November 2011) at 5-17.

¹⁶¹ It will still only be an ownership trust of which its administration comprises the conducting of a business. Du Toit F *South African Trust Law Principles and Practice* (2002) at 179.

Instead a business trust¹⁶² has certain unique features such as the contribution of the trust property by its beneficiaries, the management and control of such property by the trustees in whom it vest for profit making, the presence of the partnership concept (funds and efforts are combined) built into the trust structure¹⁶³ and often, the issue of transferable share certificates to reflect the beneficiaries' interests.¹⁶⁴ Du Toit offers the following definition:

“A business trust can be defined as a joint business venture undertaken by more than one person, the principal object of which is to generate a profit. In order to attain this goal, the participants contribute to the capital of the trust, such contributions can consist of either money or other property. The trust capital is then placed under the control of the trust's trustees who administer the property to the advantage of the various contributors as beneficiaries. The beneficiaries then share in the proceeds of the trust administration in accordance with their respective contributions to the trust capital.¹⁶⁵”

South African courts have acknowledged that trusts are used for business purposes¹⁶⁶ and have also recognized the existence of business trusts. For example, the Supreme Court of Appeal said in *Land and Agricultural Bank of South Africa v Parker*¹⁶⁷.

“So long as the functions of trusteeship remain essentially distinct from the beneficial interests, there can be no objection to business trusts, since the mechanisms of the trusts form will conduce to their proper governance, which will in turn provide protection for outsiders dealing with them.”

The underlying trust structure is often in the form of either a *bewind* trust or an ownership trust. Davis notes that if a *bewind* trust is used, it is important to be aware of the fact that the beneficiaries own the business and its assets. Practically this means that the business and its assets are exposed to the beneficiaries' creditors (ie both the business or other creditors of the beneficiaries). The same holds true vice versa, as the beneficiaries' own assets are also exposed to the business creditors.¹⁶⁸ In respect of discretionary ownership trusts, he notes that if the beneficiaries' rights are not vested, the interests of the beneficiaries in the trust are not attachable

¹⁶² Based on the American concept – Olivier et al *Trust Law and Practice* (November 2011) at 5-17 and Du Toit F *South African Trust Law Principles and Practice* (2002) at 179.

¹⁶³ *Pezutto v Dreyer* 1992 3 SA 379 (A) 390 where it was stated: “In essence therefore, a partnership is the carrying on of a business (to which each of the partners contributes) in common for the joint benefit of the parties with a view to making a profit”. Consequently the intention to create a trust must be made quite clear when creating a business trust of this kind per Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B4.2.2.2 at 18.

¹⁶⁴ Olivier et al *Trust Law and Practice* (November 2011) at 5-18 .

¹⁶⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 179. See also Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B4.2.2.2 at 18.

¹⁶⁶ *Essack Family Trust v Soni* 1973 (3)SA 625 (D) at 627.

¹⁶⁷ 2005 (2) SA 77(SCA) at par 19; see also *Nieuwoudt v Vrystaat Mielies (Edms) Bpk* 2004 3 SA 486 (SCA) 493F–G *Goodricke and Son (Pty) Limited v Registrar of Deeds, Natal* 1974 1 SA 404 (N); *Pretorius v CIR* 1984 2 SA 619 (T) and *CIR v Pretorius* 1986 1 SA 238 (A).

¹⁶⁸ Davis et al *Estate Planning* (May 2013) at 5-20.

by their creditors. Du Toit¹⁶⁹ finds their structure more akin to that of a *bewind* trusts, based on the fact that although the trust property vests in the trustees, the beneficiaries are not limited to personal rights as the shares they hold are directly related to the property. Consequently he states that the trustees are rather managers or administrators than trustees in the technical sense.¹⁷⁰

Very importantly is the point made by Pace & van der Westhuizen that the business trust must still have as object, to be for the benefit of beneficiaries, and can not simply be stated to be formed to acquire a piece of land or development of the land as for example is often the object of a company.¹⁷¹ Such objects may according to the authors, only form the ancillary objects or form part of the specific powers of the trustees.

A distinction between private and public business trusts are sometimes also made. A public business trust would be present should an invitation be made to the general public or the latter be allowed to acquire an interest in the trust property and become income beneficiaries upon payment or delivery of money or assets.¹⁷² In a private business trust the participation of the general public is absent. Certain specific types of business trust have in turn been identified: unit trusts,¹⁷³ property trusts (other than those which fall under the (former) Unit Trust Control Act),¹⁷⁴ voting trusts,¹⁷⁵ debenture trusts¹⁷⁶ etc.¹⁷⁷ However the specific nature and further elements of such trusts fall outside the scope of this discussion.

Yet it must be noted that business trusts are not regulated separately but are treated as ordinary trusts and even from a tax perspective, such trusts have no specific meaning.¹⁷⁸ A distinction which does however become apparent from the discussion on business trusts, is that of a potential

¹⁶⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 19.

¹⁷⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 180.

¹⁷¹ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B8.4.1at 44(5).

¹⁷² Geach WD & Yeats J *Trusts Law and Practice* (2007) at 23.

¹⁷³ Unit trusts are a form of public business trusts and allows beneficiaries to obtain units (which can be traded on the Johannesburg Stock exchange) in the trust which in turn holds further assets such as stocks, shares, debentures of other securities. The trust is managed by a management company or board of trustees. See Cameron et al *Honoré's South African Law of Trusts* 5th ed (2002) at 618-645 for a thorough discussion.

¹⁷⁴ Denotes property and investment trusts whereby a small group of people would come together to form such a trust aimed at the acquisition and development of fixed property. The latter is funded by the beneficiaries' contributions who in exchange obtain vested rights.

¹⁷⁵ The principal object of the trust is to ensure that a company is at all times controlled by the trust.

¹⁷⁶ These trusts are formed in terms of Section 117 which allows the creation of a trust for holding debentures.

¹⁷⁷ See Olivier et al *Trust Law and Practice* (November 2011) at 5-20 to 5-21 for further examples see Du Toit F *South African Trust Law Principles and Practice* (2002) at 182.

¹⁷⁸ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 5.

difference in the level of activities, duties and obligations the trustees may have and which is essentially determined by the type of trust and the purpose of the trust at hand. Olivier¹⁷⁹ includes for background purposes, a few examples of the types of trusts found in American law, of which one such classification is particularly relevant here, namely that of active and passive trusts.

A passive trust is described as one, where the trustee's duties simply require the preservation of the trust assets and ensuring that the interest is eventually transferred to the beneficiaries. This is opposite to an active trust, where the trustees are 'clothed with duties and obligations to actively administer the trust.'¹⁸⁰ It is submitted that this distinction between active and passive trusts may be relevant in determining the tax residence of a trust.

Overall, it is evident from these classifications based on the purpose or object of the trust, that the names attributed to a trust can often be but a "name-tag"¹⁸¹ and may be "nothing more than reflections of the primary object of the trust."¹⁸² In all these cases, the underlying structure of a trust is still present and can be identified based on the classifications discussed firstly. However, although these classifications as based on the purpose of the trust may not impact on the "incorporated, formed or established"-criterion, the purpose of a trust may determine the level of administration and control required, which affects the "effective management"-criterion of the test for fiscal residence.

2 7 5 Classification according to the place of formation

A further distinction can be made according to where the trust is formed, and thus a trust may be described as either being a local trust, or a foreign trust.¹⁸³ This classification is particularly important to the study at hand, as the place of formation is one of the criteria of the test for fiscal residence. The actual formation of a trust and the further requirements for a trust to come into existence is discussed in chapter 5 and consequently will not be dealt with here. For purposes of the discussion here, it will be assumed that the legal and administrative requirements set locally or

¹⁷⁹ Olivier et al *Trust Law and Practice* (November 2011) at 5-17. Geach also makes a distinction between business trust and passive trusts. The latter he indicates are trusts that are merely formed as part of an estate duty plan or formed to protect assets by ensuring that the assets are placed out of reach of the beneficiary's creditors/claimants. Geach WD & Yeats *J Trusts Law and Practice* (2007) at 23. However a firm distinction between active and passive trust is not made.

¹⁸⁰ Olivier et al *Trust Law and Practice* (November 2011) at 5-17. Cameron et al *Honoré's South African Law of Trusts* 5th ed(2002) at at 326.

¹⁸¹ Olivier et al *Trust Law and Practice* (November 2011) at 5-16(2).

¹⁸² Olivier et al *Trust Law and Practice* (November 2011) at 5-16 (2).

¹⁸³ A foreign trust is sometimes also referred to as an international trust.

elsewhere have been met and is not in issue.

Geach¹⁸⁴ defines a "local trust" as one which is formed in South Africa and which is subject to the jurisdiction of the Master of the High Court of South Africa, whereas a "foreign trust", is formed outside South Africa and is not subject to the jurisdiction of the Master of the High Court (save to the extent that the trust may own assets in South Africa).

From the definition Geach provides, it can be noted this classification has particular significance as to which law and institution or functionary will have jurisdiction over the trust. In this context 'the jurisdiction of the Master' denotes the powers and duties the Master of the High Court, as assigned and empowered in terms of the Trust Property Control Act.¹⁸⁵ Thus, the jurisdiction of the Master will follow where the trust is a local trust, ie one *formed* in South Africa. This is similar to the requirement posed for fiscal jurisdiction, namely that the trust will be resident, should it be "incorporated, formed or established" here.

It is however important to note that the Trust Property Control Act specifically also brings within its ambit of application, trustees appointed outside South Africa. Section 8 of the Act entitled "Foreign Trustees" states that where a foreign trustee has to "administer or dispose of trust property in the Republic", the Act will be applicable to such trustee in respect of such trust property. The section further empowers the Master to authorize such trustee in writing, to act as trustee in respect of the property.¹⁸⁶ Foreign trusts, or more specifically, their office bearers, the trustees, may thus notwithstanding the fact that the trust has been established in terms of foreign law, be subject to the Trust Property Control Act. Thus foreign trusts may fall subject to the laws of South Africa despite being established elsewhere. This also holds true for the test for fiscal jurisdiction, where a foreign trust may be tax resident here should its place of effective management be situated here.

It should further be noted that the applicable law to a trust will not always necessarily be the place

¹⁸⁴ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 27

¹⁸⁵ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 6. For example the Master's powers and duties include, the power to authorize trustees and to require security, to remove trustees, to call a trustee to account and to launch investigations in to the trustee's administration and disposal of trust property and the duty to furnish copies upon application and to apply to court where a trustee fails to perform his or her duties. See also Cameron et al *Honoré's South African Law of Trusts* 5th ed(2002) at at 181.

¹⁸⁶ Pace & van der Westhuizen states that the authorization by the Master is not obligatory as the provision uses the word "may" and consequently the Master's authorization is not a prerequisite to the foreign trustees' authority to act. Instead the provision was inserted to aid foreign trustees who may find it easier to act locally armed with a recognizable written authority. Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B6.2.1 at 29.

where it is formed. So for example the Hague Convention on the Law Applicable to Trust and their Recognition, provides in article 6, that a trust shall be governed by the law chosen by the settlor (donor), which choice must be express or implicit in terms of the instrument by which the trust is created. Where no choice was effected, article 7 provides that the law with which it is most closely connected shall govern a trust. The law so chosen or identified, will, according to article 8 of the Convention, govern the validity of the trust, its construction, its effects and administration.¹⁸⁷ South Africa is not a signatory to the Convention, yet the aforesaid may have relevance to a foreign trust which is subject to the Convention and which may have a local presence. The Master of the High Court in South Africa has jurisdiction over trusts which are formed in South Africa. The Master will also enjoy jurisdiction over trusts formed elsewhere should such trust need to administer or dispose of trust property situate in South Africa. The concomitant powers and duties of the Master as set out above and which, to large extent correlate with the list set out in article 8 of the convention, will thus come into effect.¹⁸⁸

A further point to be made in this context, is that although a trust may therefore be described in general dialogue as a local or foreign trust, this should not be equated to be a conclusive determination that its residence for tax purposes follows suit. This is a fine distinction which can be briefly illustrated by the following examples:

- (a) A trust that is formed in terms of the laws of a foreign jurisdiction, will in terms of the classification under discussion here, be termed a foreign trust. For tax purposes it will

¹⁸⁷ The article further then lists specific matters which would fall within the governance and application of that law: the appointment, resignation and removal of trustees, the capacity to act as a trustee, and the devolution of the office of trustee; the rights and duties of trustees among themselves; the right of trustees to delegate in whole or in part the discharge of their duties or the exercise of their powers; the power of trustees to administer or to dispose of trust assets, to create security interests in the trust assets, or to acquire new assets; the powers of investment of trustees; restrictions upon the duration of the trust, and upon the power to accumulate the income of the trust; the relationships between the trustees and the beneficiaries including the personal liability of the trustees to the beneficiaries; the variation or termination of the trust; the distribution of the trust assets; and the duty of trustees to account for their administration.

¹⁸⁸ The jurisdiction of South African courts in issues relating to trusts is according to Honoré largely dependent on two conditions: the first being that there must be a *ratio jurisdictionis*- good reasons why the court should take cognizance of the matter and assume jurisdiction. In this respect the court is "naturally taken to be capable of finding out about people, things and happenings in its own area." Examples of such good reasons would therefore be that that the litigants live within the court's area, the cause of action arose within the area, the contract which is in issue was made or is to be performed in the area, that the administration of the trust is effected within the area or the property is situated within the area. The second condition is that the jurisdiction of the court is likely to be effective. Also regard must be had to type of the proceedings that is envisaged as for example should the claim relate to immovable property the place where the property is situated will have jurisdiction in the matter. Cameron et al *Honoré's South African Law of Trusts* 5th ed (2002) at 648.

normally also be a non-resident,¹⁸⁹ but it may be deemed to be resident in South Africa, should the further criteria of the definition of ‘resident’ in the Income Tax Act be applicable, for example, should it be effectively managed in South Africa, then the trust will be regarded as a South African resident. This is further discussed in Chapters 5 and 6.

- (b) On the other hand, a local trust formed and established in terms of South African trust law, will generally also be a South African resident for tax purposes. However the provisions of a tax treaty may cause the trust to be deemed tax resident in another country.¹⁹⁰ Tax treaty issues are further discussed in Chapter 7.

Often too in the context of trusts of foreign origin the term “offshore trust” is used, which is the last classification discussed below.

2 7 6 Classification of offshore trusts

“Offshore trusts” refer to trusts which are established in offshore financial jurisdictions, also called “tax havens.”¹⁹¹ It has been said that the “most important component of any offshore estate plan is the offshore trust.”¹⁹² These trusts offer all the functions local trusts offer,¹⁹³ but differ from their local counterparts due to the taxhaven territory in which they are established. Tax haven jurisdictions are characterised by, amongst others, strict confidentiality laws, a history of stability during times of war and unrest, taxation benefits,¹⁹⁴ and their insolvency and legal systems are perceived to offer greater protection and convenience than other jurisdictions.¹⁹⁵

This first characteristic of tax havens translates into greater anonymity and secrecy. For example, it is difficult in these jurisdictions to ascertain a trust’s existence, its assets or the parties to it. Often

¹⁸⁹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 434.

¹⁹⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 434.

¹⁹¹ Due to fact that these jurisdictions either levy no tax, or where tax is levied, levies same only on internal taxable events/residents, or offer tax relief in that certain taxable events/persons are given special tax privileges - King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 235.

¹⁹² Davis et al *Estate Planning* (May 2013) at 17-5.

¹⁹³ It serves as a safe depository for assets, it is not connected to the risks of individual ownership (ie offers protection against creditors and insolvency) and uniquely allows individuals to still enjoy benefits from assets after divestment. It further allows for wealth preservation from one generation to - the next, avoids disruption on death, offers protection of the weak and disabled and may be applied for tax planning and estate planning purposes, the avoidance of probate and succession laws (ie forced heirship) and the minimisation of death duties. See T Cohen “Pasop vir slaggate met trust in buiteland” *Die Burger* 25 September 2010 at 24.

¹⁹⁴ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 668.

¹⁹⁵ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 244.

these jurisdictions do not require the public registration of the trust deed, or confidentiality agreements bind the trustees and prohibit them from disclosing the identity of the settlor or the beneficiaries.¹⁹⁶ This severely complicates an enquiry relating to either the "formation" of the trust, or its "effective management" as is required for the application of the test for fiscal residence. The second characteristic, namely a history of stability during times of war and unrest, allows assets to be sheltered in these trusts and protected from economic or political risk as well as instability in the original home country, including governmental considerations which are aimed at curtailing individual wealth.¹⁹⁷

The third characteristic, the limitation of potential taxes is a very important function of these havens. It is said that the most effective offshore tax plans are based upon the ability to sever the nexus, or connecting factor with a taxing country in favour of an offshore country.¹⁹⁸ By utilising a trust this is achieved, as a trust effectively breaks the chain of legal ownership between the settlor and his former assets.¹⁹⁹ In the context of the test for fiscal residence, this is therefore a direct undermining of the test and frustrates tax collection as these trusts can then be exploited by residents, legally or illegally, to avoid obligations placed upon them by the law of the place where they live, or undertake their economic activities, whilst at the same time offering little or no benefit for those resident within the offshore jurisdiction.²⁰⁰

The OECD's *Report on Harmful Tax Competition* consequently describes a "tax haven", as a country which levies no or nominal taxes on income from mobile activities and furthermore, meets at least one of the following additional conditions: it does not exchange information effectively with other countries; or it provides tax benefits to taxpayers in a non-transparent fashion; or it does not require non-residents to engage in substantial activities in the tax haven in order to qualify for tax benefits.²⁰¹ Generally the levy of no or nominal taxes, is however in itself sufficient for a country to be deemed a tax haven.²⁰² Tax havens pose a particular problem to countries which impose residence-based taxation, such as South Africa. The lack of transparency and unwillingness to

¹⁹⁶ For example in the Isle of Man the trust deed need not be public registered as opposed to South Africa. See http://www.ocra.com/jurisdictions/IsleofMan_Trust.asp - last accessed on 02/05/2013.

¹⁹⁷ Ginsberg A *International Tax Havens* (2nd edition) 1997 at 10; Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 680.

¹⁹⁸ B Spitz "Database for International Tax and Offshore Planning" Available at <http://www.barryspitz.com>- Last accessed on 02/05/2013.

¹⁹⁹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 670.

²⁰⁰ Murphy R "Tax Havens Creating Turmoil" (June 2008) at 157.

²⁰¹ OECD *Harmful Tax Competition: An Emerging Global Issue* (1998); Arnold BJ & McIntyre MJ *International Tax Primer* 2nd Edition (2002) at 139.

²⁰² Arnold BJ & McIntyre MJ *International Tax Primer* 2002) at 140.

exchange information, affects the ability of tax residence-based countries to protect themselves against harmful competition. According to Arnold & McIntyre it prevents the residence country from obtaining information about the offshore activities of its residents and without such information the residence country can not develop counter defensive measures.²⁰³ Furthermore according to the authors, it also facilitates tax avoidance of the residence country tax, as income is “booked” to the tax haven without any actual income earning activities in that country.²⁰⁴

These offshore jurisdictions have traditionally been island nations in Europe and the Caribbean. They were located off the shores of the mainland continents – hence the term offshore.²⁰⁵ But the term is no longer used in a geographical sense, for example, “onshore” countries such as Switzerland, Andorra, Liechtenstein are mainland countries, but are also regarded as tax havens.²⁰⁶ Consequently when reference is made to offshore centres, it is understood to have a broader meaning to include mainland countries, which also function as tax havens. In South Africa, in particular, Honiball & Olivier remark that the term has gained an even wider meaning and includes any non-South African or non-resident trusts.²⁰⁷

It has been noted that the establishment of such offshore trusts are becoming increasingly popular with South African residents,²⁰⁸ a trend which is sure to increase with the relaxation of our exchange controls and the concomitant enhanced ability of South Africans to invest abroad.²⁰⁹ In so doing, South Africans join the ranks of many worldwide as it has been estimated as early as 1994, that more than one quarter of the world’s funds are invested in offshore trusts. A clear confirmation that such trusts are an immensely popular investment vehicle.²¹⁰ More recently, SARS has however announced that as part of its Compliance Programme, aimed at growing the levels of compliance, wealthy individuals and their associated trusts will be investigated. In particular offshore trusts and accounts in tax havens which are used by such individuals to avoid tax, will be prioritized and to facilitate such enquiries, international cooperation agreements between the different countries will

²⁰³ Arnold BJ & McIntyre MJ *International Tax Primer* 2002) at 140.

²⁰⁴ Arnold BJ & McIntyre MJ *International Tax Primer* 2002) at 140.

²⁰⁵ Oguttu AW “A Critique on the OECD Campaign against Tax Havens : Has it been successful ? A South African Perspective” 2010 (1) *STELL LR* 172 at 173.

²⁰⁶ Murphy R “Tax Havens Creating Turmoil -Evidence submitted to the Treasury Committee of the House of Commons by the Tax Justice Network UK” (June 2008) at 183.

²⁰⁷ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at Chapter 2.

²⁰⁸ Ware J & Roper PEW “ The World of Offshore Sham Trusts” (1998) 13 *Insurance and Tax* 1.

²⁰⁹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 234 where they note that the gradual relaxation of exchange control since 1 July 1997, has led South Africans to invest abroad in greater numbers.

²¹⁰ Olivier et al *Trust Law and Practice* (November 2011) at 5-34.

be utilized.²¹¹

In light of the aforesaid, it is therefore also important to consider such trusts and to identify the features that are unique to such trusts, to do so the different types of offshore trusts will be briefly reviewed. First however the two aspects in which these offshore trusts differ most from local trust will be discussed, namely the office of the Protector and the letter of wishes.

The office of the Protector

The office of the Protector will be discussed in Chapter 3 together with the further role-players to a trust.²¹² It is therefore only stated here that the function and specific powers of the protector may impact on the “effective management” of the trust, the second criteria for determining the tax residence of a trust.²¹³ Also of concern is the impact the protector may have on the validity of trust, as should the protector be seen to be a “mere puppet of the settlor” and a front for the *de facto* control by the settlor, it may lead to the setting aside of the trust.²¹⁴ In South Africa, there is as yet no definitive answer as to whether the concept will be recognised, or the potential effect it may have on the validity of the trust itself.²¹⁵

Letter of wishes

The Letter of Wishes is a concept that it is not entirely unknown in South Africa but it is neither common nor essential to the functioning of our trusts.²¹⁶ A Letter of Wishes usually accompanies offshore trusts, and decisions are often made on the bases of these letters, as they are regarded as standard practice in those jurisdictions.²¹⁷

A letter of wishes can be described as an instrument, which does not form part of the trust deed and wherein the settlor records his preferences and intentions in respect of the trust administration, so

²¹¹ SARS Compliance Programme 2012/2013 – 2016/2017. Available <http://www.sars.gov.za/AllDocs/SARSEntDoelib/Ent/SARS-Strat-07-G02%20-%20Compliance%20Programme%202012%202013%20to%202016%202017%20-%20External%20Guide.pdf>. Last accessed on 02/05/2013.

²¹² See discussion at 3.2.4.

²¹³ This is further discussed in Chapter 3.

²¹⁴ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 125.

²¹⁵ Davis et al *Estate Planning* (May 2013) at 5-22.

²¹⁶ See for example the case of *Jordaan v Jordaan* 2001 (3) SA 288 (C) where the founder drew up a letter of wishes. Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 38.

²¹⁷ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 325; Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 38; Davis et al *Estate Planning* (May 2013) at 5-20(2).

as to serve as a guideline to the trustees in the exercise of their powers.²¹⁸ Davis states that it usually sets out the settlor's motives in establishing the trust and makes suggestions as to how the trustees should exercise their discretions and powers.²¹⁹ Essentially it is a "mechanism for communication"²²⁰ and a useful guide to the trustees, who may be unfamiliar with the beneficiaries of the trust, their respective needs or the complex relationships between them.²²¹ Honiball and Olivier explain that the need for such an instrument arose, as under the English law of equity, a trust is not regarded as a contract.²²² Thus once the settlor has transferred the assets to the trust, the settlor no longer has any control over the assets nor over the trustees. The letter thus surmounts this loss of the ability to "instruct" the trustees, and is especially valuable in circumstances which could not be foreseen by the settlor at the time of the establishment of the trust.²²³

The content of the letter is dependent on the circumstances it wishes to address. It may for example, make reference to the distribution of capital and income, the investment of assets, or deal with administrative matters. Most often it will deal with the disposition of assets after the settlor's death (as the settlor can no longer address this in his Will) or matters which the settlor would wish to remain secret and confidential.²²⁴ Honiball and Oliver note that it is specifically this latter aspect, which is the major advantage of the letter of wishes, as the settlor can express facts, beliefs, concerns and prejudices in this document, which is separate from the trust deed and to which the beneficiaries as such do not have access.²²⁵

It is customary to also stipulate that the wishes so expressed, are not intended to be binding on the trustees and must not be construed as fettering the trustees' exercise of their powers and discretion

²¹⁸ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 325; Olivier et al *Trust Law and Practice* (November 2011) at 5-29. See Duckworth "The Trusts Offshore" 1999 *Vanderbilt Journal of Transnational Law* at 882 where he describes it as "an informal document in which the settlor sets out in precatory form his wishes regarding the exercise of the trustee's distributive discretions."

²¹⁹ Davis et al *Estate Planning* (May 2013) at 5-20(2).

²²⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 38. The authors further note that Letters of Wishes are predominantly used in the context of discretionary trust as opposed to vesting or fixed-interest trusts.

²²¹ Davis et al *Estate Planning* (May 2013) at 5-20(2).

²²² Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 38.

²²³ Honiball M & Olivier L *Taxation of Trusts in South Africa* (2009) at 37 See also. Duckworth "The Trusts Offshore" 1999 *Vanderbilt Journal of Transnational Law* at 882 where he notes that no settlor can predict the needs and circumstances of those he wish to benefit.

²²⁴ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 38; Davis et al *Estate Planning* (May 2013) at 5-20 (2) ; Olivier et al *Trust Law and Practice* (November 2011) at 5-29.

²²⁵ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 38. See however the UK case of *Breakspear and others v Auckland and another* [2008] EWHC 220 (Ch) quoted by the authors wherein it was held that although a letter of wishes is inherently confidential and ordinarily need not be disclosed, in this particular matter, disclosure was ordered by the court as the potential family discord resulting from such disclosure was trumped by the need for full information by the claimants in respect of a separate matter relating to the unwinding and distribution of the trust fund.

in any way.²²⁶ In the English law of Equity, a letter of wishes is not considered to be binding on the trustees and the trustees consequently, have a discretion to follow it or not.²²⁷ This legal position is however usually expressly recorded in the letter of wishes, so as to counter an argument that the settlor is in fact in control of the trust.²²⁸ In particular if the trustees follow a letter of wishes mindlessly, the trust will be at risk to be regarded as a sham and the assets will be perceived to still be vested in the settlor.²²⁹ Substance over form will prevail in such instances. For example, should the purpose of the letter of wishes be to retain control by the settlor and the trustees consider themselves bound thereby and do not exercise their discretion freely, then the trust will be regarded a sham.²³⁰ Thus the substance will prevail regardless of the formal make over of assets to the trustees or the recordal that the wishes is not binding. The point must be made that the mere existence of a letter of wishes should not solely be regarded as conclusive evidence, that the trust is a sham, as the facts of each matter must be separately analysed.²³¹

In a recent Jersey- case²³² regarded as a landmark decision on the role of protector,²³³ the court re-affirmed the status of a letter of wishes and disapproved of the protector's misinformed role of seeking to apply it rigorously. The following extract provides guidance for both trustees and protectors in respect of a letter of wishes:

"It can be no part of the function of a protector with limited powers of the kind conferred on S by the trust instruments to ensure that a settlor's wishes are carried out any more than it is open to a settlor himself to insist on them being carried out. A trustee's duty as regards a letter of wishes is no more than to have due regard to such matters without any obligation to follow them. And a protector's duty can, correspondingly, be no higher than to do his best to see that trustees have due regard to the settlor's wishes (in whatever form they may have been imparted): from the moment of his acceptance of the office of protector his paramount duty is to the beneficiaries of the trust."²³⁴

²²⁶ Davis et al *Estate Planning*(May 2013) at 5-20(2).

²²⁷ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 325.

²²⁸ Davis et al *Estate Planning* (May 2013) at 5-20(2) ; Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 325.

²²⁹ Lacob L "The Offshore Trust World" 2000 *Juta's Business Law* Vol 8 Part 2 at 82. See also Duckworth "The Trust Offshore" 1999 *Vanderbilt Journal of Transnational Law* at 910 who states that the letter may constitute powerful evidence that the trust instrument is a sham in that it pretends to give the trustee discretion while the true understanding is that the trustee will do as it is told."

²³⁰ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 126.

²³¹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 126.

²³² *In the matter of the representation of C, D, E And F and in the matter of the A and B Trusts and in the matter of Articles 51 and 53 of the Trusts (Jersey) law 1984 (as amended)* [2012] JRC 169 A. Available at http://www.jerseylaw.je/judgments/unreportedjudgments/documents/display.aspx?url=2012%2f12-09-27_In_the_matter_of_the_A_Trust_169A.htm. Last accessed 07/05/2013.

²³³ Withers Worldwide "Withers lead on landmark case on trust protectors" - available at www.withersworldwide.com/.../withers-leads-on-landmark-case-on-trust. Last accessed 07/05/2013.

²³⁴ Par 4.

The usefulness of the letter of wishes must therefore be measured against its inherent risks. Honiball & Olivier note four risks which arise when the trustees act in accordance with the letter of wishes:²³⁵ Firstly, the trustees could be at risk in breaching their fiduciary duties, which obliges them to act in the best interest of the beneficiaries and in accordance with the trust deed. Secondly, there is a risk for the deponent of the letter of wishes, normally the settlor, that the transfer of assets to the trust, is regarded as ineffective as the letter of wishes may be seen as a guise for the retention of *de facto* control over the trust assets. Thirdly, in certain jurisdictions, the letter of wishes may be regarded as forming part of the trust deed, thereby obviating the advantage of confidentiality.²³⁶ Fourthly and particularly important to the study at hand, there is the risk in a South African tax context, that the settlor could be regarded as effectively managing the trust assets by means of the letter of wishes, so that the foreign trust could be regarded as tax resident in South Africa.

A further aspect is that the Letter of Wishes may be utilised in the establishment of “secret trusts.”²³⁷ The English trust law²³⁸ allows for a testator to create a secret trust, should three requirements be met. Firstly, there must be an intention by the testator to create a trust in language which is imperative, with a subject matter, and objects or beneficiaries which are certain; there must be a communication of the trust to the legatees; and there must be an acceptance of trusts by the legatee, even if such acceptance is silent.²³⁹ The English courts have further held that in establishing whether a secret trust has come into existence, a letter of wishes will be valid documentary evidence.²⁴⁰

²³⁵ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 38. A further risk is identified by Lacob in that the document may be viewed as a testamentary writing and may thus be void for non-compliance with prescribed formalities. Lacob L 2000 *Juta's Business Law Vol 8 Part 2* at 82.

²³⁶ Lacob notes that the this may also give rise to adverse tax implications- Lacob L 2000 *Juta's Business Law Vol 8 Part 2* at 82.

²³⁷ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 39. Moffat gives the following examples of secret trusts: A testator may leave property by his Will to a trusted friend but may inform the friend prior to his death that the property is to be held on specified trust, provided the friend accepts the trust, it will be enforceable. Alternatively the testator may leave property in his Will to a person with a direction in the Will that it is to be held on trust, with the details of the trust not contained in the Will but communicated to the person prior or at the time of the Will. See Moffat G *Trusts Law Text and Material* (2005) at 140.

²³⁸ It is noted that secret trusts are not completely unknown in South Africa. Honiball M & Olivier L discusses two cases as examples of secret trusts – *Lucas' Trustee v Ismail and Amed* 1905 T.S 239 and *Adam v Jhavary and Another* 1925 NPD 190.

²³⁹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 39.

²⁴⁰ *Margulies v Margulies and other v UK Court of Appeal* (Civil Division) (16 March 2000); Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 39.

Against the backdrop of the topic of this study, it is submitted that the above discussion has illustrated that a letter of wishes exhibits several features that may impact on the tax "residence" of a trust. To summarize: the letter of wishes may be instrument whereby the settlor effectively manages the trust, thus causing the trust to become resident in the settlor's country of residence, or worse, such control may lead to the setting aside of the trust in totality. Furthermore the contents of the letter of wishes may be such, that the establishment of a secret trust is aided thereby and the letter would thus be important to the formation of it. Alternatively the contents of such letter may cause the trustees to execute activities contrary to the trust deed, which activities may impact on the place of residence of the trust.

We now turn to various examples of offshore trusts to demonstrate the features of these trusts that are different from local trusts.²⁴¹ This is done against the background of this study, that as a general rule, when a trust is formed in an offshore jurisdiction, South Africa will not be able to tax its income, unless it is distributed to resident beneficiaries. However should such a trust be effectively managed in South Africa, then South Africa may apply the residence basis of taxation to tax the worldwide income of the trust.²⁴²

Examples of Offshore Trusts

- (a) **Reserved Powers Trust:** Also known as the "retained assets" trust, this offshore trust is a discretionary trust, where certain powers of investment in respect of certain assets are reserved by the settlor.²⁴³ In South Africa, as the settlor is usually also a trustee, it is not necessary to reserve powers, but in the offshore jurisdictions it is rare (and sometimes forbidden) for the settlor to also be a trustee, hence the need for reserved powers.²⁴⁴ The reservation of powers is not in itself a factor that invalidates the trust, but it may give rise to negative tax consequences from a South African vantage. For example, depending on the powers, the trust property could fall into the estate of the settlor for estate duty purposes.²⁴⁵ More importantly to the study at hand, the trust could be seen to be

²⁴¹ There are further examples of offshore trusts that are not discussed here as a detailed exposition on all such trusts would be too far ranging.

²⁴² Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 308.

²⁴³ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 42.

²⁴⁴ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 42.

²⁴⁵ In terms of Section 3(3)(d) of the Estate Duty Act, any property over which a person was competent to dispose of for his own benefit or for his estate, shall be included as deemed property in his estate. Consequently to the extent that the settlor's powers was such that he retained control to dispose over the trust property for his own benefit, it would form part of his estate upon his demise.

effectively managed by the settlor and tax resident in South Africa.²⁴⁶ However, these consequences may be negated should the settlor utilise the powers not only for his own benefit, but also for the benefit of the beneficiaries and does not treat the trust assets as an extension of his personal assets.²⁴⁷ As such Honiball & Olivier submits that there does not appear to be a reason why such a trust should not be regarded as a valid trust for South African tax purposes.²⁴⁸ In summary of this type of trust, the particular characteristic of this trust – the reservation of powers - signals danger in that the control of the trust could be exercised by the settlor and the trust could despite being an "offshore trust" be "effectively managed" and thus "tax resident" somewhere else.

- (b) **Blind Trusts:** Three types of blind trusts can be identified. In the first type of blind trust, (also termed a "black hole or limping trust"), the description of blind denotes that neither the real purpose, nor the identity of the beneficiaries can be established from the trust deed. Most often these trusts are used to hide assets from creditors and public scrutiny, but they can also be employed for tax evasion.²⁴⁹ The second type of blind trust is intended to keep beneficiaries unaware of the assets of the trust, whereas the third type of blind trust is used in the specific context of political party funding, as its purpose is to allow supporters to donate *incognito* to the trust fund. Politicians may then use such funds and still be able to assert that they were not influenced by the donor of the funds, as the donor's identity was not known to them.²⁵⁰ These trusts often have two layers of secrecy. Firstly, the beneficiaries are concealed as the trust deed will contain a class of named beneficiaries, usually charities, of which none are actually intended to benefit.²⁵¹ Such beneficiaries will never know of their appointment and most probable will never receive any benefit from the trust.²⁵² The trustees will be awarded an intermediate power of appointment and will exercise this power in favour of the "actual" beneficiaries, as confidentially relayed to them by the settlor or the protector.²⁵³ The second layer of

²⁴⁶ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 42. See also Duckworth "The Trust Offshore" 1999 *Vanderbilt Journal of Transnational Law* at 912 where he ask whether the settlor's involvement will shift the situs of the trust for tax purposes to the settlor's country and thus undo the purpose for which the offshore trust was established.

²⁴⁷ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 42.

²⁴⁸ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 42.

²⁴⁹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 42; Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 329.

²⁵⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 42.

²⁵¹ Moffat G *Trusts Law Text and Material* (2005) at 232.

²⁵² Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 43.

²⁵³ Honiball M & Olivier L note that the beneficiaries may be verbally nominated by the settlor or named in a letter of wishes. Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 43.

concealment is obtained through having a settlor, often a corporate figurehead, unrelated to the beneficiaries, contributing a nominal amount to the trust fund. The settlor is merely an agent or nominee for the “true settler”, whose identity is thus not revealed.²⁵⁴

Under South African law, this type of trust affronts the requirement that the trust object and the trust beneficiaries must be indicated with reasonable certainty and consequently such a trust will in all likelihood be regarded as a sham/invalid trust.²⁵⁵ Offshore jurisdictions and other countries often have specific legislation, which expressly provide for the validity of these trusts. Yet even if the jurisdiction in which it was formed recognises it as valid under its laws, other jurisdictions are not compelled to do so and it may thus be, that its validity is not recognised in the jurisdiction where its assets are situated.²⁵⁶ In relation to the study at hand, and particularly the first criterion of the trust for fiscal residence, should it be endeavoured to establish a trust with such characteristics locally, such a trust will fall foul of the criteria for a trust to be validly and effectively formed in terms of our trust law.²⁵⁷ In respect of the second criterion, such an entity may despite its offensive characteristics be regarded as a trust for purposes of the Income Tax Act if the definition is widely interpreted, which leaves its place of effective management for determination. However it is doubtful whether Revenue will even be aware of the existence of such a trust to initiate an enquiry, as the named beneficiaries will never receive any distributions, whilst the real beneficiaries may “never disclose their beneficial interest in their home country tax returns, despite being required to do so.”²⁵⁸

- (c) **The “STAR” Trusts of the Cayman Islands:** The name is an acronym from the legislation under which it is created, namely The Special Trust Alternative Regime of the Trust Law (2001 Revision) of the Cayman Islands.²⁵⁹ This trust is regarded to be highly flexible and

²⁵⁴ Moffat G *Trusts Law Text and Material* (2005) at 232; Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 43.

²⁵⁵ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 42; Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 329. So too in the context of the UK Trust law is it said that “this relatively recent offshore innovation raises in peculiarly acute form new question about a certainty of objects requirement in trust law..” See Moffat G *Trusts Law Text and Material* (2005) at 233.

²⁵⁶ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 43.

²⁵⁷ See discussion regarding the *essentia* of a trust – par 2.5 as well as the analysis of the definition for a “trust” in the Income Tax Act in Chapter 4.

²⁵⁸ Honiball M & Olivier L *The Taxation of Trusts in South Africa* at 43.

²⁵⁹ See Duckworth A “The Trusts Offshore” 1999 *Vanderbilt Journal of Transnational Law* at 938 where emphases is made that the STAR legislation will only apply to a trust if the trust instrument so provides – should it fail to do so, the trust will be an ordinary trust governed by the ordinary trust

distinct from ordinary trusts, and is often specifically created for the growth and development of a business venture.²⁶⁰ Its origins is to be found in legislation which forbade the establishment of a trust for a purpose other than for a 'charitable purposes' as defined. Specific legislation was therefore introduced to allow for trusts to be formed for other purposes, as well as for philanthropical purposes which fell outside the accepted categories of charitable purposes.²⁶¹ A unique feature of this trust is that it has trustees, but it need not have beneficiaries, so long as it has a specific purpose.²⁶² It may also have any number of purposes, and may be established for a combination of purposes as well as beneficiaries.²⁶³ Also particular to this trust is the requirement that the trust must have an "enforcer" whose name aptly describes his role, namely to enforce the provisions of the trust deed.²⁶⁴ The settlor, the intended beneficiary or some other person, including a corporate entity can be the enforcer.²⁶⁵ The enforcer is further empowered to insert a beneficiary in the trust deed at a future date.²⁶⁶ Where the enforcer is also the settlor or acting as agent to the settlor, the issue of divestment of control by the settlor, becomes an issue. It may effect the validity of the trust and cause it to be regarded as a sham trust.²⁶⁷ In relation to our study at hand, the fiscal "residence" of the trust could be impacted where the enforcer's role in the "effective management" of the trust is of such extent, that the place of effective management is no longer with the trustees offshore but with the enforcer locally.

principles inherited from England. Also Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 45.

²⁶⁰ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 333. As it is not subject to the rule regarding perpetual trusts, it may also continue indefinitely.

²⁶¹ Appleby "Guide to STAR Trusts in the Caymen Islands" (April 2011) available at [http://www.applebyglobal.com/publication-pdf-versions/guides/guide-to-star-trusts-in-the-cayman-islands-\(april2011\).pdf](http://www.applebyglobal.com/publication-pdf-versions/guides/guide-to-star-trusts-in-the-cayman-islands-(april2011).pdf) – last accessed 05/09/2013.

²⁶² Duckworth A "The Trusts Offshore" 1999 *Vanderbilt Journal of Transnational Law* at 938 where he notes that "those persons, if any, who would derive a benefit or advantage, directly or indirectly from the executor of a STAR Trust do not, as such, have standing to enforce the trust.... the only persons who have standing to enforce the trust a STAR trust are those beneficiaries or non-beneficiaries given the right or duty of enforcement by the trust instrument. STAR refers to these persons as enforcers."

²⁶³ Appleby "Guide to STAR Trusts in the Caymen Islands" (April 2011) at 3.

²⁶⁴ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 45.

²⁶⁵ Duckworth A "The Trusts Offshore" 1999 *Vanderbilt Journal of Transnational Law* at 938 notes that the court may also appoint the enforcer; Honiball M& Olivier L *The Taxation of Trusts in South Africa* (2009) at 45.

²⁶⁶ Honiball & Olivier note that it could then be argued that a person inserted in this manner, would not be deemed to have a "contingent right" during the past period when the STAR trust received income or a capital gain, with the result that from an South African perspective, provisions of section 25B(2A) of the Income Tax Act and paragraph 80(3) of the Eighth Schedule to this Act would not apply. Apposite to this argument is the submission that the ordinary meaning of "contingent right" is wide enough to cover this situation.

²⁶⁷ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 45.

(d) The BVI VISTA Trusts (“VISTA’ Trusts) of the British Virgin Islands

Similarly the VISTA Trust derives its name from legislation, namely The Virgin Islands Special Trusts Act 10 of 2003 (hereafter the “VISTA Act”).²⁶⁸ The distinctive feature of this trust is, that it allows the settlor to form a trust for purposes of holding his/her company shares, whilst also allowing the trustee to be disengaged from management responsibility and the retention of the company and its business for as long as the directors of the company deem fit.²⁶⁹ This is apparent from Section 3 of the VISTA Act, which sets out the purpose:

The primary purpose of this Act is to enable a trust of company shares to be established under which the shares may be retained indefinitely; and the management of the company may be carried out by its directors without any power of intervention being exercised by the trustee.”

These trusts are useful in the context of family-held business succession planning, where the retention of the shares is of greater importance, than maximising the values of the assets in the trust.²⁷⁰ The trust has its origin in the conflict arising from the so-called “prudent man of business rule”, which obliges trustees to monitor and intervene in the affairs of the underlying company, so as to preserve the value of the trust investment.²⁷¹ These duties entail that the trustees are compelled to monitor the conduct of directors, and to intervene where appropriate. For example, to prevent the company from entering in an unduly speculative venture, to seek the maximum financial benefit from the shareholding, to accept a financially advantageous takeover bid which could entail the sale of the company or its underlying assets.²⁷² Often such obligations would be in direct conflict with the wishes of the typical owner of the family business.²⁷³ The conflict is aptly explained by Honiball & Olivier:

“To many settlors and their families, the self-managed company represents much more than an impersonal investment; among the factors which may figure in their thinking when contemplating a trust are: family tradition, social concerns for employees or the environment, career opportunities for descendants, and business projections looking further ahead than the long term or medium term.... Thus, trustees are faced with a conflict in that , on the one hand an exposure to potential liability for failure to dispose

²⁶⁸ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 332.

²⁶⁹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 49.

²⁷⁰ McKenzie C & Glasson J “VISTA Trusts” – Available <http://www.stepjournal.org/pdf/2006i2p10.pdf>- Last accessed on 02/05/2013. Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 332.

²⁷¹ Murphy C “Commerical applications for VISTA Trust “ 2004 *Trusts and Trustees* 10 (4) at 14; Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 48.

²⁷² Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 48.

²⁷³ Murphy C “Commerical applications for VISTA Trust “ 2004 *Trusts and Trustees* 10 (4) at 14; Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 48.

of shares is realised and, on the other hand, settlor pressure to retain the shares and investments in accordance with the provisions of the trust deed and/or duly completed letter of wishes.”

These trusts overcome the difficulties by removing the trustees’ monitoring and intervention obligations.²⁷⁴ Also peculiar to this trust, is that a designated trustee must be the sole trustee of the trust, and the trustee must be a company which holds a licence to undertake trust business under the BVI Banks and Trust Companies Act of 1990.²⁷⁵ Beneficiaries of VISTA trusts are further not allowed to seek modification or termination of the trust.²⁷⁶ The shares in a VISTA trust must be shares of BVI companies, and further assets in the VISTA trust must be owned by the BVI company.²⁷⁷ Two aspects of this trust are important for taxation – the retention of control by the settlor, albeit this is usually at the director level in the company, and secondly, the limitation of the trustees’ involvement in respect of the underlying trust asset and its management. It is particularly this latter aspect, the limitation of the trustee's traditional obligations and duties, that may impact on the "effective management" of the trust and consequently its "residence."

- (e) **Asset Protection Trusts:** Trusts are often set up in offshore jurisdictions with the prime motivation of asset protection. It is important to note that for this type of trust, the fiscal benefits that may result are usually incidental, as the more pressing concern is asset protection.²⁷⁸ These trusts are predominantly set up to protect assets from home country risks such as political unrest, economic instability, local inflation, currency depreciation, creditors and liquidation risks, from partners, spouses or children, and malpractice suits. The latter is an important consideration for practicing professionals such as members of the medical profession, lawyers and accountants who by utilising these trusts, cut out the high cost of professional negligence insurance.²⁷⁹ They are sometimes also referred to as

²⁷⁴ The trust instrument may permit trustee intervention under specified circumstances – Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 51.

²⁷⁵ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 51. McKenzie C & Glasson J “VISTA Trusts” – Available <http://www.stepjournal.org/pdf/2006i2p10.pdf>- Last accessed on 02/05/2013.

²⁷⁶ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 332.

²⁷⁷ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis)(2007) at 332.

²⁷⁸ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 242; Ginsberg confirms this by stating that “Asset protection trusts are tax neutral and are normally not established for tax reasons. However, it is now possible to combine the benefits of tax deferral and asset protection in one and the same offshore trust.”- See Ginsberg A *International Tax Havens* (2nd edition) 1997 at 31.

²⁷⁹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 127; King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 242; Ginsberg *International Tax Havens* 1997 at 30; Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 52

“spendthrift trusts,” as the trustees are specifically instructed in the trust deed or letter of wishes to protect trust assets from creditors, beneficiary squander and from spouses of the beneficiaries.²⁸⁰ The reason for their enhanced creditor protection is their geographic and jurisdictional remoteness, which results in increased litigation cost, time delays and uncertainty due to the application of foreign laws, with all such factors demotivating a prospective litigant from pursuing his claim.²⁸¹ Due to their specific object, these trusts are mostly discretionary trusts, as a vesting trust may affect the protection against creditors and other claimants.²⁸²

The validity of these trusts may be attacked on the basis, that they were intentionally set up to foil current or future creditors and many jurisdictions have legislation to this effect.²⁸³ Honiball & Olivier note that South Africa does not have specific legislation in this regard, but argue that a court may regard the transfer of assets to such an offshore trust as void should the settlor, either factually or in law, not have made over the asset to the trustees.²⁸⁴ It is therefore more likely that the validity of the trust and its establishment offshore will be under scrutiny than its residence.

Conclusion in respect of the various classifications

From the various classifications discussed above it is to be agreed with Olivier²⁸⁵ who states that, “Clearly then trusts cannot and should not be classified in terms of a single criterion.” A trust can be categorized and be given a variety of names, but essentially the latter is really only determined by the angle the trust is being viewed from. In each situation it is therefore important that beyond the name given to a trust, the distinct features of the specific trust must be established as such features may impact on the tax residence as has been pointed out in the discussion above. More so, in

²⁸⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 52.

²⁸¹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 52; See also Anonymous “International Trust and Asset Protection Trust Structures” where they explain that for example in the Cook Island, Nevis and Isle of Man judgments originating in foreign countries are not recognised and litigation must be initiated in the offshore jurisdiction to reach the assets. Obstacles such as a substantial cash deposit to commence proceedings, a short prescription period or high evidentiary burden are further placed in the claimant’s way.– Available <http://premieroffshore.com/International-trust-asset-protection-trust>. Last accessed on 02/05/2013.

²⁸² Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 52.

²⁸³ Ginsberg A *International Tax Havens* (2nd edition) 1997 at 31; Shurig EM “Current Issues and Trends affecting Offshore Asset Protection trusts” – Available at http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/symposia/2007/schurig.authcheckdam.pdf Last accessed on 02/05/2013. Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 52.

²⁸⁴ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 52.

²⁸⁵ Olivier et al *Trust Law and Practice* (November 2011) at 1-4.

offshore trusts, such features may even give rise to the invalidity of the trust if viewed from the perspective of our trust law.

2 8 Conclusion

It is to be agreed with the authors, Williams & Mazansky²⁸⁶ who write,

“The tax aspects of the law of trusts in South Africa, viewed in an international perspective, cannot be understood or explained without taking account of the historical origins of South African trust law and of the core aspects of the country’s mainly Roman–Dutch common law.”

This chapter has therefore aimed to address these essential subjects so as to facilitate and ensure the understanding and explanation of the tax aspects in the chapters that follow. The discussion has in particular endeavoured to lay a solid theoretical foundation in respect of the trust concept, its definition and typical structure, as well as the *essentialia* for its valid creation and the relevant legal principles in trust law, emphasizing how these aspects are important to the study at hand and may influence the test for fiscal “residence.” An introduction to the various types of trusts as locally encountered has been provided and the importance of such classifications discussed. As trusts formed outside South Africa may also fall into the local tax net, the unique features of such trusts were traversed and several examples were given. It is therefore on this foundation, that the role-players to the trust, namely the founder, the trustee, the beneficiary and in some instances, the protector, now enter the arena and is discussed in detail in the next chapter.

²⁸⁶ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.1 available electronically on LexisNexis.

CHAPTER THREE

THE ROLE-PLAYERS (*DRAMATIS PERSONAE*) OF THE TRUST

3 1 Introduction

The *dramatis personae* or the main personalities in the South African trust can be identified as the founder, the trustees and the beneficiaries. These concepts are each individually discussed below to ensure a familiarity with the terminology used in respect of the parties to a trust. Furthermore, as these parties play an important part to the “establishment” of the trust and its “effective management” - being the two criteria for the test for fiscal “residence” - the discussion aims to provide a comprehensive introduction to these terms. Thus the meanings of the terms and their characteristics relevant to the study will be discussed, yet a detailed exposition covering all aspects relating to these role-players would be too far-ranging.¹ The office of the protector is also discussed, as the protector is an important role-player in offshore trusts.² The reason for so doing is that, offshore trusts could, despite their formation in a foreign jurisdiction, be potentially tax resident locally if effectively managed within South Africa's jurisdiction.

Olivier gives a fitting prelude to the roles of these parties and hence, to the discussion that follows below³ -

“The essential elements of a trust ... consists of the founder who has the intent to create a trust, the property which is to be administered in trust, a trustee and a beneficiary. The essential elements of a trust form the skeletal, while trust administration provides the lifeblood of the trust and enables it to function practically.”

It is against this background that we now address each of these concepts.

3 2 The Role-players (*dramatis personae*)

3 2 1 The Founder of the Trust (also referred to as the “donor” or “settlor”)

As the name indicates, the founder is the person who “founds” (creates) the trust and who must exhibit the intention of creating a trust.⁴ The founder is usually the original owner of the property

¹ Various academic textbooks provide a detailed discussion – see Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002); Olivier et al *Trust Law and Practice* (November 2011); Geach WD & Yeats J *Trust Law and Practice* (2007).

² King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 244.

³ Olivier et al *Trust Law and Practice* (November 2011) at 2-2.

⁴ Olivier et al *Trust Law and Practice* (November 2011) at 2-3. It is sometimes advised that a third

being placed initially (and possibly, also in future) in the trust.⁵ The founder is also the party who nominates the first trustees of the trust and selects the beneficiaries, or the class of beneficiaries, who will stand to benefit from the administration of the trust.⁶

Any person who enjoys contractual capacity can establish an *inter vivos* trust and anyone who is competent to make a Will, can create a testamentary trust.⁷ The founder may be a natural person or a juristic person (such as a company), or the trustees of another trust acting on its behalf.⁸ There may also be more than one founder, for example spouses may be co-founders to a trust, and typically business trusts will have multiple founders, who will also act as trustees and beneficiaries of the trust.⁹ The latter illustrates that the founder of a trust may also be a trustee of the trust,¹⁰ or a beneficiary of the trust. The founder may even be the sole beneficiary of the trust.¹¹ It is however not advisable that the founder be the sole trustee of the trust, as there is uncertainty as to whether the founder in his personal capacity can contract with himself in a second capacity as a trustee.¹² An unilateral declaration of trust is also not possible in South African law.¹³

It is consequently apparent from the aforesaid, that the founder's role is pivotal in establishing the trust and thus for purpose of determining whether and where a trust is "established" or "formed"

Party founder should be appointed ie a person unrelated to the parties so as to trump a potential estate duty liability. However this methodology is risky as it may be argued that one of the *essentia* of a valid trust – that the founder must have the intention to create a trust for the benefit of the beneficiaries – is lacking as often such be founder will not actually have such intention being an uninvolved party nor even know the beneficiaries – King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 250.

⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 4. For income tax purposes the founder is any person transferring assets to the trust – King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 250.

⁶ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 250.

⁷ Olivier et al *Trust Law and Practice* (November 2011) at 2-3.

⁸ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B6 at 26. The founder in respect of a testamentary trust will obviously not be able to be a juristic person.

⁹ It is however important in such situations that the parties intend a trust and not a related institution such as a partnership. Olivier et al *Trust Law and Practice* (November 2011) at 2-3; see also the case of *Goodricke & Son (Pty) (Ltd) v Registrar of Deeds, Natal* 1974 1 SA 404 (N).

¹⁰ This is in contrast to offshore jurisdictions such appointment is uncommon and potentially impermissible – Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.2 available electronically on LexisNexis.

¹¹ Davis et al *Estate Planning* (May 2013) at 5-6(4); Du Toit F *South African Trust Law Principles and Practice* (2002) at 5.

¹² Especially if one considers that the founder can not possess the capacity as trustee until authorisation by the Master of the High Court is obtained. The effectiveness of the relinquishment of control by the Founder in such a situation is also doubted. Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) B6.1 at 25. Davis et al *Estate Planning* (May 2013) at 5-6 (4) and the cases cited at footnote 32a.

¹³ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B6.1 at 26.

per the first criteria of the test for residence, regard must be had to the founder.

From the basic concept of the trust idea and the definitions for a trust, it is also clear that central to the trust idea, is the notion that trust property is made over for the benefit of others, whilst under the control and administration of the appointed trustees. Thus, from the point the trust is established, it is important that the founder does not retain any controlling power, as it is the trustees who should henceforth administer the trust and who must not be perceived to be controlled by the founder.¹⁴ Whilst trust founders are often willing to transfer legal ownership of the property, that willingness is often entirely lacking, when it comes to the relinquishment of actual control over the property. As Du Toit¹⁵ explains:

“Trust founders often seek to retain effective control over trust property by stipulating in the trust deed that important administrative decisions regarding trust property require the founder’s prior written consent, by directing the trustee’s administration of the trust through a letter of wishes or by retaining a lifetime power to appoint and dismiss trustees at will or to unilaterally vary trust provisions.”

Thus, although the external manifestations, such as the trust deed, the books of account and the inventory of trust assets are recorded in the trust's name, and all, may indicate to a valid trust being in existence, should the underlying structure and specifically the founder’s control over the trust property be such, that control remained vested in the founder, the application of a further principle, namely that of substance over form, will be triggered and the trust may fail.¹⁶

The case of *C:SARS v Airworld CC and Another*¹⁷ provides a striking example of the founder’s (Retief) conduct:

“The authority of Retief plainly pervades the trust. His co-trustee, Mr JD Coetzee, acknowledged in the course of his evidence that Retief is a headstrong man who ignores advice if it doesn't suit his wishes. Both his co-trustees are employed by Retief and, indeed, the evidence was that the Coetzee family had been employed as accountants and auditors of the Retief family businesses since the mid-1950s. ... For all practical purposes a payment to the trust is equivalent to a payment to Retief, for he has the power to direct its ultimate destination.”¹⁸

Williams & Mazansky¹⁹ contrast this peculiarity of South African trust law to English law by stating

¹⁴ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 250.

¹⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 5.

¹⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 5.

¹⁷ 2008 (3) SA 335 (SCA).

¹⁸ Par 32 at 351.

¹⁹ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated

as follows:

“[in South Africa]... it is open to the founder to include contractual terms by which he retains significant powers in respect of the trust, such as the power to appoint and remove trustees, the power to amend the trust deed, and the power to veto an amendment of the trust deed or to veto resolutions taken by the trustees. By contrast, since in English law a trust is not created by contract, once the settler has transferred assets to the trust, he relinquishes all control over those assets, nor does the settler have any control over the trustees or the affairs of the trust.”

From the vantage of the second criteria of the test for residence whereby the "effective management" of the trust must be determined, the founder's actual control and involvement in the administration of the trust is therefore an important consideration. We now turn to the trustees of the trust.

3 2 2 The Trustees of the Trust

It has been said that there is “no magic in the word in the use of the word ‘trustee’ and it essentially means “one entrusted with the affairs of another.”²⁰ Similarly Pace & Van der Westhuizen note that the term has “no precise connotation in our law.”²¹ In case law the ideal trustee has been described in *Land and Agricultural Bank of South Africa v Parker*²² as -

“someone who, with proper realisation of the responsibilities of trusteeship, accepts office in order to ensure that the trust functions properly, that provision of the trust deed are observed and that the conduct of trustees who lack a sufficiently independent interest in the observance of substantive and procedural requirement arising from the trust deed can be scrutinised and checked.”

Perhaps such a broad meaning can be placed in perspective by reflecting on the statutory definitions for this term, as well as the appointment and authorisation of the trustees. So too, will a review of the powers and duties of the trustees in the administration of the trust, reveal important aspects of this office. Due to the significance of the administrative role of the trustees in relation to the "effective management of the trust," as per the second criteria of the test for fiscal residence, a more detailed discussion (than the discussion of the Founder and Beneficiaries) follows.

November 2010) Chapter 6 at 6.2 available electronically on LexisNexis.

²⁰ Innes CJ in *Zinn v Westminster Bank NO1936 AD 89*.

²¹ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B6.2 at 28.

²² 2005 2 SA 77 (SCA) at 90C-D.

3 2 2 1 The Trustee - Statutory definition, appointment and authorisation

The Trust Property Control Act contains the following definition for the term "trustee" -

“**trustee**” means any person (including the founder of a trust) who acts as trustee by virtue of an authorization under section 6 and includes any person whose appointment as trustee is already of force and effect at the commencement of this Act;²³

This definition indicates that any person could potentially be a trustee once authorized, thus both natural persons and legal persons (such as companies) can be appointed to this office.²⁴ Where a legal person has been appointed to the office, a natural person as nominee will practically act on its behalf and the nominee will be reflected on the authorisation.²⁵ Important to the study at hand, non-resident persons can also be appointed as trustees.²⁶

There are no express requirements or qualifications stated in the Act²⁷ for a person to be eligible to this office. However based on the statutory grounds for removal from the office by the Master, such grounds, if present, would disqualify appointment as Trustee.²⁸ These grounds are: being an unrehabilitated insolvent, mentally incapacitated or having been guilty of an offence with dishonesty as an element.²⁹ Inherent is the qualification that the person must have the necessary legal capacity to act as a trustee.³⁰ The trust instrument itself may however impose conditions regarding the requirements or qualifications of the trustees.³¹ Du Toit notes that it further "stands to reason that the chosen trustee must indeed possess the necessary skill, be it legal, commercial or otherwise, to conduct the administration of the particular trust."³² Trustees can be appointed by

²³ Section 1 of the Trust Property Control Act, 57 of 1988.

²⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 55.

²⁵ Section 6(4) of the Trust Property Control Act requires any authorization given to a trustee which is a corporation to subject the provisions of the trust instrument, be given in the name of a nominee of the corporation for whose actions as trustee the corporation is legally liable, and any substitution for such nominee of some other person shall be endorsed on the said authorization. See also *Metequity v MWN Properties* 1998 2 SA 554 (T) where it was found that this section is an express indication of the ability of corporations to act as trustees.

²⁶ Section 6 & 8 of the Trust Property Control Act – see further detailed discussion above at 2 7.

²⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 55.

²⁸ S 20(2) of the Trust Property Control Act.

²⁹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 251.

³⁰ For example an *infans* and persons of unsound mind would not have the necessary legal capacity to act. A minor may be a trustee should he be assisted by his guardian. However Pace & Van der Westhuizen note that it appears as if the Master of the High Court refrains in practice from issuing letters of authority to minors - Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B6.2.1 at 29.

³¹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 55. For example the trust deed may specify that a trustee may only be a qualified and practising attorney or accountant etc.

³² Du Toit F *South African Trust Law Principles and Practice* (2002) at 55.

the Founder³³, the Trustees³⁴, and in certain instances by beneficiaries,³⁵ third parties,³⁶ the Master,³⁷ the High Court³⁸ and through legislation.³⁹

A trustee can be a beneficiary of the trust, but by virtue of the aforesaid principle that the trustee holds the trust property for the benefit of another, a sole trustee cannot be the sole beneficiary of a trust.⁴⁰ This is therefore dissimilar to the position of the founder. As stated above, the founder may be a trustee, however a founder can not establish the trust with himself as sole trustee, as this would contravene the principle that founder must divest himself of the trust property and relinquish control. This principle would not be offended, should a founder who is one of the co-trustees create a trust, as a partial divestment will have taken place. There are further no limitations in the Act on the number of trustees who must be in office,⁴¹ although the trust

³³ The Founder usually selects the initial trustees and in an *inter vivos* trust it is these trustees with whom the Founder will contract and who will accept the initial donation. It is however possible for the Founder to retain a power to appoint further trustees, replace trustees and fill vacancies.

³⁴ The trust instrument frequently empowers trustees to appoint additional trustees by granting them a power of assumption alternatively to appoint successive trustees on the vacancy of their office in terms of a power of subrogation. Du Toit F *South African Trust Law Principles and Practice* (2002) at 57.

³⁵ Du Toit notes that the appointment by beneficiaries of trustees is more the exception than the norm - Du Toit F *South African Trust Law Principles and Practice* (2002) at 58. However in certain instances to safeguard the beneficiaries' interest a trust instrument may provide for the beneficiaries' to select a trustee from their rank or to be party to the selection and appointment of trustees. It must be noted that in the event of an appointment by the Master the Trust Property Control Act obliges the Master to consult with interested parties which would include beneficiaries and the court will similarly request their view.

³⁶ Olivier notes that the Founder can empower "any body, or group of persons or bodies, to make nominations and appointments." He is further of the view that there is no objection to a direction in the trust that all vacancies may only be filled by appointees nominated - for example, by the trust's auditors. Olivier et al *Trust Law and Practice* (November 2011) at 3-5.

³⁷ The Trust Property Control Act in S 7(1) statutorily empowers The Master to appoint a trustee if the office of a trustee cannot be filled or becomes vacant and the trust instrument contains no direction, subsequent to consultation with as many interested parties as deemed necessary in the Master's discretion. Alternatively the Master is empowered in terms of S 7(2) to, notwithstanding the trust instrument, appoint any person whom he deems fit as co-trustee to any serving trustee.

³⁸ The High Court contains an inherent jurisdiction to appoint trustees in terms of our common law. Du Toit F *South African Trust Law Principles and Practice* (2002) at 60.

³⁹ The trustees of Trusts created by legislation may similarly be appointed by such legislation. Olivier *Trust Law and Practice* (November 2011) at 3-5.

⁴⁰ See *Land & Agricultural Bank of South Africa* 2005 (2) SA 77 (SCA) at para 19 where it said that "... the central notion is that the person entrusted with control exercises it on behalf of and in the interest of another. This is why a sole trustee cannot also be the sole beneficiary; such a situation would embody an identity of interest that is inimical to the trust idea, and no trust would come into existence."

⁴¹ Neither the common law nor the Trust Property Control Act sets a specific number. It is however recommended that more than one trustee be appointed so to allow for continuity in the operations of the trust. Du Toit F *South African Trust Law Principles and Practice* (2002) at 61.

instrument will usually provide for a minimum number which must be met for the trust to have capacity.⁴² A trust will however not fail should it not have, or, lose all its office bearers.⁴³

The office of the trustee should not be equated to be one of an agent acting on behalf of a principal. Albeit a trustee acts for the benefit of another, a trustee still acts in his own right and on his own responsibility.⁴⁴ This was clearly expressed in the case of *McCulloch v Fernwood Estates Ltd*⁴⁵ where it was held that the term "implies that the person described is the *dominus* of the relative subject matter which the term agent does not imply."⁴⁶

The definition in the Act above also gives an indication of the official requirements imposed – namely the authorisation by the Master of the trustee in the office. There is an important difference between the *appointment* of the trustees and their *authorisation* to act in such office. Du Toit⁴⁷ explains it as follows: -

"A trustee who has been validly appointed and who has accepted such appointment, accedes to the office of trustee. He may however not perform any act as trustee until receipt of the necessary written authorisation in the form of a letter of authority from the Master."

The Master will not grant such authorisation, unless security has either been furnished to the satisfaction of the Master for the due and faithful performance of the duties as trustee, or such security has been exempted.⁴⁸ The authorisation takes the form of a letter of authority⁴⁹ issued by

⁴² Geach WD & Yeats J *Trusts Law and Practice* (2007) at 79. Geach explains that that the minimum number of trustees is a capacity-defining condition and serves a prerequisite before the trust estate can be bound. Should it not be met, the trust suffers from incapacity which precludes action on its behalf by the trustees.

⁴³ Although a trustee forms such a link it is also to be noted that a trust will not fail for want of a trustee nor thereby nullified – See Olivier et al *Trust Law and Practice* (November 2011) at 2-3. Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B6.2.2 at 30 states that "if the only missing link in the created trust chain is a trustee... the courts will not hesitate to appoint one in order to give effect to the testator's intention to create a trust."

⁴⁴ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 257.

⁴⁵ 1920 AD 204.

⁴⁶ Geach refers to *Joubert v Van Rensburg* 2001 (1) SA 753 (W) where the court held that a trustee operates as a principal and not as a functionary or agent - Geach WD & Yeats J *Trusts Law and Practice* (2007) at 71.

⁴⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 61. Honore states that the trustee's appointment derives from the trust instrument and that such appointment becomes effective upon authorization by the Master -E Cameron, M de Waal, B Wunsh & P Solomon *Honoré's South African Law of Trusts* 5th Ed (2002) at 179.

⁴⁸ S 6(2) –(3) of the Trust Property Control Act. A trustee may be exempted from furnishing security in terms of the trust instrument, or court order or by the Master. Yet even where such exemption is granted in a trust deed, the Master may override same (S6(3)(d)) and require security. King & Victor state that the Master looks for appropriate trust administration experience to decide whether to call for security. King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 267.

the Master. The purpose of this provision has been aptly described by the court in *Simplex (Pty)(Ltd) v van der Merwe*⁵⁰ -

"I am further of the view that s 6(1) is not purely for the benefit of the beneficiaries of the trust but in the public interest to provide proper written proof to outsiders of incumbency of the office of trustee. The whole scheme of the Act is to provide a manner in which a Master can supervise trustee in the proper administration of trust properly and s 6(1) is essential for such purpose. By placing a bar on trustees from acting as such until authorised by the master, the Act endeavours to ensure that trustees can only act as such if they comply with the Act. This ensures that the trust deed is lodged with the Master and that Security, if necessary, is lodged with him before trustees start binding the trust's property."

The precise effect on such actions taken in contravention of this statutory provision has been the subject of various court cases,⁵¹ which expressed conflicting views.⁵² In the aforesaid case of *Simplex (Pty)(Ltd) v van der Merwe*, it was held that the wording of the section is peremptory and places an unambiguous prohibition on incumbents not to act in the office of trustee until authorised thereto. Such authorisation was regarded by the court as a precondition to the trustee's right to act as such.⁵³ The court rejected the argument that as the Act does not expressly declare such actions to be void nor states them to be criminal offences, the Legislator's intention was not to visit such actions with nullity. In the court's view these omissions rather indicate that the Legislator felt no need to spell out the voidness of such actions as it was self-evident, nor to punish an act which had no legal consequences.⁵⁴ As to whether such actions can be "resuscitated by subsequent ratification, either by the Master or by the trustees after receipt of the necessary authority", the court answered in the negative, finding that the well-established principle in law – "there can be no ratification of an agreement which a statutory prohibition has rendered *ab initio* void" is applicable.⁵⁵ Nor can the court validate such actions prohibited by statute as to do so would appropriate to the court the power to trump valid legislative acts.⁵⁶

The approach in this case, to view all actions taken without authorisation as invalid, was tailored in *Watt v Sea Plant Products*.⁵⁷ The latter case found that only actions whereby rights may be acquired

⁴⁹ Subsequent authorizations of further or successive trustees are presented in a Master's Certificate
⁵⁰ 1996 1 SA 111 (W).

⁵¹ *Simplex v van der Merwe* 1996 (1) SA 111 (W); *Kropman NO v Nysschen* 1999 (2) SA 567 (T); *Watt v Sea Plant Products* 1998 4 All SA 109 (C); *Thorpe v Trittenwein* 2007 2 SA 172 (SCA); *Luppachini v Minister of Safety and Security*.

⁵² Du Toit F *South African Trust Law Principles and Practice* (2002) at 63.

⁵³ *Simplex v van der Merwe* 1996 (1) SA 111 (W) at 122I.

⁵⁴ 113B.

⁵⁵ 113F-G.

⁵⁶ 114H-I.

⁵⁷ 1998 4 All SA 109 (C) 122I-J.

or contractually liabilities incurred fell within the ambit of the prohibition, and thus issues such as the *locus standi* of a party for purposes of litigation, or the liability of a party for wrongful acts was not affected by the prohibition.⁵⁸ However in a recent judgment, *Lupacchini v Minister of Safety and Security*,⁵⁹ the latter approach was criticized, the court concluding that "the section makes it clear that a trustee may not act in that capacity at all without the requisite authorisation. If we were to find that acts performed in conflict with the section are valid it seems to me that we would be giving legal sanction to the very situation that the legislature wished to prevent."⁶⁰ As this is a decision of the Supreme Court of Appeal, the view expressed therein is considered with reverence and stands to be endorsed by the lower courts.

The last statutory definition considered in this discussion here, is that of the Income tax Act which describes a "trustee"⁶¹ as-

“ ‘trustee’, in addition to every person appointed or constituted as such by act of parties, by will, by order of declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interests or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability;”

Such a definition is much broader than the Trust Property Control Act and includes not only role-players of trusts in the wider sense, but seemingly also of legal constructions other than trusts.⁶² This aspect is further addressed in Chapter 4. The Trust Property Control Act does not in its definition elaborate on the function or tasks of the trustee, whilst the definition in this Act emphasizes a certain characteristic quite relevant to the trustee’s office, namely that it is the person under whose “administration or control” of the trust property vest. Neither this definition nor the definition in the Trust Property Control Act however sets out the actual functions, duties and powers of a trustee, which is the subject we now turn to, for as Olivier put it "in the

⁵⁸ 112G.

⁵⁹ 2010 (6) SA 457 (SCA).

⁶⁰ 468G.

⁶¹ S1.

⁶² *Commissioner for Inland Revenue v Friedman and Others* NNO 1993 (1) SA 353 (A) at 312 where it is stated that the definition is "widely extended to encompass a number of persons who would not ordinarily be regarded as trustees... who administer or control *res alienae* the ownership of which does not vest in them for purposes of administration." Furthermore reference is also made to certain relations of property subject to a usufruct, fideicommissum or other limited interest which are generally not considered to be relations of trusteeship.

administration of the trust, the position and role of the trustee are all-important⁶³ and thus more so in achieving the objectives of this study.

3 2 2 2 The Trustee – Functions, duties and powers in the administration of the trust

General

The function of the trustees can be derived from the trust concept defined above in paragraph 2 2. The trustees are the parties who will hold and administer the property for the benefit of the beneficiaries or for an impersonal object.⁶⁴ The Court has best described the function of the trustees as follow -

"Except where statute provides otherwise, a trust is not a legal person. It is an accumulation of assets and liabilities. These constitute the trust estate, which is a separate entity. But though separate, the accumulation of rights and obligations comprising the trust estate does not have legal personality. It vests in the trustees, and must be administered by them - and it is only through the trustees, specified as in the trust instrument, that the trust can act."⁶⁵

In practical terms, the trustees are therefore the medium through which the trust acts, they are the "management" of the trust and conduct the administration of the trust.⁶⁶ As such, they are crucial to the "effective management of the trust" and thus to the study at hand. In the management and administration of the trust, the trustees are governed by three main principles identified by Honoré⁶⁷-

- (a) the trustees must give effect to the trust instrument, properly interpreted, as far as it is lawful and effective under the law of the place where the administration is to take place;
- (b) the trustees must in the performance of their duties and the exercise of powers act 'with care, diligence and skill which can reasonably be expected of a person who manages the affairs of another'; and
- (c) except as regards questions of law the trustee is bound to exercise an independent discretion."

The first principle underlines the importance of the trust instrument as it is a principal source of the trustees' powers and duties. Yet it is not the only source, statutory law such as the Trust Property

⁶³ Olivier et al *Trust Law and Practice* (November 2011) at 3-3.

⁶⁴ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (2007) at 312 note that the trustees do not have any beneficial interest in the property except where the trustee also happens to be a beneficiary as well.

⁶⁵ *Land and Agricultural Bank of South Africa v Parker And Others* 2005 (2) SA 77 (SCA) at para 10.

⁶⁶ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 251.

⁶⁷ Cameron et al *Honoré's South African Law of Trusts* 5th ed (2002) at 16.

Control Act⁶⁸ and the common law are further sources from which the trustees duties and powers are determined.⁶⁹ A discussion of the powers of the trustees now follows with the trustees' duties under scrutiny thereafter. Such a discussion, it is submitted, will demonstrate the pivotal role the trustees play in the "effective management of the trust" so important to the study at hand.

The Powers of the Trustees

The powers available to a trustee in the administration of a trust will depend on the contents of the relevant trust instrument.⁷⁰ This firstly implies that as trust instruments differ from each other in respect of contents, so too will the powers of a trustee differ from one trust to another.⁷¹ Secondly it denotes that the trustee's powers are limited to those in the trust instrument and for this reason, trust instruments are often in practice drafted with far-reaching powers to allow trustees all possible powers required for the effective administration of the trust.⁷² King & Victor explain that "what is being created is in effect similar to a separate legal personality, and ... one does not want to bring into existence a personality that is severely constrained, and thus unable to achieve the purposes for which it was created."⁷³ Where a trust instrument makes no provision for a particular power, it could further be inferred that the founder did not wish the trustees to have such a power.⁷⁴ Olivier gives an example: the power to sell property does not include the power to mortgage and thus an assumption could arise the latter power was not intended to be exerted by the trustees.⁷⁵ It is further important that trustees are aware and acquainted with the extent of their powers as the consequence of a transaction taken by a trustee without the necessary powers to do so, is that it is null and void.⁷⁶

Discretion

There is often an inherit discretion as to the manner in which a trustee exercises a particular

⁶⁸ 57 of 1988

⁶⁹ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B15 at 50.

⁷⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 74; Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B16 at 29.

⁷¹ Davis et al *Estate Planning* (May 2013) at 5-8(12).

⁷² B16. RP & Van der Westhuizen WM *Wills and Trust* (October 2012) -B16.1 at 59; Davis et al *Estate Planning* (May 2013) at 5-8(12).

⁷³ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 267.

⁷⁴ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B16.1 at 59. Davis et al *Estate Planning* (May 2013) at 5-8(12). Trustees powers are strictly interpreted.

⁷⁵ Olivier et al *Trust Law and Practice* (November 2011) at 3-43.

⁷⁶ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 96.

power.⁷⁷ For example a trustee may be empowered to award income earned by the trust and in such power, a discretion to the allocation or retention, the extent and timing of awards, may resort with the trustee.⁷⁸ This discretion of the trustee may be limited in the trust deed itself, alternatively the common law and Trust Property Control Act will implicitly limit it as it imposes a duty upon the trustee to exercise such powers with the standard of care, diligence and skill which can reasonably expected of one who manages the affairs of another.⁷⁹ Even where the trust deed may stipulate that the trustees enjoy an absolute unlimited or unfettered discretion, it does not empower them to "do as they please".⁸⁰ They remain in a fiduciary position and thus subject to the limitations of such office.⁸¹

Delegation of powers

Trustees may delegate the administration of the trust to others.⁸² Honoré⁸³ explains-

"A trustee can employ subordinates to attend to humdrum aspects of trust administration, and even pass on everyday aspects of running the trust to an outside agency or company... This may be to a co-trustee, to a firm in which the trustee is or is not a partner, to a relative, to a suitably qualified professional person or even to a management committee."

A trustee may consult professionals or employ experts in matters requiring specialized skill or knowledge.⁸⁴ A recent example of this can be found in the case of the *Oceanic Trust Co Ltd No v Commissioner of SARS*⁸⁵ where the relevant trust, being a Mauritian registered trust with a Mauritian based trustee but with a South African asset based portfolio, had utilized such professionals by appointing a South African company as its asset manager and investment advisor. This case is in detail discussed in Chapter 6.

A trustee may further delegate the execution of his powers to a nominee who then acts as an agent.⁸⁶ However whilst a trustee may attend to a delegation of powers, an abdication of powers is not allowed: the distinction between these two concepts lies therein that with a delegation another

⁷⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 74.

⁷⁸ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B14 at 49.

⁷⁹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 75.

⁸⁰ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B14 at 49.

⁸¹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 75. They are also subject to the control of the Master of the High Court, and the High Court itself, respectively.

⁸² Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 327.

⁸³ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 327.

⁸⁴ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 328.

⁸⁵ Decided on 14 June 2011. (2012) 74 SATC 127.

⁸⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 79.

person is appointed to act on the trustee's behalf, yet the trustee remains responsible for such actions whilst an abdication of powers relates to the appointment of another person to relieve the trustee of such responsibilities.⁸⁷ This rule is principled on the fact that the obligation of the trust burdens the trustee and the trustee must act to fulfil it.⁸⁸ As explained in the case of *Hoosen NO v Deedat* the "fundamental decisions relating to a trust need to be taken by the trustees, the implementation of such decisions may be delegated to others, although the ultimate responsibility remains with the trustees."⁸⁹

A further principle that was endorsed in this case, is that when a trustee has been appointed to the office due his personal attributes, skill or some special qualities, he or she may generally (unless trust instrument provides otherwise) not delegate his or her powers to anyone else.⁹⁰ It must lastly be noted that even where the delegation is permissible, the trustee is not absolved from liability,⁹¹ nor from the duty of supervision and review of the actions taken by those to whom the delegation was made, as the primary responsibility to the beneficiaries and the attainment of the trust object remains with the trustee.⁹²

The Duties of Trustees

As stated above, the duties of the trustees⁹³ hail in part from the trust instrument, and partly from the common law and statutory law, such as the Trust Property Control Act.⁹⁴ In terms of the latter such duties include

- (a) to lodge the trust instrument (including any amendments thereto) with the Master of the High Court before the trustee assumes control of the trust property.⁹⁵

⁸⁷ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B16.1 at 60.

⁸⁸ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 327.

⁸⁹ 1999 (4)SA 425 (SCA) at para 24.

⁹⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 79.

⁹¹ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B16 at 60 who cite the example that a trustee will not necessarily be protected from liability based on the fact that he/she acted on wrong legal advice. *Boyce NO v Bloem* 1960 3 SA 855 (T); *Jowell v Bramwell-Jones* 1998 1 SA 836 (W); 2000 3 SA 274 (SCA).

⁹² Davis et al *Estate Planning* (May 2013) at 5-8(12). Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 328.

⁹³ A list of such duties in summation form is available in Davis et al *Estate Planning* (May 2013) at 5-8(16).

⁹⁴ 57 of 1988.

⁹⁵ Section 4 requires the original or a notarial copy of the trust instrument and amendments to it to be lodged with the Master unless he is already in possession thereof. The latter would for example be the case where a successive trustee is appointed. It is also required that the Master's fee be paid when lodging the trust instrument.

- (b) to furnish the Master with an address for service of notices and processes;⁹⁶
- (c) to furnish security to the Master unless the trustee has been exempted;⁹⁷
- (d) to obtain written authority to act in the position of trustee from the Master and to act in that capacity only once such authorization is received;⁹⁸
- (e) to act in the performance of his duties with the care, diligence and skill which can reasonably be expected of a person who manages the affairs of another;⁹⁹
- (f) to deposit money received in the capacity of trustee in a separate trust account at a banking institution or building society;¹⁰⁰
- (g) in respect of the registration and identification of trust property, a trustee must indicate clearly in his bookkeeping property held in his capacity as trustee; register trust property in a manner to make it clear from the registration that it is trust property; designate any account or investment at a financial institution identifiable as a trust account or trust investment; and in other cases, make the property identifiable as trust property in the best possible manner;¹⁰¹
- (h) to account for his administration and disposal of trust property to the Master if called upon to do so and to deliver to the Master any book, record, account or document⁹⁶ relating to his administration or disposal of the trust property, if requested to do so and further, to answer to the best of his ability honestly and truthfully any question put to him by the Master in connection with the administration and disposal of the trust property;¹⁰²
- (i) to refrain from destroying any document which serves as proof of an investment, the safe custody, control, administration, alienation or distribution of trust property before a period of five years from the termination of the trust has lapsed.¹⁰³

If a trustee fails to perform any of the duties imposed upon him by the trust instrument or by law, the Act provides that the Master or any person having an interest in the trust property may apply

⁹⁶ S5.

⁹⁷ S6 – See discussion above at 3 2 2 1 regarding the security requirement as well as the validity of actions taken without authorisation.

⁹⁸ S6

⁹⁹ S9. This section further declares any provision in a trust instrument which has the effect of exempting a trustee from this obligation or indemnifying him against liability where he fails to exhibit the required degree of care, diligence and skill to be void. This duty appears to be the statutory version of the trustee's common law fiduciary duty (discussed below). Pace note however that it goes beyond the common law duty in that its application is not dependant on acceptance by the beneficiaries but exists from the moment the trustee accept his duties. Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B15.2.4 at 57.

¹⁰⁰ S10.

¹⁰¹ S11.

¹⁰² S16.

¹⁰³ S17.

for a court order directing the trustee to perform such duty.¹⁰⁴ The Act further allows for the removal of a trustee by the Master if a trustee should fail to perform satisfactorily any duty imposed upon him by the Act or a lawful request by the Master.¹⁰⁵

Importantly to the study at hand, and specifically to the "incorporated, established or formed" part of the test for fiscal residence, is the fact that despite the Act prescribing such requirements as the lodgement of the trust instrument and the authorisation of the trustees, and the further practical duties upon the trustee, these are not preconditions to the trust being formed.¹⁰⁶

Further duties may be listed in the trust instrument, and will then be specific to the relevant trust instrument at hand.¹⁰⁷ However Olivier notes that mostly trust instruments will list a trustee's powers but be silent regarding their duties. He submits a possible reason for this is that a duty is the obverse of a power, and that the powers of the trustees have as their object, to aid the trustee in executing the fiduciary duties which attach to his office.¹⁰⁸ These fiduciary duties attach legally to the office of the trustee as a trustee stands in a fiduciary relationship towards the beneficiary.¹⁰⁹ Essentially, a fiduciary is a person who undertakes or assumes responsibility to act for, on behalf of and in the interest, of another, and such fiduciary duties regulate the conduct of such person.¹¹⁰ Thus there are certain fundamental fiduciary duties: the duty not to exceed the powers granted to them, not to exercise their powers for improper purpose, to avoid a conflict of interest, not to make a secret profit or compete with any business of the trust, not to favour one beneficiary to the detriment of another.¹¹¹ All such duties are underscored by the principle that a fiduciary in his actions must promote and protect the beneficiary's interests.¹¹² Consequently in a trust setting, the dominant consideration inherent to the trustees' duties is to act in the best interest of the beneficiaries.¹¹³ The fiduciary capacity in which the trustee acts is furthermore crucial to the definition of a 'trust' in the Income Tax Act, and consequently the discussion here will again come under consideration in Chapter 4.

As stated above, the fiduciary relationship gives rise to several duties, which are imbedded in our

¹⁰⁴ S19.

¹⁰⁵ S20(2)(e).

¹⁰⁶ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 176; Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* 325.

¹⁰⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 67.

¹⁰⁸ Du Toit F *South African Trust Law Principles and Practice* (2002) at 64; Olivier et al *Trust Law and Practice* (November 2011) at 3-26.

¹⁰⁹ Olivier et al *Trust Law and Practice* (November 2011) at 3-26.

¹¹⁰ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 89.

¹¹¹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 89.

¹¹² Geach WD & Yeats J *Trusts Law and Practice* (2007) at 89.

¹¹³ Olivier et al *Trust Law and Practice* (November 2011) at 3-26.

common law. The following duties resting upon the trustees can thus be identified:

- (a) Give security to the Master for the due and faithful administration of the trust unless exempted from doing so;¹¹⁴
- (b) Observe the trust deed;¹¹⁵
- (c) Take possession of the trust property. As the trustee is the person who manages the trust property, he must acquaint himself with the nature and extent thereof.¹¹⁶ The trustee must take possession thereof in the sense that same is under his control.¹¹⁷
- (d) Render the trust property more productive;¹¹⁸
- (e) Preserve the trust property;¹¹⁹
- (f) Distribute the income and capital to the beneficiaries per the trust instrument;¹²⁰
- (g) Account to beneficiaries;¹²¹
- (h) To act with impartiality;¹²²
- (i) The duty to always act in good faith and the duty of care.

Due to the fact that the duty of good faith and care is implicit to all the trustee's actions, it is discussed in more detail. The office of the trustee is a fiduciary position which obliges the

¹¹⁴ This obligation has also been regulated statutorily in the Trust Property Control Act, see S6.

¹¹⁵ As is evident from the aforesaid discussions, the trust instrument represents the constitution whereby the trustees should conduct their affairs, and consequently, to comply therewith, they must obtain a copy of the trust instrument and acquaint themselves with the contents. (Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – at B15.1.3 at 54. Should a trustee fail to observe the trust deed it can be a ground for the removal of a trustee as per the *Tijmstra v Blunt-Mackenzie* 2002 1 SA 459 (T) 468H–J.

¹¹⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 68. The author further note that the kind of trust as well as the nature of the trust property will dictate the form of control necessary. An inventory of the trust property should be made.

¹¹⁷ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) –B15.1.4 at 54(3).

¹¹⁸ Pace expresses this obligation as including the duty to see that a reasonable return is obtained on the trust fund - Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) -B15.1.5 at 54(4). Du Toit notes that the trust funds must be invested prudently and trust debts collected with reasonable diligence -Du Toit F *South African Trust Law Principles and Practice* (2002) at 69.

¹¹⁹ This duty obliges the trustees to conserve and maintain the trust property but does not necessarily imply a prohibition on the disposal of the property for a trust deed may allow such property to be substituted by other property. Du Toit F *South African Trust Law Principles and Practice* (2002) at 68.

¹²⁰ This duty also encompasses the duty to identify beneficiaries and to further identify them as capital or income beneficiaries. Davis et al *Estate Planning* (May 2013) at 5-8(14).

¹²¹ A trust beneficiary (even one without a vested right) and a co-trustee are entitled in the common law to demand from a trustee information pertaining to the state of the trust administration.

¹²² This duty firstly refers to the duty upon a trustee to avoid a conflict of interest between his personal affairs and his fiduciary duties as trustee - and thus to guard against self-interest. (Davis et al *Estate Planning* (May 2013) at 5-8(16). Generally, trustees are therefore not allowed to purchase trust property or borrow trust monies, nor to derive profits or benefits from a transaction at the prejudice of the trust and its beneficiaries. (Du Toit F *South African Trust Law Principles and Practice* (2002) at 71). Secondly it refers to the duty not to favour a beneficiary or a group of beneficiaries above others.

trustee to act in good faith.¹²³ The latter standard resembles the Roman legal concept of "*bonus et diligens paterfamilias*."¹²⁴ This concept is not exclusive to trust law but is frequently encountered in South African law. It denotes the reasonable care that can be expected from a reasonable person in certain circumstances.¹²⁵ Thus in a trust setting, it is said to mean that the trustee should act like a reasonable, prudent person in his undertakings.¹²⁶ Resorting under this standard, is the degree of care and diligence the trustee should apply in the trust administration. Du Toit regards the duty of care as the "most important manifestation of the fiduciary office" and reiterates that it is an accepted principle in South Africa, that a trustee as a functionary to a fiduciary relationship, must perform his duties in the utmost good faith.¹²⁷

Already in case law of the previous century, it was found that the standard imposed upon the trustee, necessitates that he acts with greater care in handling the trust property, than he may in handling his personal property and moreover is "obliged in dealing with and investing the money of the beneficiary, to observe due care and diligence, and not to expose it in any way to any business risks."¹²⁸ Olivier describes the conundrum resulting herein as on the one hand, owing to this duty, the trustee should avoid all elements of risks whilst on the other, reasonable chances should be taken by the trustee to achieve the trust objectives.¹²⁹ A more appropriate expectation of the trustee has therefore been given in *Herschel v Mrupe*¹³⁰ -

"The concept of a *paterfamilias* is not that of a timorous fainthearted always in trepidation lest he or others suffer some injury; on the contrary, he ventures out in to the world engages in affairs and take reasonable chances. He takes reasonable precautions to protect his person and property and expect others to do likewise."

This standard of care has further been included in the Trust Property Act and requires the trustee to, in the performance of his duties and the exercise of powers, act 'with care,

¹²³ Du Toit F *South African Trust Law Principles and Practice* (2002) at 71.

¹²⁴ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 275.

¹²⁵ Olivier et al *Trust Law and Practice* (November 2011) at 3-34. Honore states that the standard of care expected will depend on the facts of the case and the social, political and economic conditions - Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 263.

¹²⁶ Olivier et al *Trust Law and Practice* (November 2011) at 3-34.

¹²⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 71. The author further notes that the trustee's fiduciary office and this duty of care form the basis for the various remedies of the beneficiaries and third parties when there has been a breach of trust.

¹²⁸ *Sackville-West v Nourse* 1925 AD 516 at 527-528.

¹²⁹ Olivier et al *Trust Law and Practice* (November 2011) at 3-34.

¹³⁰ 1954 (3)SA 464 (A) at 490.

diligence and skill which can reasonably be expected of a person who manages the affairs of another'.¹³¹ King & Victor note that the role of the trustee in a business trust is currently being reviewed and anticipate that legislation will follow whereby such a trustee will be expected to exercise the care, diligence and skill of a director.¹³²

- (j) Keep the trust property separate.¹³³ This duty has also been statutorily enshrined in the Trust Property Control Act. It stresses the importance that there should not be a fusion of the trustees' personal property and the property of the trust. In the view of Pace and van der Westhuizen, this duty goes hand in hand with the degree of control exercised by the trustees.¹³⁴ They explain that when an individual trustee controls a trust, the latter can become such a trustee's *alter ego*.¹³⁵ To determine whether the control of a trustee renders the trust to be the person's *alter ego*, a two-legged test is to be applied. Firstly the trust deed and its provisions is examined, to establish whether it allows for *de jure* control by the particular party. In the second stage the actual conduct of the particular party and the administration of the trust, is reviewed, to determine whether there was *de facto* control.¹³⁶ In this second leg of the test the failure to separate trust property from a trustee's personal property may be indicative of such *de facto* control.¹³⁷ In *Badenhorst v Badenhorst*,¹³⁸ the fact that the trustee paid scant regard to the difference between the trust and his own assets, indicated trust assets as his own on a credit application, had insured a trust asset in his personal name, had financed personal asset from the trust and took receipt of income due from a company owned by the trust, were all factors evincing *de facto* control.

The last two duties to be discussed, are particularly important to the conduct of the trustees in their administration of the trust. The first of these is expressed as the obligation to comply with the duty of active supervision and inquiry. A trustee is tasked to take active steps to become knowledgeable about the status of the trust property, the need to invest trust property as well as the opportunities to secure a good return on capital.¹³⁹ A trustee can not therefore adopt a passive approach of waiting upon such information, as "not knowing what one ought to have known" is

¹³¹ S9(1).

¹³² King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 255.

¹³³ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 292.

¹³⁴ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) –B 15.1.6 at 54 (7).

¹³⁵ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) –B 15.1.6 at 54 (7).

¹³⁶ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) –B 15.1.6 at 54 (7).

¹³⁷ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) –B 15.1.6 at 54 (7).

¹³⁸ 2006 2 SA 255 (SCA).

¹³⁹ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) –B15.1.8 at 54(13).

regarded as negligence.¹⁴⁰ Similarly, should the trustees passively exercise no independent views, it can be a ground for removal of the trustees.¹⁴¹ This relates to the third principle of Honoré quoted above – "except as regards questions of law the trustee is bound to exercise and independent discretion."¹⁴² This exercise of this discretion is according to Pace and van der Westhuizen¹⁴³ governed by fundamental principles of natural justice, which requires that -

"... that whenever any discretion is legally given to anybody, such a person – ie a trustee – must apply his/her mind to the actual exercise of any such power or discretion. It is an inherent requirement of the exercise of any discretion that it be given real and genuine consideration, actively and conscientiously. The exercising of any discretion therefore calls for a wider, more comprehensive inquiry into matters by the trustee than he/she might have applied in his/her personal decision-making."

Similarly Geach states that a trustee must actively participate in the affairs of the trust, and declares that "there is no room in South African law for a silent, sleeping or puppet trustee."¹⁴⁴ He further states that a trustee must not act under the instructions or undue influence of any parties to the trust, thus a trustee must at all times exercise an independent and objective judgment.¹⁴⁵ Olivier puts it succinctly, "Active administration is essential."¹⁴⁶ Davis¹⁴⁷ states that each of the trustees must exercise an independent judgment as to what constitutes the best interests of the trust, particularly as it has been held that the same legal principles, which apply to directors, are applicable to trustees. These have been described as follows -

"...The director's duty is to observe the utmost good faith towards the company, and in discharging that duty he is required to exercise an independent judgment and to take decisions according to the best interests of the company as his principal. He may in fact be representing the interests of the person who nominated him, and he may even be the servant or agent of that person, but, in carrying out his duties and functions as a director, he is in law obliged to serve the interests of the company to the exclusion of the interests of any such nominator, employer or principal. He cannot therefore fetter his vote as a director, save in so far as there may be a contract for the board to vote in that way in the interests of the

¹⁴⁰ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at326.

¹⁴¹ *Tijmstra v Blunt-Mackenzie* 2002 1 SA 459 (T) 472A–C; Davis et al *Estate Planning* (May 2013) at 5-8(4)-(5) list such ground of removal as being the reliance upon a dominant co-trustee without expressing an independent view.

¹⁴² Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 264.

¹⁴³ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) – B14 at49.

¹⁴⁴ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 72.

¹⁴⁵ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 72. He further states (when discussing the potential liability of the trustee at 100 that "there is no defence for a trustee to argue that he/she did not take an active part in the affairs of the trust... a trustee must at least perform a watchdog role, especially when one is a managing trustee. This position should be compared with that of an executive and non-executive director."

¹⁴⁶ Olivier et al *Trust Law and Practice* (November 2011) at 3-26(1).

¹⁴⁷ Davis et al *Estate Planning*(May 2013) at 5-8(13) citing *PPWAWU National Provident Fund v CEPPWAWU* 2008 (2) SA 351 (WLD) as authority.

company, and, as a director, he cannot be subject to the control of any employer or principal other than the company."¹⁴⁸

In this regard there have been calls for the appointment of an independent trustee, or that there should always be a majority of independent trustees.¹⁴⁹ Such calls trail in the wake of the well-known dictum of *Land and Agricultural Bank of South Africa v Parker & Others*,¹⁵⁰ where the court offered the following solutions to the abuse of the trust form –

"These include the power to appoint trustees in the absence of provision in the trust instrument, and to appoint any person as co-trustee of a serving trustee where he considers it 'desirable', notwithstanding the provisions of the trust instrument.... The debasement of the trust form evidenced in this and other cases, and the consequent breaches of trust this entails, suggest that the Master should, in carrying out his statutory functions, ensure that an adequate separation of control from enjoyment is maintained in every trust. This can be achieved by insisting on the appointment of an independent outsider as trustee to every trust in which (a) the trustees are all beneficiaries and (b) the beneficiaries are all related to one another."¹⁵¹

In describing the identity of such an "independent outsider" the court noted, that it is not a requirement that the person must be professionally trained, such as an attorney or accountant, but must have a proper realisation of the responsibilities of trusteeship. In particular such person should accept the office to ensure that the trust functions properly and here the court mentioned two important functions: the observance of the provisions of the trust deed, and the scrutiny and checking of the conduct of trustees who lack a sufficiently independent interest in the trust.

There is however criticism against the stance adopted by the court.¹⁵² Pace & van der Westhuizen¹⁵³ query why the court singled out the trust entity and did not extend this requirement to other entities, where such a potential fusion of control and ownership could result. For example a company where the sole shareholder is the only director, or the close corporation with only one member. Meyerowitz questions this requirement on both a practical¹⁵⁴ and legal basis¹⁵⁵, and

¹⁴⁸ *Fisheries Development Corporation of SA Ltd v Jorgensen & Another; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd & Others* 1980 (4) SA 156 (W) at para 29, quoted in Davis et al *Estate Planning* (May 2013) at 5-8(13).

¹⁴⁹ Geach refers to the King Code on Corporate Governance which recommended a majority of non-executive directors on the board of directors to ensure good corporate governance in companies. Similarly he submits that a majority of independent trustees (unconnected to the founder, beneficiaries, planner) will aid good corporate governance, and ensure a proper separation of control and enjoyment. Geach WD & Yeats J *Trusts Law and Practice* (2007) at 84.

¹⁵⁰ 2005 (2) SA 77 (SCA).

¹⁵¹ Para 33-36.

¹⁵² Davis et al *Estate Planning* (May 2013) at 5-7 to 5-8. Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B6.2 at30.

¹⁵³ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B6.2 at30.

¹⁵⁴ In this respect Meyerowitz draws attention to the fact that the Master does not have the

submits that "the cure" if implemented "could be worse than the disease, or to put it another way, be more academic than practicable."¹⁵⁶

The second of these duties is the duty of the trustees to act jointly. This duty derives from the fact the trustees are regarded as co-owners of the trust property (albeit not in their personally capacity the owners as they own the property on behalf of the beneficiaries) and as co-owners must act jointly, so too must trustees as such act jointly.¹⁵⁷ Geach states this duty therefore obliges trustees to "act jointly in trust affairs, consult with each other and strive to reach agreement on disputed matters."¹⁵⁸ The trustees must therefore all act jointly, alternatively one or more of the trustees can act, provided that they are authorised by the other trustees to act on behalf of *all* of the trustees.¹⁵⁹ This rule that the trustees must act jointly is however qualified therein, that the trust deed may provide otherwise.¹⁶⁰ Thus, should the trust deed not regulate this issue, then the trustees must act by unanimous vote.¹⁶¹ The trust deed may however regulate same expressly and require majority vote, which if met, would bind the trust. Yet even where the trust deed requires majority vote, it does not mean that the majority of the trustees in office can take a binding decision without meeting or consulting the further trustees.¹⁶²

necessary expertise or capacity to decide whether a person is an independent trustee, a completely independent trustee would be costly to find, and would moreover not be *au fait* with the family circumstances and thus frustrate the founder's intentions.

¹⁵⁵ Here Meyerowitz gives the example of a difficult situation which could result where a trust instrument provides for majority vote, the further trustees all beneficiaries and the independent trustee does not have a veto right.

¹⁵⁶ 2005 The Taxpayer 181.

¹⁵⁷ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 72 and 76. *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) at 85A.

¹⁵⁸ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 76.

¹⁵⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 76. *Thorpe v Trittenwein* 2007 2 SA 172 (SCA) at 176l.

¹⁶⁰ 2007 2 SA 172 (SCA) (at 176l); Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B 15.1.1 at 53; In *Thorpe v Trittenwein* it was decided that in the absence of a contrary provision in the trust deed, the trustees had to act jointly and consequently a trust could not be bound by the assent of a single trustee in the absence of the joint decision of the co-trustees (or the majority, if that is all the trust deed requires). Geach holds the view that notwithstanding such a provision, all trustees should still act jointly as the responsibilities attached to their office cannot simply be dispensed with by the trust deed - Geach WD & Yeats J *Trusts Law and Practice* (2007) at 76 and 91.

¹⁶¹ Cameron, E, *Honoré's South African Law of Trusts* 5th Ed (2002) at 323; *Coetzee v Peet Smith Trust* 2003 5 SA 674 (T).

¹⁶² Davis et al *Estate Planning* (May 2013) at 5-8(4); *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) where the court states "the majority remained part of a three trustee complement, and it had to exercise its will in relation to that complement..." Thus although a decision could have been taken by majority vote, all the trustees had to be part of the decision-making process. Olivier et al *Trust Law and Practice* (November 2011) at 3-38.

This was affirmed in *Thorpe v Trittenwein*,¹⁶³ where the court stated that a trustee who was not a party to the decision-making process and has consequently not authorised the contract, would be free to challenge the validity of the transaction.¹⁶⁴ The recent decision of *Steyn and Others NNO v Blockpave (Pty) Ltd*,¹⁶⁵ provides further endorsement. Here the court decided that a decision taken by a majority of trustees in the absence and without the knowledge of a marginalised trustee is invalid. The court explained that -

“A trust operates in two different spheres. Internally trustees may disagree. A matter on the agenda may be debated. If the trustees are not unanimous, matter must be put to a vote. The majority vote then prevails as the decision of the trustees. The dissenting trustee has to subject himself to the democratic vote of the majority. Externally, trustees cannot disagree. The internal split decision becomes the resolution of the trust in its dealing with the world at large. The dissenting trustee is just as bound by the resolution as those who had supported it all along during the debate in the internal sphere. In the external sphere the trust functions by virtue of its resolutions which have to be supported by its full complement of the trust body.”¹⁶⁶

Important to the study at hand, is then the internal administration of the trust. The Trust Property Control Act does not address this save to prohibit the destruction of any document that serves as proof of the investment, safe custody, control, administration, alienation or distribution of the trust property,¹⁶⁷ to require the trustees to account in their bookkeeping for trust property¹⁶⁸ and to require the trustees to serve with care, diligence and skill (discussed above).¹⁶⁹ From the aforementioned provision, an implicit duty to record and file all documentation material to the trust administration can be identified. Most often, the internal administration is regulated by the trust instrument.¹⁷⁰ The trust instrument must therefore not only deal with substantive matters such as the powers and duties discussed above, but also must provide guidance as to the procedural matters such as the format, regularity and procedures to be followed at trustee's meeting.¹⁷¹

¹⁶³ 2007 2 SA 172 (SCA)

¹⁶⁴ Para 178 C-D.

¹⁶⁵ 2011 (3) SA 528 (FB).

¹⁶⁶ Para 37-39. The court concluded that “a majority of trustees in office may form a quorum internally at a trust meeting, but they cannot externally bind the trust by acting together. These are two features of the decision that are instructive. It is not the majority vote but rather the resolution by the entire complement which binds a trust estate. A trust operates on resolutions and not votes.”

¹⁶⁷ S17.

¹⁶⁸ S11.

¹⁶⁹ S9.

¹⁷⁰ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 321.

¹⁷¹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 79; Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 321. The latter authors note that where the trust instrument are silent on such matters, guidance can be sought from the law relating to voluntary associations but subject to the caveat that there are important differences.

Honoré is of the view that where there is more than one trustee, a chairman or senior trustee should be appointed.¹⁷² Such a chairman is granted with certain "super powers" in respect of the procedural administration. For example to determine the time and place of meeting, the frequency of such meetings¹⁷³, as well as the right to veto or to cast a determining in an equality of votes.¹⁷⁴ Although the founder has no legal right to this position¹⁷⁵, he or she will most often occupy this position and may, as King and Victor warn, retain *de facto* control so far as investment decisions and the general running of the trust are concerned.¹⁷⁶ A further variation is found in business trusts, where an executive or managing trustee is appointed to run the trust's affairs.¹⁷⁷ This trustee's authorisation to act will either be expressly recorded in the trust instrument, or be granted by the others trustees expressly or implicitly.¹⁷⁸ In respect of decisions, Du Toit notes that trust instruments usually provides for procedural matters to be resolved by majority vote, but require an unanimous vote in matters of substance.¹⁷⁹ The discussion regarding the duty to act jointly thus has reference here. Honoré endorses the view that as a basic rule in the trust administration, decisions of substance must be reached unanimously and to bind the trust the trustees must therefore act jointly.¹⁸⁰ This also corresponds with the consequence that all trustees will in general be liable individually and fully for one another's defaults in the trust administration.¹⁸¹ As per recent case law, it appears that the courts recognise that the trust deed may provide otherwise, for example allowing majority vote – and that same will take precedence over such rule. From the perspective of outsiders dealing with the trust, it is trite they are entitled to assume that all powers vested in the trustees must be exercised by all the trustees, unless otherwise directed in the trust instrument.¹⁸² Olivier puts it thus way, "As far as outsiders are concerned, the board of trustees is a

¹⁷² Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 321.

¹⁷³ Honoré is of the view that a minimum of one meeting in a year is necessary even if only to present and pass the financial statements, but the intervals of such meetings will be dependant on the standard of care the trustees need to meet, regarding particular affairs of the trust business Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 327.

¹⁷⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 80.

¹⁷⁵ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 322.

¹⁷⁶ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 266 – The authors further note that frequently the spouse of the founder is also appointed as a trustee and takes over the position of chairperson upon his/her demise.

¹⁷⁷ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* 327.

¹⁷⁸ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* 327.

¹⁷⁹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 80.

¹⁸⁰ Cameron E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 323.

¹⁸¹ Cameron E et al *South African Law of Trusts* 5th Ed (2002) at 322.

¹⁸² Du Toit F *South African Trust Law Principles and Practice* (2002) at 80. E Cameron, M de Waal, B Wunsh & P Solomon *Honoré's South African Law of Trusts* 5th Ed (2002) at 324.

united body, regardless of any internal administrative arrangements there may be.”¹⁸³ They are furthermore entitled to accept that co-trustees will incur joint and several liability resulting from such dealings.

Conclusion

From the above discussion it is to be agreed with the statement, that the implementation of the trustee’s duties provides “the electrical current which ensures proper and enduring light for the trust”,¹⁸⁴ and as such, a review of the particular functions, powers and duties stemming from the trustee’s office in the trust administration, is indispensable to the study at hand. It is evident from the aforesaid discussion, that it is the trustees, the performance of their duties and tasks in the administration of the trust and the extent to which they have delegated same, or have had such functions usurped by other parties, that will be key considerations in determining the “effective management” of the trust. It is therefore trusted that the aforesaid discussion laid a solid foundation for further investigations into the “effective management of the trust”, which is crucial to the determining of the “residence” of a trust.

3 2 3 The Beneficiaries of the Trust

The meaning of this term can be inferred from the trust concept defined above. The trust property is held and administered for the benefit of the beneficiaries. They are therefore said to be the equitable “owners” of the trust property.¹⁸⁵ The beneficiaries can be specifically named in the trust deed, or may be ascertainable, ie they may be elected from a class of beneficiaries.¹⁸⁶ The latter is in sharp contrast to classical Roman law, where it was required that the testator must have a “clear picture” of the person who is to benefit as legatee/heir in mind, failing which the bequest would fail for uncertainty. Honoré explains certain “persons” could obviously not be visualized as such: persons not yet born, members of a body corporate, or relating to charitable bequests, a particular poor person who is to benefit.¹⁸⁷ Whilst in today’s age, this “clear mental picture” is no longer a requirement, a trust without a named or ascertainable beneficiary is a nullity unless it is created for an impersonal object.¹⁸⁸

¹⁸³ Olivier et al *Trust Law and Practice* (November 2011) at 3-42.

¹⁸⁴ Olivier et al *Trust Law and Practice* (November 2011) at 2-2.

¹⁸⁵ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 251.

¹⁸⁶ Olivier et al *Trust Law and Practice* (November 2011) at 2-4.

¹⁸⁷ Cameron E et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 152.

¹⁸⁸ Olivier et al *Trust Law and Practice* (November 2011) at 2-4.

The beneficiaries appointed by the trust deed will not indefinitely always remain the same. Most often trust deeds make provision for the beneficiaries to be amended whether by addition, or deletion.¹⁸⁹ An interesting case in this respect was *ITC 1829*¹⁹⁰ in which the events took place prior to the introduction of anti-avoidance amendments to the Transfer Duty Act aimed at combatting the “sale of a trust.”¹⁹¹ The latter refers to an arrangement, whereby the trustees and beneficiaries of a trust holding immovable property, would instead of selling the property out of the trust conventionally and thus giving rise to transfer duty, be substituted as trustees and beneficiaries by the purchasing parties in exchange for an agreed sum of money.¹⁹² Thus avoiding payment of transfer duty as there was no transfer of property. In the facts of this particular case, this arrangement for all practical purposes can be said to have been duplicated. The tax court found that transfer duty was however payable on the grounds that a new trust had come into existence upon the change in beneficiaries, which had occasioned the end of the old trust, causing the property to be transferred from the old trust to the new trust.¹⁹³ Whilst this case was decided on the particular facts and in the context of different legislation, it is an important warning that care must be taken, when a complete changeover of beneficiaries is undertaken, so that a new trust is not deemed to have been created.¹⁹⁴

A distinction is further made in respect of the beneficial interest of the beneficiaries to the trust assets and they are accordingly classified as either income or capital beneficiaries.¹⁹⁵ Income beneficiaries may be awarded the income of the trust, but not the capital (unless they are also capital beneficiaries).¹⁹⁶ In a vested trust the beneficiaries have a specific entitlement to the income and the trustees are obliged to award the income to them, whereas in a discretionary trust a

¹⁸⁹ Anonymous “A dubious decision on trusts by the Tax Court” (February 2008) *Synopsis Tax Today* PriceWaterhouseCoopers.

¹⁹⁰ *ITC 1829* 70 SATC 106 (first published as *The T Trust v CSARS* in the Gauteng Tax Court).

¹⁹¹ Amendments introduced by the Revenue Laws Amendment Act 74 of 2002, effective 13 December 2002.

¹⁹² Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 228.

¹⁹³ See par 52 – “The net effect of the above is that the principal object and purpose of the original trust as envisaged by the donor had been terminated in that a different ascertainable object and purpose to the original trust had been effected.”

¹⁹⁴ Anon raises several interesting questions regarding the practical implications of this decision: Firstly, does it follow that upon each occasion of a change in the trust beneficiaries, the old trust comes to an end and the property of the old passes to the new? How does the property pass - are the assets magically and without any legal process simply transferred to the new trust? How is the old trust distinguished from the new trust as they still share the same registration number? As letters of authority have not been issued to the new trustees, have they been acting without authority? – Anonymous (February 2008) *Synopsis Tax Today* PriceWaterhouseCoopers.

¹⁹⁵ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 251.

¹⁹⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 5 explains that the income beneficiaries benefit from the income or proceeds generated from the trust property – interest, dividends, rentals – whereas capital beneficiaries benefit from the trust property or capital.

beneficiary will only become entitled to the income, should the trustees exercise their discretion in his or her favour.¹⁹⁷ Capital beneficiaries share in the capital of the trust. In a vested trust the rights of the capital beneficiaries form an asset in their estate. In a discretionary or vesting trust the beneficiaries are earmarked to become the ultimate owners of the capital as and when the trustees exercise their discretion or upon the happening of a certain event.¹⁹⁸ Similarly they have no right to the income unless they are also income beneficiaries.

The beneficiaries are the only parties who have the right to enforce the trust provisions.¹⁹⁹ A beneficiary has a personal right against the trustees for the proper administration of the trust, which right flows from the fiduciary nature of the trustee's office and is the counterpart to the trustee's duty to conduct the administration of the trust in the utmost good faith.²⁰⁰ The role of a beneficiary and the nature and extent of his or her rights are determined by the fiduciary nature of the trustee's office, but are also dependent on the particular trust at hand and its trust instrument.²⁰¹ So for example the beneficiaries may be awarded the right to appoint trustees in the trust instrument or to veto decisions. Their specific rights will therefore need to be determined in each factual situation.

These rights of the beneficiaries and more particular to which extent the exercise of these rights may impact on the "effective management" of the trust, is therefore a factor to keep in mind in reviewing the test for fiscal residence.

3 2 4 The Office of the Protector

A concept that is not readily applied in South African law, is that of the "protector," although it is a prominent feature of trusts in offshore jurisdictions. King & Victor²⁰² give the following description of the term –

¹⁹⁷ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 251.

¹⁹⁸ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 21-22. King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 251.

¹⁹⁹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 251 where they note that the Founder does not have this right unless he is also a beneficiary and then it will be in his capacity as such.

²⁰⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 108. However it must be noted that based on the typification of the trust *inter vivos* as a *stipulatio alteri* by the Appellate Division a beneficiary can only enforce this right after acceptance of the trust benefits.

²⁰¹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 21.

²⁰² King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 252.

“In general terms, the protector is a person with certain powers over the trustees or the trust fund, including the appointment or removal of trustees, and in some cases the consent of the protector is required before capital distributions are made.”

Honiball and Olivier explain the term as follows –

“... generally describes a person who is either a relative of the settlor or is a professional person (a corporate person or a committee of persons, the latter being referred to as a protection committee) with a particular oversight role in respect of the administration of the trust by the trustees. The protector is generally a third party (that is, not a founder, beneficiary or trustee) with contractual powers and obligations recorded in the trust deed.”²⁰³

Olivier notes that this person or committee is usually a countryman of the settlor or a person falling under the same jurisdiction, who serves as a link between the settlor and the foreign trustees.²⁰⁴

The need for a protector in such jurisdictions stems from the fact, that the settlor is usually not involved as a trustee and professional trustees manage the trust assets. By appointing a protector who overlooks the activities and appointment of trustees, the settlor is reassured and has a greater sense of security.²⁰⁵ Honiball & Olivier reaffirm this by stating that the development of the concept of the protector took place due to the escalation of delinquent trustees in these offshore jurisdictions.²⁰⁶

The extent of the powers of the protectors are determined by the trust deed of the particular trust to whom they are appointed, but may include -

“the exercise of veto rights in respect of decisions taken by the trustees; the removal and appointment of trustees; the amendment of the trust deed for administrative purposes or to achieve certain tax effects; the approval of a change of the applicable law of the trust and/or the location of the administration of the trust; the alteration of the beneficial interest of the beneficiaries by adding or removing beneficiaries or amending provisions dealing with distributions; the veto of the approval of, or input relating of the approval of trust distributions; the approval of the apportionment of agents or advisors generally or in relation to specific matters; the approval of investment recommendations; the appointment of replacement (successor) protectors; and the termination of the trust or approval of the termination of the trust under the terms of the trust deed.”²⁰⁷

²⁰³ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 35.

²⁰⁴ Olivier et al *Trust Law and Practice* (November 2011) at 5-34.

²⁰⁵ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 252; Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 123 where they note that the Protector is usually a person who the settlor would have appointed as a trustee had he been able to do so – sometimes foreign jurisdictions prohibit the appointment of non-residents as trustee which obstacle is indirectly overcome by the appointment of a protector. See also Antony G D Duckworth “The Trusts Offshore” 1999 *Vanderbilt Journal of Transnational Law* 32 at 882 where he states that when the settlor requires greater reassurance a solution is to provide a watchdog mechanism that often takes the form of a protector – usually equipped with the power to replace the trustee.

²⁰⁶ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 35.

²⁰⁷ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 35.

Such powers are usually quite extensive and therefore King & Victor state, that in light of recent developments in the trust law, the use of the office of a protector may cause a trust to fall foul of the tax laws as it could be perceived to be control by the founder.²⁰⁸ Honiball & Olivier are however of the view, that there is no prohibition nor reason why the protector cannot be accepted in South African trust law, but add a *caveat*: that it would be particularly important “that the protector does not become a vehicle used to disguise the *de facto* control by another person of the assets of the trust and must not interfere with or impede the ability of the trustees to comply with their fiduciary duties”²⁰⁹ A further view is that it depends on whether it is requirement in South Africa for the continuation of the trust, that the trustees must act independently. If it is not, then the existence of the protector would not invalidate the trust, but if it is a requirement, then the existence of a protector may lead to the invalidity of the trust, depending on the nature of the protector’s powers.²¹⁰ Alternatively to declare the whole trust deed invalid, a court may strike out the clauses dealing with the provision of the protector, leaving the remainder of the trust deed intact.²¹¹ A further warning regarding the use of the protector, is made by Olivier who writes that although precise tasks and powers must be described in the trust deed, it must not be construed that the protector is regarded as one of the trustees.²¹²

A recent case in Jersey²¹³, serves as an practical example of how the protector’s role may be misunderstood. Here the court found that “the root of the problem lay in S’s [the Protector] misconceived view of himself as the living guardian and enforcer of the settlors’ wishes.”²¹⁴ The court further elaborated -

²⁰⁸ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 252. See also Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 124 where they state the normal role of the protector entails liaising with the founder to ensure that the settlor wishes are followed. Usually through the exercise of negative controls such as a veto right. This power to veto decision could substantiate the submission that the trust is a sham as the settlor never intended to hand over control of the assets to the trustees.

²⁰⁹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 36. The authors argue that South African trust law is based effectively on contractual principles and thus there is no reason why the role of protector can not be included to fulfill the functions internationally associated with the concept. They further point out that pursuant to the 2003 Tax and Exchange control various foreign trust with pre-existing protectors were re-domiciled to South Africa so that the settlor or the beneficiary could utilize the amnesty.

²¹⁰ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 124.

²¹¹ Davis et al *Estate Planning* (May 2013) at 5-22.

²¹² Olivier et al *Trust Law and Practice* (November 2011) at 5-34.

²¹³ *In the matter of the representation of C, D, E And F and in the matter of the A and B Trusts and in the matter of Articles 51 and 53 of the Trusts (Jersey) law 1984 (as amended)* [2012] JRC 169 A– available at <http://www.jerseylaw.je/judgments/unreportedjudgments/documents/display.aspx?url=2012%2f12-09-27%2fIn%20the%20matter%20of%20the%20A%20Trust%20169A.htm>. Last accessed 07/05/2013.

²¹⁴ Par 3.

“We accept, on the evidence, that S’s [the Protector] motivation for the way he exercised his role as protector was *bona fide*, his behaviour being driven by conviction that it was his duty to ensure that the trusts were administered according to his perception of what the settlors would have wanted... Unfortunately the role in which he cast himself went well beyond what was proper for someone in his position and led him, not just to insist on playing an overactive part in the management of the trusts, but also to take up indefensible positions as regards his successor, his reluctance to recognise the potential jeopardy to the trusts created by his over-zealous involvement...”²¹⁵

Without any judicial pronouncements, or in-depth consideration of the protector locally, there is no clear answer as to how this concept would be treated in South Africa and at most it can be advised, that each case must be reviewed on its own facts to determine whether the protector is a mere puppet of the settlor, or whether he acts in an advisory capacity in the best interest of the beneficiaries.²¹⁶ It is however clear from the above discussion, that the protector's tasks and powers in relation to the trust property and its assets may be considerable, and where found to be so, the "effective management" of the trust as per the second criteria of the test for fiscal residence, may be greatly impacted thereby.

3 3 Conclusion

Whilst it has been said that that the trustee is “an indispensable link in the trust chain”,²¹⁷ the role of the further links to the trust chain, such as that of the founder and the beneficiaries of the trust, should not be overlooked. The above discussion has shown that each party to the trust has a specific and distinct role to play in the varied facets of the trust and its functioning. As such, the potential impact of each respective party on the criteria for the test for fiscal residence in South Africa, must be kept in mind. It has been illustrated above that each of these parties play a vital role in the trust being established and thus may influence the “incorporated, established or formed” criteria. It has further been shown that each of these parties may also through their actions weigh in on the management scale, and thus impact on the “place of effective management” criteria. Based on the foundation lain in this chapter as well as the preceding chapter, we now turn from trust law to tax law.

²¹⁵ Par 1.1(ii) of the summary set out in the judgment. See also Withers Worldwide “Withers lead on landmark case on trust protectors” - available at www.withersworldwide.com/.../withers-leads-on-landmark-case-on-trust. Last accessed 07/05/2013.

²¹⁶ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 125.

²¹⁷ Olivier et al *Trust Law and Practice* (November 2011) at 2-4.

CHAPTER FOUR

THEORETICAL FOUNDATIONS OF THE SOUTH AFRICAN TAX LAW PERTAINING TO TRUSTS

4 1 Introduction

It is to be agreed with Cameron who succinctly states, “Tax law and trust law are two dense and difficult fields.”¹ Yet the nature of this study is such, that both these fields are of significant importance and must of necessity be considered despite their difficulty. The aim of this study is after all, to investigate the particular meaning of the test set for residence in South Africa's income taxation laws as applicable to trusts.

In order to set the stage for such an investigation, it is therefore essential to reflect on several features of the South African Income Tax framework applicable to trusts. It is submitted that to appreciate the importance of adequate rules in determining the residence of a trust, it is necessary to have an overview of the fiscal structure applicable and the practical tax consequences of a trust being resident or not in South Africa.² Subject to the limitations set out in the Scope of the Study in paragraph 1 4, this chapter is therefore dedicated to this task.

It must however be noted that it is here where major reforms of the applicable tax laws and principles, are anticipated, following the Budget Speech earlier this year.³ In the Budget Speech it was announced that legislative measures will be introduced to address tax avoidance through trusts. In particular it was stated that “certain aspects of local and offshore trusts have long been a problem for global tax enforcement, due to their flexibility and flow-through nature.”⁴ The proposals the South African Revenue Service have released to date are discussed later in this chapter. Due to their lack of detail, they are veiled in much uncertainty and speculation. In order to understand the proposed changes and reforms, the current structures and applicable laws are discussed below.

¹ Cameron in the Foreword to Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at v.

² It is reiterated that the study is aimed at determining the fiscal jurisdiction to tax the trust as based on the definition furnished in the Income Tax Act and consequently an in-depth discussion of the actual taxation of trusts - the rules and principles whereby taxes are levied, calculated and collected – falls outside the scope of this study.

³ 2013 Budget Speech delivered to Parliament on 27 February 2013 (at 21) as was further elaborated in the Budget Review 2013 issued by National Treasury in Chapter 4 dealing with “Revenue Trends and Tax Proposals” at 54. The Budget Speech is available at <http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf> and the 2013 Budget Review at <http://www.treasury.gov.za/documents/national%20budget/2013/review/default.aspx>. Last accessed on 01/05/2013.

⁴ Chapter 4 of the 2013 Budget Review under the heading “Tax Avoidance” at 54.

4 2 The South African Income Tax Framework in respect of trusts

4 2 1 The trust as a taxable entity

In terms of the Income Tax Act and in particular section 5, being the “charging section,” an annual tax as determined by Parliament, shall be paid to the National Revenue Fund in respect of the taxable income received by or accrued to or in favour of -

“ any person (other than a company) during the year of assessment ended the last day of February each year; and any company during every financial year of the company.”⁵

As a trust is clearly not a company, for this section to be applicable and taxes to be imposed on a trust, a trust must fall into the first category as a “person other than a company.”

For many years this posed a particular conundrum to the legal fraternity as it was trite that in terms of the common law, a trust is not a legal person nor does it have a separate *persona*.⁶ Thus on a strict legal interpretation, a trust certainly could not fall into this category and be taxed.⁷ Regardless of this technical legal predicament, the Receiver of Inland Revenue (now the South African Revenue Services), for all practical purposes did treat the trust as a taxable entity⁸ and taxed the trustees as representative taxpayers to it. This practice was upheld in various income tax court decisions⁹ and several legal writers also supported this view.¹⁰

Eventually in the case of *CIR v Friedman and Others NNO*¹¹ this issue came before the Supreme Court of Appeal, who definitively pronounced that the trust was not a “person” within the meaning of that word in the Income Tax Act and consequently, the Receiver was not entitled to levy taxes on a trust as a 'taxable entity' in regard to the undistributed income of the trust. It was also decided by the court, that the trustees could further not be “representative taxpayers” to the trust or to the potential beneficiaries, as a representative taxpayer must firstly represent a real taxpayer and

⁵ S 5 of the Income Tax Act, 58 of 1962; see also Meyerowitz *Meyerowitz on Income Tax (2007-2008)* at par 5-1.

⁶ See discussion above at paragraph 2.6 regarding the legal nature of a trust.

⁷ Olivier states that it “gave rise to many arguments and much speculation in legal circles - Olivier et al *Trust Law and Practice* (November 2011) at 2-33.

⁸ Davis, DM “The Taxation of a Trust” 1991 *SALJ* at 225.

⁹ *ITC 37 2 SATC 65; ITC 288 7 SATC 330; ITC 400 10 SATC 102 and ITC799 20 SATC 222.*

¹⁰ Meyerowitz and Spiro *Income Tax in South Africa* para 1194; Silke *South African Income Tax* 11th ed paras 12.14-12.25; Honoré *The South African Law of Trusts* (1985) 3rd ed at 340; Broomberg *Tax Strategy* 2nd ed at 212.

¹¹ 1993 (1) SA 353 (A) which confirmed the decision of the lower court in *Friedman and Others NNO v CIR: In re Phillip Frame Will Trust v CIR* 1991 (2) SA 340 (W).

further has to represent the taxpayer in respect of a specific sum, which he holds on the taxpayer's behalf.¹²

Faced with such a potentially far-reaching decision that would negatively affect its tax base, it was not surprising that the Legislature reacted quickly thereafter. Thus, the Income Tax Act was amended to also include a trust in its definition of a person.¹³ This was achieved by firstly expanding the definition of "person," to include a trust and by defining the term "trust."¹⁴ It must be noted however that the amended legislation did not result in the trust being taxed in a different way. Rather it gave support to the method of taxation as practiced by the Commissioner through statutory legislation, as opposed to case law.¹⁵

The inclusion of the trust as a "person" thus results in the trust constituting a taxable entity upon which taxes may be levied, and which may further, and importantly to the study at hand, be a resident of a particular country.

4 2 2 The definition of a "trust" in the Income Tax Act

The Income Tax Act, as amended subsequent to the above case, defines a "trust" in Section 1 as –

“**Trust**’ means any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person;”

Du Plessis¹⁶ submits that this Income Tax Act’s definition is thus wider in scope, than the definition in the Trust Property Control Act (as set out and discussed in paragraph 2 3 above.) Unlike the Trust Property Control Act, there is no "making over or bequest" of ownership of the trust property imposed as prerequisite. The central features identified in this definition only relate to the administration and control in a fiduciary capacity of the trust fund and a "trust" will thus be present for Income Tax purposes, even though transfer of the property to the trustees or beneficiaries is not

¹² For a discussion of the court *a quo*’s decision see Davis “The Taxation of a Trust” 1991 *SALJ* at 225-231; Eden,P & Emslie,T “The Taxation of a Trust in South African Law or can a Trust be taxed?” 1991 *SALJ* at 231-237.

¹³ Olivier et al *Trust Law and Practice* (November 2011) at 2-33.

¹⁴ This definition has been set out in the discussion at 2.3 – particularly see the comments given there as to the wide ambit of the trust. Further it must be noted that at such time Section 25B was also introduced which deals with the taxation of trust income.

¹⁵ See discussion below at 3.2.3. D Seccombe “Trust Taxation Seminar” – Notes of a seminar hosted by BDO Spencer Steward Chartered Accountants on 20 August 2008.

¹⁶ Du Plessis I (2009) *SA Merc LJ* at 324.

effected nor intended.¹⁷ However it may be stated that the Income Tax Act is thus concerned with trusts in the “wide sense” as defined by Honoré and differs from the Trust Property Control Act, which does not cover such trusts.¹⁸ This statement is implicitly affirmed by the definition of “trustee” in the Income Tax Act –

“ ‘trustee’, in addition to every person appointed or constituted as such by act of parties, by will, by order of declaration of court or by operation of law, includes an executor or administrator, tutor or curator, and any person having the administration or control of any property subject to a trust, usufruct, fideicommissum or other limited interests or acting in any fiduciary capacity or having, either in a private or in an official capacity, the possession, direction, control or management of any property of any person under legal disability;”

This definition specifically includes executors, curators, tutors and the like, thus role-players of trust in the wider sense, and can further be said to include officers of other constructions than trusts. The definition in the Income Tax Act of a “trust” can also be said to be wider than the Trust Property Control Act on the basis, that it includes oral *inter vivos* trusts, as it only requires an “agreement” and not *per se* a written agreement which the Trust Property Control Act requires.¹⁹

Somewhat strange, is that in the Income Tax Act's definition of a trust, trusts created by “statute or court order” is omitted.²⁰ Yet such trusts appear to be envisaged as it is contained in the definition of “trustee” and hence would appear to be implicitly included in the Act's ambit. Du Plessis also notes that the definition describes a ‘trust fund’ as comprising cash and assets, giving rise to an obvious question as to why liabilities were not included.²¹ Our common law is quite clear that a trust denotes an ‘accumulation of assets and liabilities.’²² If regard is had to the case which prompted the legislature to specifically include a trust as person, Judge Joubert had stated that a trust is “... an entity whose assets and liabilities vest in its trustee for purposes of administration.”²³ It is strange therefore that against the background of such express confirmation, the legislature opted for a different wording and may thus be an oversight. Du Plessis submits that the legislature could not have intended that liabilities must be disregarded as elsewhere in the Act certain provisions require such liabilities to be taken into account.²⁴ In light of these drafting

¹⁷ Du Plessis I (2009) *SA Merc LJ* at 324.

¹⁸ Du Plessis I (2009) *SA Merc LJ* at 325.

¹⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 234; Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 65.

²⁰ De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.14.

²¹ Du Plessis I (2009) *SA Merc LJ* at 324.

²² *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) at 83.

²³ *Friedman and Others NNO v CIR: In re Phillip Frame Will Trust v CIR* 1991 (2) SA 340 (W).

²⁴ Du Plessis I (2009) *SA Merc LJ* at 324. She cites trusts with an assessed loss for s 103(2). See also sections 25(b) (4) –(6) discussed at par 4 3 2 below.

anomalies, it is called upon the legislature to refine the wording so that these inconsistencies may be eliminated.

It may also be asked whether by reason of the emphasis placed on defining a trust as a trust fund, it is the trust fund and the assets it comprises, that constitute the taxable entity for purpose of the Act. Such a proposition is not supported. The background to the inclusion for the definition of a trust in the Act demonstrate that the focus was on the trust and its qualification as a "person" for the levying of taxes. Moreover the definition contained in the Act does not only make reference to the trust fund, but also to the person administering or controlling the fund in a fiduciary capacity as well as the trust instrument by which the person was appointed.²⁵ Consequently the definition itself implies that a more holistic viewpoint must be taken than only the trust fund. It is therefore submitted that it is the trust entity, and not only the trust fund, which constitutes the taxable entity.²⁶

Olivier and Honiball note that this definition for a trust includes both *inter vivos* and *mortis causa* South African trusts as well as foreign trusts.²⁷ In respect of the latter, they further remark that based on the Act's definition, it would be difficult to argue successfully that a relationship where assets or funds are controlled by one person for the benefit of another, is *not* a trust for South African income tax purposes.²⁸ Thus, they submit that the broad definition would also bring within its ambit most offshore trusts, unless they are classified in terms of Section 1 of the Act as a company or they do not constitute a valid trust under South African law.²⁹ We agree with the aforesaid statement, save to the extent that even where a trust is not *per se* valid in terms of South African trust law, it may still meet the requirements of a "trust" for purposes of this definition – a fund administered by a person in a fiduciary capacity - and consequently the Income Tax Act.

In other instances the requirement in the definition that the person acts in a 'fiduciary capacity' may cause such offshore trusts to fall foul of the definition. Davis gives the example of the so-called "non-charitable purpose trusts" found in the Isle of Man, Cayman Islands, Mauritius, Jersey and the British Virgin Islands.³⁰ They are also referred to as "STAR" trusts and have been discussed above at par 2 7 6. From such discussion, it would be recalled that the peculiar features of these trusts

²⁵ Such a view is also held by Du Plessis - Du Plessis I (2009) *SA Merc LJ* at 324.

²⁶ This is also supported by Du Plessis - Du Plessis I (2009) *SA Merc LJ* at 324.

²⁷ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 65.

²⁸ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 135; Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 65.

²⁹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 135.

³⁰ Davis et al *Estate Planning* (May 2013) at 6-10(2).

include, that firstly, such trusts need not have ascertainable beneficiaries, but may instead be formed for a particular purpose. Secondly, a mandatory "enforcer" is appointed, to ensure that the trust is managed according to the trust provisions and for the stipulated purpose.³¹ Whilst earlier it was noted that these trusts are usually formed with the goal to grow and develop business ventures, Davis notes that the particular purpose need not be its true purpose, thus enhancing these vehicles' usefulness.³² He also refers to Cassell who remarked that "during the trust period the assets can be, but do not have to be, applied towards the purpose. Simply holding the assets in itself can be a purpose."³³ Whilst it is apparent that the trustee has certain contractual obligations, whether he can be said to act in a fiduciary capacity is according to Davis a matter of interpretation.³⁴

To interpret the phrase, the Act does not provide assistance as it contains no further definition. Guidance can be sought from the word's grammatical origins. Dharmaratne embarks upon such an exercise and concludes that "fiduciary from Latin *fiduciarius*, meaning "(holding) in trust"; *fides*, meaning "faith," and *fiducia*, meaning "trust" clearly shows that the basis of a fiduciary relationship rest on the concepts of honesty, utmost trust and the central notion of loyalty."³⁵ In a wide sense the phrase 'fiduciary capacity' can thus be said to denote "any person in whom trust or confidence is reposed" or "a person who receives property conditionally upon his or her assuming an obligation."³⁶

More specifically flowing from the fact that trust is reposed in such person, various fiduciary duties would attach to the capacity. Such duties have been discussed in detail above at par 3 2 2 2, and in particular certain fundamental fiduciary duties have been identified as resting upon fiduciaries - the duty not to exceed the powers granted to them, not to exercise their powers for improper purpose, not to fetter their discretion, to avoid a conflict of interest, not to make a secret profit or compete with any business of the trust, not to favour one beneficiary to the detriment of another.³⁷ In light of these, Geach offers a more narrow view of someone acting in a fiduciary capacity –

³¹ See par (c) above at 2 4 6.

³² Davis et al *Estate Planning* (May 2013) at 6-10(2).

³³ Davis et al *Estate Planning* (May 2013) at 6-10(3).

³⁴ He notes that interestingly the purpose trust would be able to fall within the ambit of the statutory definition for a trust in the Trust Property Control Act, as well as the common law as trust for impersonal objects are allowed. Davis et al *Estate Planning* (May 2013) at 6-10(3).

³⁵ Dharmaratne, K "A Consideration of Whether Directors should stand in a Fiduciary Relationship with the Company's Related and Inter-related Companies" available at <http://www.cgblaw.co.za/fiduciary-relationship.pdf> - last accessed 05/09/2013.

³⁶ De Waal et al *LAWSA Wills and Succession* 31 (2) at par 347 fn 2.

³⁷ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 89. A director of a company is also in terms

"A fiduciary is a person who undertakes or assumes responsibility to act for or on behalf of and in the interest of another. Fiduciary duties regulate the conduct of persons who administer the affairs of others. Fiduciary duties require a person to act, if such person acts at all, to promote and protect the beneficiary's interest... A fiduciary duty must not be confused with the duty of care and skill. A fiduciary duty requires a person to act honestly and genuinely in someone else's interest...."³⁸

As was stated earlier, all such duties are underscored by the principle that a fiduciary in his actions must promote and protect the beneficiary's interests.³⁹ Thus where there are no beneficiaries in a 'trust', then, on a narrow interpretation of this phrase, the description of a person acting as a 'fiduciary,' would be challengeable. It must be noted that in our law, a trust created for an impersonal object is allowed, for example for a charitable cause or for the benefit of the public.⁴⁰ In such instances, there are still people who will benefit from the trustee's administration at the end of the line – be it the community at large, or a specific class of people.⁴¹ Thus a fiduciary relationship will still be present.

Support for this view is found in Blackman's discussion of the nature of the fiduciary relationship⁴² –

"Generally, a fiduciary is a person who undertakes or assumes responsibility, or is required by law, to act for or on behalf of and in the interests of another. A fiduciary stands in a fiduciary relationship to that other person, his beneficiary or principal (the beneficiary) which relationship imposes fiduciary duties or obligations upon the fiduciary... The purpose of the fiduciary duties imposed on the fiduciary is to protect the beneficiary from this particular form of vulnerability [vulnerability to self-interested conduct on the part of the fiduciary]."

of our common law in a fiduciary relationship to the company – he is both an "agent of the company in the execution of transactions, and a trustee, acting as guardian of the company's assets." Similarly then the fiduciary relationship impose such fundamentals on the the directors – to act in good faith towards the company, to exercise their power for the benefit of the company, avoid conflicts of interest, gain from confidential information and act independently in the exercise of their discretion. – Mammatt, J et al *The Company's Director Handbook* (2009) at 23 available electronically on Jutastat.

³⁸ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 89.

³⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 89.

⁴⁰ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B44)5) at 90. The authors note that a trust for an impersonal object can be valid only if it charitable or for the public benefit. Olivier notes charitable purposes can include religious and educational purposes as well as purposes which benefit specific sections such as the aged, the impaired, the underprivileged, or specific sectors of the community. Olivier et al *Trust Law and Practice* (November 2011) at 5-38.

⁴¹ As Olivier states "in the end, there are persons who benefit, but the object ... relates to the general public or defined section of the community." Olivier et al *Trust Law and Practice* (November 2011) at 5-37.

⁴² Blackman et al *Commentary on the Companies Act Vol 1* Revision Service 9 (March 2012) available electronically on Juta Law Online Publications at par 208.

In particular it has been found that a fiduciary relationship will be present should certain characteristics be present. Firstly a scope for the exercise of discretion or power, secondly, that the power or discretion may be used unilaterally and affect the legal or practical interests of the beneficiaries and thirdly that a vulnerability therefore exists to the exercise of such discretion or power.⁴³ However it has also been remarked that whilst the identification of such characteristics are helpful, they are not necessarily decisive.⁴⁴ Furthermore that the title of a party will not be conclusive as "it is the nature of the relationship , not the specific category of actor involved that gives rise to the fiduciary duty."⁴⁵

Blackman therefore concludes that fiduciary duties regulate the conduct of persons who administer the affairs of *others*, emphasizing that it has "no application whatsoever to the person who, under no obligation whatsoever to act for another, simply conducts his own affairs in his own interest and deals with others at arm's length." Case law endorses the view with the Appellate Division stating at the turn of the last century that a fiduciary relationship will exist where "one man stands to *another* in a position of confidence involving a duty to protect the interest of that other."⁴⁶ More recently the court found that there is no closed list of fiduciary relationships in our law and that it requires an assessment of whether reliance by the one party on the other was justified,⁴⁷ thus implicitly indicating the crux of such relationship is built upon one party acting for another. Whether such a relationship will be present is however always a factual enquiry⁴⁸ – as the court in *Phillips v Fieldstone Africa (Pty) Ltd & Another*⁴⁹ succinctly concluded -

" there is no magic in the term 'fiduciary duty'. The existence of such a duty and its nature and extent are questions of fact to be adduced from a thorough consideration of the substance of the relationship and any relevant circumstances which affect the operation of that relationship..."

⁴³ *Phillips v Fieldstone Africa (Pty) Ltd & Another* 2004 (3) SA 465 (SCA) at par 34.

⁴⁴ Par 34.

⁴⁵ *Hodgkinson v Simms* 1994(3) SCR 377 (SCC) as quoted in *Phillips v Fieldstone Africa (Pty) Ltd & Another* 2004 (3) SA 465 (SCA) at par 34

⁴⁶ Per Innes CJ in *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168. It was noted that this principles underlies 'an extensive field of legal relationships' including that of a guardian to his ward, a solicitor to his client, an agent to his principal etc. (178-179).

⁴⁷ *Volvo (Southern Africa) (Pty) Ltd v Yssel* 2009(6) SA 531 (SCA) at par16.

⁴⁸ See for example *ITC No 526* (1942) 12 SATC 426 (U) where it was found that an appellant who had held a horse racing meeting for a charity could not be said to be either an agent or trustee iro the meeting nor did it received the proceeds of such meeting in a fiduciary capacity on behalf of the charity.

⁴⁹ 2004 (3) SA 465 (SCA) at par 27.

The outcome of how narrowly or broadly the term 'fiduciary capacity' will be interpreted, and the particular factual circumstances, will therefore be conclusive to determine whether the entity qualifies as a "trust" for purposes of the Income Tax Act.

In determining the "residence" of a trust for Income Tax purposes, this definition therefore acts as an important indicator, by subtly establishing that the Act is not limited to only entities recognized as trusts per the definition in the Trust Property Control Act. It will therefore in most instance have a wider catchment area to include other entities, both local and foreign which may not traditionally be perceived as trusts, yet none-the-less be regarded as such for purposes of the Income Tax Act. Yet the definition itself contains certain inherent limitations and requires the presence of a fiduciary relationship. Thus each case must be measured against same.

4 2 3 The imposition of taxes on the trust based on "residence"

As stated above, the inclusion of a trust as a "person" thus denotes that for tax purposes the trust is recognized as an entity distinct and apart from its trustees and beneficiaries, and can be taxed as such.⁵⁰ The consequence of an entity meeting the definition of a "trust" discussed above and thus being regarded as a "person" for the Income Tax Act, is that taxes may be imposed on it by the fiscus. The imposition and extent of this tax liability under the Income Tax Act is greatly impacted by whether the trust is regarded as a resident or non-resident.⁵¹ This is explained below.

Income tax is the tax levied on the taxable income of a person (thus including a trust)⁵² and where such trust is regarded as resident, it is liable for taxation on its worldwide income.⁵³ Should the trust not be so resident, a liability only arises in respect of income received or accrued from a source *within* South Africa.⁵⁴ The Act also contains anti-avoidance rules that are specifically applicable in the context of non-resident trusts. This is further discussed below.⁵⁵

⁵⁰ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 234.

⁵¹ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 241 note that foreign trusts were removed from the definition of controlled foreign entity, now called controlled foreign company and is taxed in the foreign country with no tax liability incurred in the Republic unless the below mentioned provisions determine otherwise.

⁵² See Section 5 as set out above. Income tax is the tax levied on income received by or accruing to or in favour of any person during the year of assessment excluding receipts and accruals of a capital nature.

⁵³ See the definition of gross income per Section 1 of the Income Tax Act.

⁵⁴ Also Section 1.

⁵⁵ See Section 25B(2A) which includes vested rights to the capital of such non-resident trusts in the income of resident taxpayers.

A further tax that is levied under this Act is tax on capital gains, which is, since 1 October 2001⁵⁶ payable on the disposal⁵⁷ of capital non-cash assets.⁵⁸ Strictly speaking it is not a separate tax to the income tax. Capital gains are included in the taxable income of the taxpayer, which income is then subjected to the normal tax rate.⁵⁹ Where the trust is resident, it is liable to tax on capital gains, on the disposal of its worldwide assets. Thus regardless of their location, should the trust be locally tax resident, a liability will arise. A non-resident trust, is however liable only in relation to its interest in locally situated immovable property.⁶⁰ Paragraph 2 of the Eight Schedule to the Income Tax Act sets out such circumstances: (i) the disposal of immovable property situated in South Africa, (ii) the disposal of an interest or a right in immovable property situated in South Africa and (iii) disposal of any asset attributable to a permanent establishment of a non-resident in South Africa.

A non-resident trust may further be liable to withholding tax upon the disposal of immovable property.⁶¹ Such withholding taxes were introduced in 2007 to alleviate the administrative burden of collecting taxes from non-residents, and is levied at 10% if the non-resident is a trust.⁶²

Where a non-resident becomes a resident, or a resident ceases to be a resident, it may also result in a capital gains tax liability.⁶³ These taxes are often referred to more informally as “exit taxes”, or “exit charges”: if a person ceases to be a resident of South Africa, he is deemed as having disposed of his assets, and to have immediately reacquired them at the value on the date immediately prior

⁵⁶ Capital gains tax is levied by the provisions of the Eight Schedule to the Income Tax Act, 58 of 1962. King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 117.

⁵⁷ This term is defined in the Act. Du Toit notes that in respect of trusts, it generally includes the “sale, donation, expropriation, conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset as well as the forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset” with more specific disposals being the “vesting of an interest in an asset of a trust in the trust’s beneficiary as well as a decrease in value of a person’s interest in a trust as a result of a value-shifting arrangement.” It must also be noted that a change in trustees or the distribution of an asset in a beneficiary with a vested right is not a disposal. Du Toit F *South African Trust Law Principles and Practice* (2002) at 157. Geach notes certain less obvious disposals: waiver of a debt, renunciation or termination of a right - Geach WD & Yeats J *Trusts Law and Practice* (2007) at 253.

⁵⁸ Same is defined to be property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum and a right or interest of whatever nature to or in such property.” Par 1 of the Eight Schedule to the Income Tax Act.

⁵⁹ Haupt P *Notes on South African Income Tax 2013* at 833.

⁶⁰ Davis et al *Estate Planning* (May 2013) at 6-45.

⁶¹ S 35A; Davis et al *Estate Planning* (May 2013) at 6-45. The obligation to withhold the tax falls upon the purchaser- the tax is therefore collected and paid to the government by the purchaser.

⁶² Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 402.

⁶³ Paragraph 12 (2) (a) & Par 12 (4) of the Eight Schedule to the Income Tax Act. Strictly speaking when a non-resident becomes a resident there is no tax liability at that juncture, but the base cost is established at that point in relation to assets which upon their disposal attract capital gains.

to giving up residence.⁶⁴ Similarly, a person who takes up residence in South Africa is deemed to have disposed of his assets at market value and to have reacquired them at that value on the date immediate prior to taking up residence.⁶⁵ Certain anti-avoidance rules are contained in the Act, which are only applicable in the context of capital gains and non-resident trusts.⁶⁶ This latter aspect is discussed further in paragraph 4.3.3.

Furthermore, the particular action/transaction in relation to the non-resident trust, may also trigger the application of the transfer pricing rules contained in Section 31 of the Act.⁶⁷ Williams & Mazansky provides the following example of a situation where such rules may be invoked - "if a South African resident makes an interest-free loan to a non-resident that is a connected person, then SARS effectively has the power to tax the resident as if he had received an arm's length amount of interest in relation to that loan."⁶⁸

Donations tax, a tax levied on the disposal of an asset under a donation, is further levied under this Act. A donation is defined as "any gratuitous disposal of property including any gratuitous waiver or renunciation of a right."⁶⁹ Donations tax is however only levied upon residents and thus only a resident trust will be liable for same.⁷⁰ The Income Tax Act also provides for the levying of other different types of taxes such as turnover tax for micro-business, dividend withholding taxes, but these taxes, including donations tax, will not be addressed in this study.⁷¹ An entity which is found to be a "resident", will further not be regarded as a controlled foreign entity and consequently loses the exemption to South African income tax. This is particularly relevant to foreign subsidiaries of South African companies.⁷²

It is therefore clear from the above discussion that the fiscal status of a trust as resident or non-resident has important and possibly far-ranging consequences.

⁶⁴ Para 12 & Para 13 (1)(g)(i); Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.28 available electronically on LexisNexis.

⁶⁵ Para 12 & Para 13 (1)(g)(i); Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.28 available electronically on LexisNexis.

⁶⁶ Paragraph 80(3) of the Eight Schedule to the Income Tax Act.

⁶⁷ Eg an offshore trust is funded by a low or no-interest loan from a resident. Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 152.

⁶⁸ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.28 available electronically on LexisNexis.

⁶⁹ S 55.

⁷⁰ S 54.

⁷¹ See demarcations of the scope of this study set out in Chapter 1.

⁷² S9 D of the Income Tax Act; SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

4 2 4 The levying of taxes on the trust

Whilst an in-depth discussion on the particular operation of the income and capital gains taxes levied under the Income Tax falls outside the Scope of the Study,⁷³ it may be worthwhile to specifically reflect on their impact in relation to trusts.

In respect of the tax levied on income, since the year of assessment ending 28 February 2003,⁷⁴ the taxable income of a trust is subject to tax at a flat rate of 40%. This rate is equivalent to the top marginal rate imposed on individuals.⁷⁵ It is however only applicable to trusts other than special trusts, which are further discussed below. Unlike individuals, trusts do not qualify for interest exemption,⁷⁶ nor are they entitled to any of the personal rebates.⁷⁷

In respect of capital gains tax, for the first decade since its introduction in 2001, capital gains arising in the hands of the trust were included at an inclusion rate of 50% and taxed at the flat income tax rate of 40%.⁷⁸ The effective capital gains tax rate in relation to trusts was therefore 20%. For the 2012/2013 tax year, applicable to all disposals after 1 March 2012, the inclusion rate was increased to 66.67% for trusts and companies, and thus the effective rate in respect of trusts is now 26.7%.⁷⁹

Mention has been made above of the “special trust.” A trust qualifies as such, if it meets the strict criteria set out in the definition of a special trust in the Act. Essentially the function of these trusts is to benefit a person who is unable to manage his/her own affairs, due to a mental/physical impediment, or where its beneficiary is younger than 18 and is the beneficiary of a testamentary trust, created by a deceased relative.⁸⁰ These trusts are taxed in the same manner as an individual,

⁷³ See paragraph 1 4 above.

⁷⁴ King & Victor explain that until 1998, trusts were taxed as individuals and thus on increasing scales. The Minister of Finance at the time, Mr Trevor Manuel announced however during the 1998 Budget Speech that it was Revenue’s view that trusts have become widely used for income splitting so as to reduce the tax rate at which income is ultimately taxed. Thus, to bring trust tax in line with personal tax and other entities, the rate was changed to 35% on all income up to R100 000, and 45% on amounts above that. In the 2000 Budget Speech, the rate was then lowered to 32% and 42% respectively. From the year of assessment ending on 28 February 2003, trusts are now taxed on a flat rate of 40% on all retained income. See King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 262.

⁷⁵ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 67.

⁷⁶ S 10(1)(i)(xv).

⁷⁷ As available in terms of S 6.

⁷⁸ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 237.

⁷⁹ SARS Tax Proposals Budget 2012 – Available at <http://www.treasury.gov.za/documents/national%20budget/2012/sars/SARS%20Tax%20Proposals.pdf> . Last accessed on 02/05/2013.

⁸⁰ A Special trust is defined in S1 as a trust created either “solely for the benefit of a person who

and thus are more favourably treated than other trusts.⁸¹ As the focus of the study is on trusts that are encountered most generally in everyday legal and commercial practice, the special trust with its singular features and its unique tax treatment falls outside the scope of this study. For tax purposes, it is also possible to distinguish between personal service trusts,⁸² realization trusts,⁸³ share incentive trusts⁸⁴ as well as charitable trusts, that qualify as public benefit organizations.⁸⁵ Again these trusts all exhibit unique characteristics and have specific tax rules that are applicable to them. Similarly then, these trusts due to their highly specialized nature fall outside the scope of the study.

If regard is had to these high tax rates applicable to trusts and it is compared to other taxpayers, then one is inclined to agree with some who call it the “most expensive tax vehicle we have,”⁸⁶ a “tax nightmare”⁸⁷ or “prima facie, tax inefficient.”⁸⁸

suffers from any mental illness as defined in the Mental Health Care or who suffers from any serious physical disability, and who cannot earn sufficient income for self-maintenance, or cannot manage his or her own affairs” or “created by or in terms of the will of a deceased person, solely for the benefit of beneficiaries who are relatives in relation to that deceased person and who are alive on the date of death of that deceased person where the youngest of those beneficiaries is on the last day of the year of assessment of that trust under the age of 18 years.” The Taxation Laws Amendment Act, 22 of 2012 with effect from 1 January 2013 lowered the age from 21 to 18 to be in line with the age of majority which is set at 18.

⁸¹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 237.

⁸² This trust is defined in paragraph 1 of the 4th Schedule of the Income Tax Act and is essentially treated as an employee for tax purposes - Geach WD & Yeats J *Trusts Law and Practice* (2007) at 233.

⁸³ A description of such a trust is found in *Malone Trust v SIR 1977 2 SA 819 (A)* where it is said that “if a trust is formed for the purpose of facilitating the realisation of property and the trust does no more than act as the means whereby interest of its beneficiaries may be property realised in the property, surpluses made from the sales of the property are not taxable as trading profits since such surpluses are capital receipt.” Essentially the trust acts as conduit to convey capital to the beneficiaries which capital retains its identity – see Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.9 at 90.

⁸⁴ Such trusts are often used by business entities to enable their employees to acquire shares in the business entity. Davis thus notes that the aim is to “incentivise the employees and to increase their loyalty.” Davis et al *Estate Planning* (May 2013) at 6-8(7).

⁸⁵ This type of trust must be recognized as a public benefit organisation under S 30 of the Income Tax Act. Essentially these organisations are conducted on non-profit basis and are engaged in public benefit activities of a humanitarian, religious, cultural, or charitable nature. In light of their altruism and philanthropical activities, these organisations are accorded preferential tax treatment. See Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) in Chapter 7 at 207.

⁸⁶ Zerbst, F “Why Trust Reform will affect your Tax Planning” Published 4 April 2013, available at http://www.fanews.co.za/article.asp?Front_Page_Features~25,Featured_Story~1147,Why_trust_reform_will_affect_your_tax_planning~13374. Last accessed 05/05/2013.

⁸⁷ Pretorius, H “Trusts: A Tax Nightmare?” Published 18 July 2012, available at <https://www.thesait.org.za/news/97832/Trusts-A-tax-nightmare.htm>. Last accessed 05/05/2013.

⁸⁸ Lester, M “The Debate around the Taxation of Trusts” available at <http://glacier-theinsidestory.co.za/Article/75/14>. Last accessed 05/05/2013.

Similarly one would tend to agree with Olivier & Honiball⁸⁹ who remark that “over the past few years trusts have been singled out for harsh treatment by the South African legislator...” and that there has been a “continued attack on the trust structure.”⁹⁰ Indeed for the 2012/2013 tax year it was announced that as one of the seven priority areas, trusts will be singled out for closer scrutiny, more compliance checks and integrated audits.⁹¹ For the 2013/2014 tax year, legislative reform has been announced with anticipated changes that are expected to overhaul the fundamental principles associated with the taxation of trusts. We return to such proposals later.

The tax treatment of a trust as a taxable person has however, to date, been very different from natural persons as well as other artificial “persons,” such as companies or close corporations with such differences not limited to differences in tax rates.⁹² These differences are best set out by discussing the fundamental taxation principles applicable to trusts, principles which may however be challenged by the proposed legislative reforms.

4 2 5 General taxation principles applicable to trusts

4 2 5 1 The trust as taxpayer of the last resort

One prominent difference is that even though amounts may be received by a trust, those receipts may not be taxed in the trust at all, but may be taxed in the hands of the others.⁹³ For example, any

⁸⁹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 134. See also footnote 33 setting out the historical rates applicable to trusts.

⁹⁰ BDO “The Continued Attack on the Trust Structure” available at <http://www.bdo.co.za/resources/showitemarticle.asp?ResourceSectionId=4&ResourceSectionName=Publications&ResourceId=7&ResourceName=Tax%20Flash&IssueId=401&ContentPageId=4&Archive=&articleid=399>. Last accessed 05/05/2013.

⁹¹ SARS *Compliance Programme 2012/2013 – 2016/2017*. Available at http://www.sars.gov.za/AllDocs/SARSEntDoelib/Ent/SARS-Strat-07_G02%2020Compliance%20Programme%202012%202013%20to%202016%202017%20-%20External%20Guide.pdf - Last accessed on 02/05/2013. As the Minister stated in the 2012 Budget Speech “ Poor tax compliance is also apparent in respect of trusts..” This coupled with the fact that “Wealthy individuals are also generally linked to a number of trusts and companies, some of which are used as vehicles to channel and hide their assets and income. ...A total of 67% of audits conducted into trusts show serious under-reporting” prompted the targeting of trusts. See also Pickworth, E “SARS gets rough with family trusts” – published on 15 March 2012, Business Live – Available at <http://www.businesslive.co.za/experts/2012/03/15/sars-gets-rough-with-family-trusts> and Vanek, M “ SARS to get tough on wealthy South Africans and their trusts.” Available at <http://www.moneyweb.co.za/moneyweb-tax/sars-to-get-tough-on-wealthy-south-africans-and-th?sn=2009+Detail> – Last accessed on 02/05/2013.

⁹² Geach WD & Yeats J *Trusts Law and Practice* (2007) at 233.

⁹³ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 233.

one of the following parties can be held responsible for the tax liability:⁹⁴

- (a) the founder of the trust,
- (b) one or more of the donors (other than the founder) to the trust,⁹⁵
- (c) the trustees as representative taxpayers on behalf of the trust,
- (d) the beneficiaries in terms of the trust deed, or
- (e) other persons as identified by the provisions of the Act.⁹⁶

The determination of which taxpayer the liability will rest upon is according to Pace & Van der Westhuizen⁹⁷ dependent on the following factors:

- (a) the nature of the transaction (in other words is the transaction a donation or a sale or a loan with or without interest);
- (b) the provisions of the trust deed with regard to the type of rights of beneficiaries and the discretionary powers given to trustees;
- (c) whether income is distributed or whether it is retained in the trust;
- (d) the minority or majority of beneficiaries.⁹⁸

These factors are central to the operation of the statutory provisions applicable to trusts. In respect of income tax, the most important statutory provisions are section 25B and section 7, and in respect of capital gains tax, section 25B as read with paragraph 80 and paragraphs 68-73 of the 8th Schedule to the Act.⁹⁹ A brief illustration of the interaction between section 25B and section 7 follows to illustrate the principle, that parties other than the trust (or the trustees as representative taxpayers to it) may be taxed:

Section 25B, the principal taxing section relating to trusts, allows for the income of the trust to be taxed in either the trust or the beneficiaries' hands.¹⁰⁰ This particular section in effect disregards

⁹⁴ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.2 at 75.

⁹⁵ Also referred to as a “disponer” - Davis et al *Estate Planning* (May 2013) at 6-3.

⁹⁶ See for example S 7(4). This section essentially deems income of a minor to be that of his parent should the parent or his/her spouse have made a disposition or given some consideration, whether directly or indirectly, in favour of the donor or his family. The aim of the section was to prevent parents from circumventing the further deeming provisions in relation to their minor children by introducing a third party- See Olivier et al *Trust Law and Practice* (November 2011) at 7-23.

⁹⁷ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.2 at 75.

⁹⁸ The age of majority is now set at 18. Section 17 of the Children's Act, 38 of 2005. Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.2 at 75.

⁹⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 233.

¹⁰⁰ Haupt P *Notes on South African Income Tax 2013* (2013) at 796.

the trust as a person for tax purposes, if any income is allocated or paid to a beneficiary or beneficiaries in the year that the income is received by or accrues to a trust.¹⁰¹ Geach explains that for tax purposes, the beneficiaries will be deemed to have received the receipts or accruals and as having incurred the related expenditures, even though the income initially accrued to or was received by the trust and although the related expenditures were incurred by the trust.¹⁰² As such the beneficiaries will be taxed at their respective tax rates, which are generally more advantageous than the flat rate of the trust. Section 25B is however subject to the application of the provisions of section 7. Section 7 is essentially an anti-avoidance section and attempts to ensure that if a person gratuitously divests himself or herself of an asset, any income from that asset will still be taxed in the hands of that person.¹⁰³ Section 7 provides that even though income is allocated or distributed to a beneficiary, someone other than the beneficiary, namely the donor, will be deemed to have received the amount for tax purposes in certain circumstances.¹⁰⁴ The effect of the interaction between these sections is, that a trust will only be taxed if the income is not deemed to be that of a beneficiary in terms of section 25B, or if it is not deemed to be that of a donor in terms of section 7.¹⁰⁵

As a result the trust is often referred to as a taxpayer of the last resort.¹⁰⁶ It must be noted that the advantage of having income and capital gains taxed in the hands of other parties than the trust, further affords great tax flexibility to the trust and is a benefit not available when income is received by other entities such as companies.¹⁰⁷ This is aptly described by Williams & Mazansky¹⁰⁸ –

“There is thus a potential tax saving where matters can be arranged so that an amount is taxed in the hands of the trust beneficiaries (if they are individuals) rather than in the hands of the trust. If the amount can be distributed to beneficiaries who have little or no other income, the result may be that the distribution escapes income tax altogether, or is taxed at a significantly lower rate than if taxed in the trust.”

We now turn to the second principle.

¹⁰¹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 235.

¹⁰² Geach WD & Yeats J *Trusts Law and Practice* (2007) at 235.

¹⁰³ Du Toit F *South African Trust Law Principles and Practice* (2002) at 133 and Geach & Yeats *Trusts Law and Practice* (2007) at 235.

¹⁰⁴ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 235.

¹⁰⁵ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 235.

¹⁰⁶ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 235.

¹⁰⁷ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 233 and at 274. The authors give the example of income received by a close corporation. The only way that the income could be taxed in the hands of a member of the close corporation and not in the hands of the close corporation itself would be to pay out that income to a member or other person by way of salary, commission or other form of remuneration which could result in the withholding of PAYE by the corporation.

¹⁰⁸ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.2 available electronically on LexisNexis.

4 2 5 2 The conduit principle

A further difference is that the trust can act as a *conduit* or channel, through which income and capital gains can flow to its beneficiaries and be taxed in their hands, whilst retaining its original nature.¹⁰⁹ This was confirmed in the cases of *Armstrong v CIR*¹¹⁰ and *SIR v Rosen*¹¹¹ as well as a Practice Note¹¹² issued by the South African Revenue Services. In the former case the court explained the rationale for the principle –

“In the simple case I am now examining, namely, that of a trio, comprising a company, the intervening trustee, and a beneficiary, it is manifest that in the truest sense the beneficiary derives his income from the company, that income fluctuates with the fortunes of the company and the trustee can neither increase nor diminish it, he is a mere ‘conduit pipe.’”¹¹³

The virtues of this principle was articulated in the latter case where the judge stated that –

“The principle rests upon sound and robust common sense, for by treating the intervening trustee as a mere administrative conduit-pipe, it has regard to the substance rather than the form of the distribution and receipt of the dividends.”¹¹⁴

Thus the trust will receive the income or capital gain in the first instance, but will merely act as a *conduit* pipe through which the income or capital gains flows to the beneficiary. Du Toit notes that the *conduit* principle gives rise to two important results. The first of which he regards as being that the trust income, which vest in a beneficiary is thus taxable in such a beneficiaries’ hands and not in the trust, which merely acts as a *conduit*.¹¹⁵ As such, the mechanism for determining the liable taxpayer as provided for in section 25B, can be said to statutorily embody the *conduit* principle.¹¹⁶ The second important consequence of this principle is, that “the nature and identity of the trust income retains its identity despite the passage through the hands of the trustees.”¹¹⁷ For example, if the trust income consists of interest and it is distributed to a beneficiary, it retains its nature as interest and is taxable as such in the beneficiary’s hands.¹¹⁸ The beneficiary will be entitled to claim

¹⁰⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 233.

¹¹⁰ 1938 AD 343.

¹¹¹ 1971 1 SA 172 (A). The case is further of importance as it put forth the view that trust income may change its nature if it is retained and accumulated by the trustee and paid out to the beneficiaries in a later year, even having already been taxed in the hands of the trustee. However this was not decided firmly.

¹¹² Practice Note 23 *Government Gazette* 15805 dated 24 June 1994.

¹¹³ At 349.

¹¹⁴ At 188A.

¹¹⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 132.

¹¹⁶ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 261.

¹¹⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 132

¹¹⁸ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 261. An important statutory exception to trust income retaining its status when passed down to the trust beneficiary

any exemption related thereto.¹¹⁹ A third consequence is perhaps to be found, in the fact that if the income has already been taxed, it will not again be taxed in the beneficiary's hands, thus a case of double taxation is avoided. This was confirmed by *Estate Dempers v SIR*,¹²⁰ where it was held that once income had been taxed in the donor's hands, it is deemed for all the time to be his income, and cannot be taxed as accruing to the beneficiaries.¹²¹ Thus income taxed in the hands of a founder or other donor to the trust and which subsequently accrues to a beneficiary, will not again be taxed, being deemed forever to be that of the former party.¹²²

It is this *conduit*-principle that is currently earmarked for amendment by the proposed legislative reforms SARS announced in the Budget Speech.¹²³ We therefore turn to these proposals now.

4 2 5 3 Legislative reforms to the taxation of Trusts: Proposals announced in the 2013 Budget Speech

The legislative measures intended at curtailing the tax avoidance through trusts has been thus far been set out in three proposals contained in the Budget Review, Chapter 4, entitled 'Revenue Trends and Fiscal Proposals.'¹²⁴ These proposals are succinctly:

Firstly in relation to discretionary trusts:

- "Discretionary trusts should no longer act as flow-through vehicles. Taxable income and loss (including capital gains and losses) should be fully calculated at trust level with distributions acting as deductible payments to the extent of current taxable income. Beneficiaries will be eligible to receive tax-free distributions, except where they give rise to deductible payments (which will be included as ordinary revenue)."

Secondly in respect of trading trusts, a similar (if not identical approach) will apply:

is that any trust income channelled to the beneficiary as an annuity will be taxed in his/her hands as an annuity. See s10 (2)(b) which if read with the dividend exemption clause –s 10 (1) (k)- has the effect that the dividend exemption will not be applicable where it is paid as portion of an annuity.

¹¹⁹ Silke *South African Income Tax* 11th ed paras 12.16 The authors further explain that if the trust receives interest income, the beneficiary must be regarded as having received this income, and if he qualifies he will enjoy the exemption from normal tax offered by s 10(1)(h) .

¹²⁰ 1977 3 SA 410 (A)

¹²¹ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.2 at 75..

¹²² Du Toit F *South African Trust Law Principles and Practice* (2002) at 132.

¹²³ The Budget Speech is available at <http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf> Last accessed on 01/05/2013.

¹²⁴ The 2013 Budget Review at <http://www.treasury.gov.za/documents/national%20budget/2013/review/default.aspx>. Last accessed on 01/05/2013.

- “Trading trusts will similarly be taxable at the entity level, with distributions acting as deductible payments to the extent of current taxable income. Trusts will be viewed as trading trusts if they either conduct a trade or if beneficial ownership interests in these trusts are freely transferable.”

Essentially therefore the conduit principle, which allowed for such flow-through is targeted by these proposals.¹²⁵ Instead of the income and capital gains flowing through to the beneficiary’s hands where it would be taxed at his or her rate, income and capital gains will now be taxed in the trust’s hands (at a higher rate), with distributions to the beneficiaries then received tax-free in their hands, alternatively the trust may deduct the distribution from its taxable income and the beneficiary will then pay tax on the distribution as ordinary income.¹²⁶ Trust will further only be allowed to distribute “taxable income,” as calculated in accordance with the specific definition of this term in the Income Tax Act.¹²⁷ Whilst income would still be distributed, such distribution would now be ‘taxable income’, and thus not retain its original identity.¹²⁸ Also as it is taxable income that is distributed, it would require that the prior to effecting the distribution, any capital gains would first be included at the considerably higher inclusion rate of trusts. Thereafter it may be distributed to the beneficiary as ‘income’, to be taxed at the relevant marginal tax rate.¹²⁹ The attribution provisions set out in Section 7 and 25B, as well as the correlating provisions in relation to capital gains tax in the Eighth Schedule, which accommodated the flow through, will therefore in part or totality, be revoked or amended.¹³⁰ Thus the perceived tax advantages of trust will be largely

¹²⁵ Mollaggee, O “Newly Proposed Tax On Trust” Interview Article available at <http://www.moneyweb.co.za/moneyweb-safm-market-update/r-927>. Last accessed on 05/05/2013.

¹²⁶ Malapela, K “Protecting the Tax Base Through Trust Reform. Article available at <http://www.ey.com/ZA/en/Services/Tax/2013-Budget---Kabelo-Malapela---Protecting-the-tax-base-through-trust-taxation-reform>. Last accessed on 05/05/2013. Worsdale, R quoted in Du Preez, L “Plan to tax capital gains as income will kill discretionary trusts”- Published 3 March 2012 on Personal Finance – available at <http://www.iol.co.za/business/personal-finance/tax/plan-to-tax-capital-gains-as-income-will-kill-discretionary-trusts-1.1479432>. Last accessed on 01/05/2013.

¹²⁷ The term “taxable income” has a specific meaning assigned to it per Section 1 of the Act.

¹²⁸ Thus where previously if the income was dividends it would pass into the hands as dividends and be exempted from tax, or if interest, qualify for an interest deduction – following the change it will be income regardless of its original nature. Carroll, T “Budget 2013/2014: The Taxation of Trusts” Sanlam Estate Planning Essentials Vol 51 –Published 12 March 2013. Zerbst, F “Why Trust Reform will affect your Tax Planning” Published 4 April 2013, available at http://www.fanews.co.za/article.asp?Front_Page_Features~25,Featured_Story~1147,Why_trust_reform_will_affect_your_tax_planning~13374. Last accessed 05/05/2013.

¹²⁹ Mollaggee, O “Newly Proposed Tax On Trust” Interview Article available at <http://www.moneyweb.co.za/moneyweb-safm-market-update/r-927>. Last accessed on 05/05/2013. Zerbst, F “Why Trust Reform will affect your Tax Planning” Published 4 April 2013, available at http://www.fanews.co.za/article.asp?Front_Page_Features~25,Featured_Story~1147,Why_trust_reform_will_affect_your_tax_planning~13374. Last accessed 05/05/2013.

¹³⁰ Van Gijzen, F “Where did the Trust Go?” Available at <http://www.accountancysa.org.za/resources/ShowItemArticle.asp?ArticleId=2626&Issue=1125>; Lester, M “ The Debate around the Taxation of Trusts” available at <http://glacier-theinsidestory.co.za/Article/75/14>. Last accessed 05/05/2013.

undermined,¹³¹ or as one author put it, “in one fell swoop the Minister has injected a fatal tax advantage vaccination to the concept and logic of Trusts.”¹³²

There is no indication in the proposals, that any distinction will be made between testamentary and *inter vivos* trusts, which is important as with the former their provisions can not ordinarily be amended so as to address such tax changes, nor is there any indication that the envisaged taxing of income and capital gains tax will be done at a different rate, than the maximum marginal tax rate of 40% as is currently applicable.¹³³ As the first proposal is stated to be applicable to discretionary trusts, it could be assumed that in respect of vested (or vesting) trusts the *conduit* principle will apply, but a conundrum may result, where the trust has both vesting and discretionary rights applicable (which may be in respect of income or capital or both).¹³⁴

Lastly in respect of foundations it is stated:

- “Distributions from offshore foundations will be treated as ordinary revenue. This amendment targets schemes designed to shield income from global taxation.”

Thus the same dispensation will be applicable to income received from offshore trusts. Distributions will be subject to income tax, regardless of its original nature. This holds true should the reference to “foundations” refer to trusts, as it is unclear why SARS specifically used the former terminology and not the latter. The term “foundation” is not defined in the Act. Foundations however have different characteristics than trusts. For one they are regarded as a legal person.¹³⁵ A succinct description is that they are “hybrid between a trust and a company.”¹³⁶ Honore provides more insight¹³⁷ –

“ A foundation or a stiging is a juristic person consisting of a collection of assets or funds devoted to a defined (usually charitable) purpose and managed by administrators. The ownership of the assets resides in the foundation and in neither the administrators nor the beneficiaries, if any... there is some evidence that foundations are recognized in South African law, but it is not clear whether they are conceived as consisting of an aggregate of assets and liabilities and whether they can be created by unilateral act by a living person...”

¹³¹ Van Gijsen summarises it “, the effectiveness of trusts as a means of reducing your tax liability has largely been curtailed” - Van Gijsen, F “Where did the Trust Go?” Available at <http://www.accountancysa.org.za/resources/ShowItemArticle.asp?ArticleId=2626&Issue=1125>. Last accessed 05/05/2013.

¹³² Duncan, A “The Hold Your Breath Budget” – available at http://www.walkers.co.za/index.php?option=com_content&view=article&id=247:the-hold-your-breath-budget&catid=26:financial-surveillance&Itemid=56. Last accessed 05/05/2013.

¹³³ Emslie, T (Ed) “Losing Trust?” 2013 *The Taxpayer* Vol 62 no 3 &4 at 41.

¹³⁴ Emslie, T (Ed) “Losing Trust?” 2013 *The Taxpayer* Vol 62 no 3 &4 at 41.

¹³⁵ De Waal, MJ *The Law of Succession* (2008) 186-189.

¹³⁶ Sacks, B “Trust Reform” June/July 2013 *Businessbrief* 43.

¹³⁷ Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 62.

It is generally held that a living person cannot by unilateral act create a trust in South African law."

De Waal however mentions several examples of foundations that have been established in South Africa.¹³⁸ De Waal describes their legal nature as follows¹³⁹ –

"A foundation is a juristic person without members. As such it thus has legal capacity, that is to say the capacity to be the bearer of rights and duties. As a juristic person the foundation owns assets and bears other rights itself and can also be held liable for duties itself. It participates in the legal traffic by means of its 'controllers, administrators, managers or representatives.' Because the latter are not members of the foundation they have no claim to the assets of the foundation and also do not share in its profits or returns. Although a foundation may well serve the interest of a specific beneficiary, it is more usually instituted for some or other impersonal objective."

Thus whereas with a trust, the trustee would be the owner of the assets in his fiduciary capacity, the foundation itself is here the owner. De Waal also notes that there are no prescribed formalities for the establishment of a foundation and that government permission or registration in the companies' register is therefore not required.¹⁴⁰ It has however been reported that foundations are not widely used by South Africans, locally and abroad.¹⁴¹

Duncan regards the proposal to be a punitive measure, but postulates that it is perhaps in keeping with the Minister's approach in respect of international companies that manoeuvrability of their tax liability should be limited.¹⁴² It has since also been reported that a working group would be set up to investigate the prevalence of foreign trusts and foundations in South Africa.¹⁴³

The proposals will not be applicable to trusts, which have in the opinion of SARS been established for legitimate reasons. SARS cites two examples, a trust for minor children or for persons with disabilities. Worsdale has argued that this denies that trusts are set up for other valid legal reasons aside from tax efficiency and may often fulfil important social functions, ie protection of the

¹³⁸ Certain foundations have been established in terms of legislation, the SABC ito Act 22,1939, the Land Bank ito Act 18,19 replaced by Act 13,1944 as well as by private persons for example, the Abraham Kriel Children's Home in Johannesburg, the Urban Foundation etc. De Waal, MJ *The Law of Succession* (2008) at 187-188.

¹³⁹ De Waal, MJ *The Law of Succession* (2008) at 187.

¹⁴⁰ De Waal, MJ *The Law of Succession* (2008) at 188. If formed in a Will, the testamentary formalities for its validity, would be applicable mero motu.

¹⁴¹ Comment by the Industry Delegates to the Treasury – Croome, B "The Future Taxation of Trusts" (26 June 2013). Available at <http://www.thesait.org.za/news/130111/The-future-taxation-of-trusts.htm> - last accessed 05/09/2013.

¹⁴² Duncan, A "The Hold Your Breath Budget" – available at http://www.walkers.co.za/index.php?option=com_content&view=article&id=247:the-hold-your-breath-budget&catid=26:financial-surveillance&Itemid=56. Last accessed 05/05/2013.

¹⁴³ Jones, G "Crackdown on Trusts 'is attack on wealthy' *Business Day* 5 August 2013.

financially inexperienced, or shielding spouses from avaricious relationships.¹⁴⁴ Whilst trusts for minor children are often established in Wills, subsequent to the lowering of the age of majority from 21 to 18, these are often stipulated to have an extended duration to more mature ages, to allow the beneficiary to reach a responsible age, yet such trusts would now also fall into the net and be punitively treated.¹⁴⁵ Emslie's view is similar and urges the drafters of such reforms to also adhere to the valued maxim of neutrality –

“...trusts are not merely vehicles used for tax avoidance. There are many sound reasons why the flexibility associated with trusts is useful and these are not limited to what are currently defined as ‘special trust.’ One appreciates that any responsible *fiscus* would wish to curtail ‘tax avoidance associated with trust’ but there are many legitimate uses of trust that have nothing whatsoever to do with tax.. Reformation of the taxation of trusts is perhaps a golden opportunity to honour the canon of neutrality, so that the decision whether or not to utilise a trust is not dictated by fiscal considerations.”¹⁴⁶

These proposals resort under the section “Protecting the Tax Base” and are regarded as forming part of SARS’ targeting of high net worth individuals with trusts an associated casualty of the attack, as they are perceived to be most often used by these wealthy individuals.¹⁴⁷ Thus in the 2012 Budget Speech, the Minister of Finance stated “Poor tax compliance is also apparent in respect of trust,” which coupled with the fact that “wealthy individuals are also generally linked to a number of trusts and companies, some of which are used as vehicles to channel and hide their assets and income...” prompted the Minister in the 2013 Budget Speech, to announce that “various measures [are] proposed to protect the tax base and limit the scope for tax leakage and avoidance. The taxation of trusts will come under review to control abuse...”¹⁴⁸

¹⁴⁴ Worsdale, R quoted in Du Preez, L “Plan to tax capital gains as income will kill discretionary trusts”- Published 3 March 2012 on Personal Finance – available at <http://www.iol.co.za/business/personal-finance/tax/plan-to-tax-capital-gains-as-income-will-kill-discretionary-trusts-1.1479432>. Last accessed on 01/05/2013.

¹⁴⁵ Worsdale, R quoted in Du Preez, L “Plan to tax capital gains as income will kill discretionary trusts”- Published 3 March 2012 on Personal Finance – available at <http://www.iol.co.za/business/personal-finance/tax/plan-to-tax-capital-gains-as-income-will-kill-discretionary-trusts-1.1479432>. Last accessed on 01/05/2013.

¹⁴⁶ Emslie, T (Ed) “Losing Trust?” 2013 *The Taxpayer* Vol 62 no 3 &4 at 42.

¹⁴⁷ Pickworth, E “Much of Tax Burden falls on the Wealthy” Article published 1 March 2013, available at <http://www.bdlive.co.za/economy/2013/03/01/much-of-tax-burden-falls-on-the-wealthy>. Last accessed on 05/05/2013. He quotes Mr Piet Nel (Tax Project Director at the South African Institute of Chartered Accountants) who states that these trust generally accommodate estates of more than R7 million and is only sensible for an asset holding of more than R 10 million. Yet trusts are not only the “preserve of the wealthy.” –Williams, G “A Matter of Trusts” (8 Aug 2013) *Finweek* at 18 .

¹⁴⁸ Van der Walt, J “ Reforming the taxation of trusts: a long time coming” in Budget Alert February 2013 – available at <http://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/news/publications/2013/tax/downloads/Budget-Alert-2013.pdf> - last accessed on 05/05/2013.

The further details of these proposals are however as yet “confusing,”¹⁴⁹ “very vague” and give rise to much speculation.¹⁵⁰ Yet they have “caused alarm bells to ring across the country.”¹⁵¹ As they are merely proposals, Stein states that “it is extremely dangerous to act on them” and that it is essential to wait for the final version as “history confirms that there is many a ‘slip twixt draft and final law.’”¹⁵² So too, do the Editors of *The Taxpayer Journal*, recommend an approach of working with the law as it currently reads, whilst staying aware of such imminent changes. They further caution that “when tax legislation changes, however, the devil is usually in the detail, and of course, the law of unintended consequences is always a factor when fiscal laws are amended.”¹⁵³

Since the Budget, the Treasury is reported to have met with industry players on two occasions, and whilst those in attendance are skeptical about the Treasury's insight and understanding of trusts, how trusts operate and the reasons for establishing them, they welcome the engagement of Treasury and its willingness to listen to the concerns.¹⁵⁴ Subsequent thereto, when the Draft Taxation Laws Amendment Bill was issued, Treasury indicated that the proposals regarding trust reforms require further consultation and would be dealt with “later this year or as part of new year's process.”¹⁵⁵ It has now been further reported that no measures will be issued this year by Treasury,¹⁵⁶ but that the matter remains high on their agenda and will continue to receive attention.¹⁵⁷ This leads one author to conclude that Treasury does not have “any firm views or ideas about trust reform as yet.”¹⁵⁸ The Editors of *The Taxpayer Journal*, find this state of affairs most unsatisfactory and summarize their frustration –

“Certainty, or at least as much certainty as is attainable, is the requisite of any good tax

¹⁴⁹ Carroll, T “Budget 2013/2014: The Taxation of Trusts” Sanlam Estate Planning Essentials Vol 51 –Published 12 March 2013.

¹⁵⁰ Lester, M “ The Debate around the Taxation of Trusts” available at <http://glacier-theinsidestory.co.za/Article/75/14>. Last accessed 05/05/2013.

¹⁵¹ Ed “Alarm Bells Ringing” (2013) 27 No 2 *Tax Planning Corporate and Personal*.

¹⁵² Ed “Trusts Proposals” (2013) 54 No 4 *Income Tax Reporter* 131.

¹⁵³ Ed “The Taxation of Trusts – Fiscal Change Management” (2013) 62 no 7 *The Taxpayer* at 121

¹⁵⁴ It firstly met with the Society of Trust and Estates Practitioners, and then with the Fiduciary Institute of Southern Africa, The Financial Planning Institute, the Law Society of SA, SAICA and the South African Institute of Tax Practitioners - Jones, G “Crackdown on Trusts ‘is attack on wealthy’ *Business Day* 5 August 2013.

¹⁵⁵ National Treasury “Media Statement- Draft Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill, 2013” issued 4 July 2013.

¹⁵⁶ Ed “The Taxation of Trusts – Fiscal Change Management” (2013) 62 no 7 *The Taxpayer* at 121.

¹⁵⁷ Jones, G “Crackdown on Trusts ‘is attack on wealthy’ *Business Day* 5 August 2013.

¹⁵⁸ Van der Walt, J quoted in Jones, G “Crackdown on Trusts ‘is attack on wealthy’ *Business Day* 5 August 2013. See also Van der Walt, J “Trust Taxation Reform – Where is this Heading?” Cliffe Dekker Hofmeyr Tax Alert of 16 August 2013. Available at <http://www.cliffedekkerhofmeyr.com/export/sites/cdh/en/news/publications/2013/tax/downloads/Tax-Alert-16-August-2013.pdf> - last accessed 05/09/2013.

system, and in our view, extends to what one might call *fiscal change management*. No tax system is changeless, but change should be managed in an orderly fashion that restricts uncertainty about the future to an acceptable minimum.... such change as is necessary is introduced incrementally, rather than in the present stop and start (or is it start and stop?) manner."¹⁵⁹

Until such time as such details are refined and cast into the final taxation amendment bill, the uncertainty will therefore prevail.¹⁶⁰ It is however clear that the distinction between resident and non-resident will be important and thus remains a key factor to consider.

4 3 The taxation of the trust and the parties to the trust

4 3 1 The liability of the trust

As is evident from the discussion above at paragraph 4.2.1, the trust is a taxable entity and may therefore be taxed in its own right.

Specifically Section 25B of the Act provides, that any amount¹⁶¹ received by or accrued to or in favour of a trustee of a trust, shall, subject to the provisions of section 7 be deemed to be an amount accrued to the trust, unless such amount has been derived for the immediate or future benefit of an ascertained beneficiary, who enjoys a vested right to such amount, alternatively of a beneficiary who acquires a vested right, by virtue of the exercise of the trustee's discretion. The effect of section 25B is therefore to make the trust liable for taxation on amounts, for which there is no beneficiary with a vested right to it, or where the amount is not allocated or distributed to any beneficiary but retained in the trust, and overall, none of the deeming provisions of section 7 (also

¹⁵⁹ Ed "The Taxation of Trusts – Fiscal Change Management" (2013) 62 no 7 *The Taxpayer* at 121.

¹⁶⁰ Lester refers to it as "watch this space" situation, also noting that it may be some time before such legislation is in its final form and promulgated : first it needs to be drafted and debated through the prescribed parliamentary processes, complicated issues may be referred to the Davis Commission for further enquiry, a lobby group may come to the fore insisting upon a relief period to be granted for taxpayers to undo their trust arrangements. Lester, M " The Debate around the Taxation of Trusts" available at <http://glacier-theinsidestory.co.za/Article/75/14>. Last accessed 05/05/2013.

¹⁶¹ Davis highlights the fact that section 25B uses the term "amount" and not "income". The authors explain that the reason given for this in the Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004 is that the term "income" might lead to the ordinary interpretation of "gross income" less "exempt income" which would deprive section 25B of much of its force as an anti-avoidance measure in respect of off-shore trusts. They agree that such an interpretation should be avoided but submits that that the term "gross income" should have been used instead of "amount". They warn that although it is clear that the meaning of "gross income" was intended by the use of the term "amount" there is a risk that the term "amount" may mean something more than "gross income". See Davis et al *Estate Planning* (May 2013) at 6-3.

called the tax-back or attribution rules) apply.¹⁶²

In respect of capital gains, section 26A obliges a person (including thus a trust), to include in its taxable income the taxable capital gain for the year of assessment.¹⁶³ Similarly to the income tax provisions, Paragraph 80 of the Eight Schedule of the Income Tax, deems the capital gain to be that of the beneficiary should certain circumstances be met, failing which, the trust. The latter is recorded in paragraphs 68, 69, 71 and 72.¹⁶⁴ The effect is that the trust will only be taxed, should neither the deeming provisions nor attribution rules be applicable.¹⁶⁵

Albeit that the trust may itself be taxed, practically the trust is an artificial entity and is incapable of physically acting, including paying its taxes, and can only do so through its trustees. In terms of the Act, the trustee is appointed as the “representative taxpayer” of the trust in respect of any income, which is the subject of a trust.¹⁶⁶ This latter condition denotes that the trustee is only the representative taxpayer in respect of the income of the trust and not in respect of income that is taxable in the hands of others, such as the beneficiaries or a donor (unless the trustee has been appointed by the Commissioner as agent.)¹⁶⁷ Income in this definition also encompasses capital gains, as the definition is expressly stated to include any amount received or accrued in consequence of the disposal of any asset, as envisaged in the Eight Schedule.¹⁶⁸

In terms of the Tax Administration Act¹⁶⁹ and in particular Section 154, as a representative taxpayer, the trustee is in relation to the income to which it is in his representative capacity entitled, subject to the same duties, responsibilities and liabilities as the taxpayer he represents, and is entitled to claim any abatement, deduction, exemption, right to set off or loss as such person he represents, would have been able to. Furthermore, the trustee is also liable to assessment, but any such assessment is deemed to be made upon him in his representative capacity only.¹⁷⁰ The trustee may further, where he pays any tax as representative taxpayer, recover the amount so paid from the trust on whose behalf it was paid, or retain it from moneys that he has in his possession as

¹⁶² Geach WD & Yeats J *Trusts Law and Practice* (2007) at 242. See also discussion below.

¹⁶³ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B27.1 at 125.

¹⁶⁴ Paragraph 80(1) & (2).

¹⁶⁵ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 145.

¹⁶⁶ See para (c) of the definition of “representative taxpayer” in s 1 of the Act. The Act also contains a definition for the term “trustees.” In *Estate Smith v CIR* 1960 3 SA 375 (A) 379 it was stated that these two definitions, must be read together.

¹⁶⁷ Davis et al *Estate Planning* (May 2013) at 6-42(6) ; See S99.

¹⁶⁸ S1 of the Income Tax Act.

¹⁶⁹ 28 of 2011. The Act revoked Sections 95-97 of the Income Tax Act, and came into operation on 1 October 2012. Section 154 (1).

¹⁷⁰ S 154(2) of the Tax Administration Act, 28 of 2011.

trustee, or may come to him in his representative capacity.¹⁷¹ Yet the trustee's liability is not always limited to a representative capacity. Section 155 provides for personal liability where the tax remains unpaid and the trustee alienates, charges or disposes of the income in respect of which the tax is chargeable; or the trustee disposes of or parts with any trust money, which is in his possession or comes to him after the tax is payable, if the tax could legally have been paid from out of such funds or money.¹⁷²

Davis notes that in a trust with multiple trustees, it is often the practice for a single trustee to carry out all the duties and responsibilities imposed by the Act, with SARS treating such one trustee as the representative taxpayer to the trust. Indeed on the application form to register a trust as taxpayer, it is requested that the particulars of the "main trustee" be provided first, with the particulars of two other trustees following.¹⁷³ Notwithstanding such practice, the other trustees also remain subject to the same duties, responsibilities and liabilities of the main representative.¹⁷⁴

The trust will be taxed at the rates set out in paragraph 4.2.4 above and as such rates are in most instances higher than individual beneficiaries' rates, the trust income is often instead apportioned to the beneficiaries to be taxed at their rates - this is discussed next.

4 3 2 The liability of the beneficiaries

Alternatively, the tax liability may fall upon the beneficiary of the trust. A 'beneficiary' is defined for the purposes of the Act in section 1 as follows:

"beneficiary" in relation to a trust means 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.'

The ambit of the definition is wide enough to include beneficiaries of both vested trusts and those of a discretionary trust.

In terms of the above referred Section 25B(1), any income received by or accrued to or in favour of any person, in his capacity as a trustee of a trust, shall, subject to the provisions of section 7, to the extent that it has been derived for the immediate or future benefit of an ascertained beneficiary

¹⁷¹ S 160 of the Tax Administration Act, 28 of 2011.

¹⁷² S1 55 of the Tax Administration Act, 28 of 2011.

¹⁷³ Form IT 77 TR – Application for registration as a taxpayer of changing of registered particulars: Trusts – to be accessed on SARS website at <http://www.sars.gov.za/AllDocs/OpsDocs/SARSForms/IT77TR%20-%20Application%20for%20Registration%20as%20a%20Trusts%20and%20Change%20in%20Particulars%20Trust%20-%20External%20Form.pdf>. Last accessed on 02/05/2013.

¹⁷⁴ Davis et al *Estate Planning* (May 2013) at 6-42(6).

who has a vested right to such income during such year, be deemed to be income accrued to the beneficiary and will consequently be taxed in the beneficiary's hands. It is apparent from the reading of this section, that it is required that the beneficiary must have a vested right to the income, ie the beneficiary must have a right to claim the income and such right must be unconditional.¹⁷⁵ The meaning of a vested¹⁷⁶ right, and the distinction between such a right and a contingent right, has been discussed above in paragraph 2.7.3, but is briefly addressed here as well. The distinction has been explained well in the case of *ITC 76*¹⁷⁷ -

“Vesting implied the transfer of dominium, and the children had clearly not in the year under review acquired dominium of the trust income or any portion thereof. A vested right was something substantial; something which could be measured in money; something which had a present value and could be attached. A contingent interest was merely a *spes* – an expectation which might never be realized. From its very nature it could not have a definite present value. In the income tax sense, therefore, a vested right was an accrued right.”

Silke¹⁷⁸ explains the working of this section from the viewpoint of the trustee –

“When the income that is the subject of a trust is received by or accrues to a trustee in his representative capacity and, at the time of the receipt or accrual, he is legally obliged to pay it over or some part of it to or to accumulate or expend the income or some part of it for the benefit of any person specified in the trust deed as the beneficiary of the income, the income, to the extent to which the trustee is so legally obliged to apply it, will be regarded as the income of that beneficiary.”

In a vested trust such as a *bewind* trust, where the beneficiary has a vested right to the income and capital of the trust, it is clear that such a beneficiary will have the requisite vested right to be taxed in terms of this section. It must further be noted that in a vested trust, the income need not actually be distributed or paid over to the beneficiary, it may for example, even be held in the trust on loan account for the beneficiary, as long as the beneficiary is unconditionally entitled to the income, it vests in the beneficiary.¹⁷⁹

In a discretionary trust, the rights of the beneficiaries depend on the nature and exercise of the trustee's discretion.¹⁸⁰ The beneficiaries have no vested right until the trustees exercise their discretion in the beneficiary's favour. Until such time the beneficiary merely has a contingent interest. In terms of section 25B(2), if the beneficiary acquires a vested right to income in

¹⁷⁵ Olivier et al *Trust Law and Practice* (November 2011) at 7-13.

¹⁷⁶ The term “vested” is not defined in the Act.

¹⁷⁷ Per G J Maritz, President of the Special Court for Hearing Income Tax Appeals, in *ITC 76 (1927) 3 SATC 68* at 70 as quoted in De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.15.

¹⁷⁸ De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.15.

¹⁷⁹ Davis et al *Estate Planning* (May 2013) at 6-5.

¹⁸⁰ Cameron, E et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 243.

consequence of the exercise by the trustees of a discretion vested in them by the trust deed, agreement or will, such income is deemed to be derived for the benefit of such beneficiary.¹⁸¹ Thus, once the trustees exercise their discretion, the contingent right of a beneficiary becomes a vested one, and the beneficiary will be liable to tax in terms of this section 25B(2). It may happen that a discretionary trust also contains components of a vesting trust, or example, some beneficiaries may have vested rights to income and contingent rights to capital, whilst other may have vested rights to capital and contingent rights to income.¹⁸² Where a trust has beneficiaries with both vested and contingent rights, Section 25B(1) will be applicable to the income received by or accrued to a beneficiary with vested rights and section 25B(2) will apply to income received by or accrued to beneficiaries with discretionary rights.¹⁸³ Similarly, in a discretionary trust, the vesting may take the form of an actual distribution, or be held on credit with a payment in future.¹⁸⁴ In a discretionary trust, the extent to which the beneficiary will be taxed is dependant on the award made to him. It may therefore be possible that both the trust and the beneficiary will be taxed - the beneficiary on the amount awarded to him and the trust on the income retained. However double taxation would not arise as it is not the same income that is taxed.¹⁸⁵ Furthermore the conduit principle applies and the income will retain its nature.

It is however not only income that may accrue to either the beneficiary or the trust by virtue of the operation of section 25B, but also deductions and allowances. Section 25B(3) provides specifically, that any deduction or allowance which may be made in terms of the Income Tax Act in the determination of the taxable income and which relates to income which has been received by or has accrued to a beneficiary or to the trust, is deemed to be a deduction or allowance in the hands of such beneficiary or trust, but only to the extent to which such amount is deemed to have accrued to the beneficiary or to the trust.¹⁸⁶ Thus to the extent amounts have been retained in the

¹⁸¹ Silke summarizes it as follows income discretionarily awarded to a beneficiary by the trustee will be treated as that beneficiary's income. (subject to the provisions of S7). De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.15.

¹⁸² Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 74.

¹⁸³ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 75.

¹⁸⁴ Davis et al *Estate Planning* (May 2013) at 6-5.

¹⁸⁵ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 77.

¹⁸⁶ Geach explains this effectively, "Any tax deductions incurred in producing a trust's income, are deductible – either in the hands of the trust or the hands of the beneficiary – in the same proportion that the income has been allocated. In other words, if no income is allocated or distributed to a beneficiary all expenses incurred in the production of the income (provided these expenses are tax allowable) are deductible in determining the taxable income of the trust. To the extent that any income is allocated or distributed to a beneficiary, any tax deductions relating to that income are deemed to be a deduction available to the beneficiary in the proportion that the income that is allocated or distributed to the beneficiary bears in relation to the total income that accrued to the trust." Geach WD & Yeats J *Trusts Law and Practice* (2007) at 243-244.

trust, the trust may avail itself of these deductible allowances, whilst to the extent amounts accrued to the beneficiaries, they may claim the *pro rata* expenditure.¹⁸⁷¹⁸⁸

Section 25B(4)¹⁸⁹ imposes a limitation hereon by providing, that any deduction or allowance referred to in section 25B(3), which is allocated to a beneficiary, shall be limited to the income accruing to the beneficiary from that trust in the year of assessment. Thus, if the amount of expenditure and allowances apportioned to a beneficiary, exceeds the amount deemed to be derived by the beneficiary from the trust during the year of assessment, the deductions or allowances will be capped at the amount deemed to accrue to the beneficiary.¹⁹⁰

The excess of expenditure over income in section 25B(4), may in terms of section 25B(5) be treated in one of two ways and the distinction between trusts taxable in South Africa, and not taxable in South Africa, is important here. In terms of section 25B(5)(a), if the trust is subject to tax in South Africa, the excess expenditure may be deducted by the trust in that year, but such deduction is limited to the taxable income of the trust before the deduction of such expenditure.¹⁹¹ Where the trust is not subject to tax in South Africa, the excess expenditure is carried forward and treated as a deduction or allowance, which the beneficiary may claim in the immediately succeeding year of assessment in terms of section 25B(5)(b).

If the collective deductions exceeds both the income accrued to the beneficiary (as provided for in section 25B(4)) and the taxable income of the trust (as provided for in section 25B(5)), then the excess may in terms of section 25B(6) be claimed by the beneficiary in the next year of assessment, subject to the same limitation as in section 25B(4).¹⁹² Haupt summarizes the objective of sections 25B(4)-(6) by stating that it prevents the trust from distributing losses to beneficiaries and in conjunction with section 25B(3) requires the deductions and allowances to be allocated between

¹⁸⁷ De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.14A.

¹⁸⁸ Olivier notes that should a beneficiary have a vested right to both the trust capital and income of a trust, he is liable to tax not only on the income he receives from the trust but also on any inadmissible expenditure – such as donations- laid out by the trust. Olivier et al *Trust Law and Practice* (November 2011) at 7-13. Silke summarizes the position as being that the gross income accrues to the beneficiary, the inadmissible expenditure is disbursed on his behalf, and the taxable income is derived by him and not the trust. De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.14A

¹⁸⁹ Section 24B(4) and the subsections(5) and (6) discussed further applies in respect existing trusts with effect from years of assessment commencing on or after January 1999 and to all new trusts created on or after 11 March 1998. Davis et al *Estate Planning* (May 2013) at 6-6.

¹⁹⁰ De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.14A.

¹⁹¹ Davis et al *Estate Planning* (May 2013) at 6-5.

¹⁹² De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.14A.

the trust and beneficiaries pro rata the amount of income allocated to the beneficiaries and retained by the trust.¹⁹³

The last subsection of section 25B, namely section 25B(7), provides that where a beneficiary is not subject to tax in South Africa on any amount deemed to have accrued to the beneficiary in terms of section 25B(1), the provisions of section 25B (4) to (6) do not apply.¹⁹⁴ Silke states that this will be the case, where for example a beneficiary who is a non-resident has a vested right to income of a trust, but the income is not derived by the trust from a source within or deemed to be within in the Republic.¹⁹⁵ Davis also explains that in such a case, the deductions and allowances relating to the income of the beneficiary become irrelevant.¹⁹⁶ They are however not accessible to the trust as the income is not regarded to have accrued to the trust.

In respect of capital gains, corresponding provisions can be found in Paragraph 80 of the Eighth Schedule. Paragraph 80(1) provides, that where a capital gain is determined in respect of the vesting by a trust of an asset in a trust beneficiary who is a resident, that gain must be taken into account in calculating the capital gain of the beneficiary to whom the asset was so disposed of.¹⁹⁷ Alternatively where a capital gain results upon the disposal of an asset, and a beneficiary who is a resident has a vested right, or which acquires a vested interest (ie the exercise of a discretion) in the capital gain, but not in the asset, Paragraph 80(2) determines that to the extent which such gain is vested, it must be included in calculating the capital gain of the beneficiary in whom the gain vests.¹⁹⁸

Non-residents trusts

Olivier & Honiball explain the background to the inclusion of Section 25B (2A) as originating from the viewpoint that income, which is received by a trust, changes its nature if it is not distributed. It becomes “capitalized” in the trust.¹⁹⁹ In the context of non-residents trust, this view was often applied to accumulate foreign income in the trust beyond the year of assessment, with the intention that it will thereafter be distributed as capital and thus be a non-taxable award to a resident beneficiary.²⁰⁰ Section 25B(2A) combats this potential tax avoidance and statutorily trumps

¹⁹³ Haupt P *Notes on South African Income Tax* 2013 (32nd ed) at 797.

¹⁹⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 133.

¹⁹⁵ De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.14A.

¹⁹⁶ Davis et al *Estate Planning* (May 2013) at 6-6.

¹⁹⁷ Par 80(1); Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B27.1 at 125.

¹⁹⁸ Par 80(2).

¹⁹⁹ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 76.

²⁰⁰ Davis et al *Estate Planning* (May 2013) at 6-8(8).

the view that when accumulated income²⁰¹ vests in the beneficiary, it is of a capital nature and therefore not taxable.²⁰² This section provides that, where during any year of assessment any resident acquires any vested right to any amount representing capital of any trust, which is not a resident, and such capital arose from income received by or accrued to such trust; or from any receipts and accruals of such trust, which would have constituted income, if such trust had been a resident in any previous year of assessment during which such resident had a contingent right to such income or receipts and accruals; and such income or receipts and accruals have not been subject to tax in the Republic in terms of the provisions of this Act, such amount shall be included in the income of such resident in such year of assessment.²⁰³ In essence this section thus includes vested rights to the capital of non-resident trusts, in the income of residents of the Republic, in the year that they acquire the vested right.²⁰⁴

It appears that Section 25B (2A) is the only provision available, to tax the income of a non-resident trust in the hands of a resident tax beneficiary, where section 7 does not apply.²⁰⁵ It is therefore argued, that it is implicit that the provisions of S25B (3)-(7), dealing with the claimable deduction and allowances associated with the income of the trust, is only applicable to resident trusts.²⁰⁶ Albeit this is not expressly stated, it is inferred by academic authors from the fact, that it is only S25B (2A) of the various sub-sections of S25B, which directly address the resident beneficiaries of non-resident trusts.²⁰⁷

Haupt regards section 25B (2A) to applicable to *capital* which is distributed by a non-resident trust, whilst *income* which is distributed by the non-resident trust will be taxed in the hands of the beneficiary in terms of Section 25B as vested income.²⁰⁸ Where the income is not distributed but

²⁰¹ Honiball & Olivier point out that the view that income changes its nature when it is not distributed and becomes capital was not endorsed by the then highest court of appeal, the Appellate Division and it is therefore arguable that this section is unnecessary. They quote the case of *Estate Dempers v CIR 1977 (3) SA 410A* where the court stated, "... The fact that the trust deed speaks of such accumulated income being capitalized and added to the trust fund cannot alter its essential character, in the eye of the income tax law, of being income." Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 77.

²⁰² Davis et al *Estate Planning* (May 2013) at 6-8(1).

²⁰³ S25B (2A).

²⁰⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 132. The tax liability is thus delayed until the acquisition of the vested right - Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 77.

²⁰⁵ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 77.

²⁰⁶ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E) (Last updated November 2010) Chapter 6 at 6.11 available electronically on LexisNexis.

²⁰⁷ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E) (Last updated November 2010) Chapter 6 at 6.2 available electronically on LexisNexis; Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 76-79.

²⁰⁸ Haupt P *Notes on South African Income Tax 2013* (32nd ed) at 809.

retained in the trust, its taxability will depend on whether it is from a South African source and whether any attribution rules are applicable. If none of the attributing provisions of Section 7 are applicable, and the income was sourced from a South African source then it will be taxed in the trust.²⁰⁹ The attribution rules may however be applicable – for example Section 7(5) which would deem the income to be that of the donor if its retained due to a stipulation that it shall not be paid pending the happening of a certain event.²¹⁰ As the section refers to "income," per the latter's definition in Section 1, it would only be applicable to South African sourced income. Alternatively Section 7(8) may be applicable where an amount is received in consequence of a donation or disposition made by a South African resident and here, as the section refers to an "amount" would include income from both, a South African source and non-South African source.²¹¹

Similarly Paragraph 80(3) provides, that where a South African resident beneficiary acquires a vested right to capital of a non-resident trust and that capital arises from either a capital gain made by the trust in a prior tax year, during which the South African resident had a contingent right to that capital; or an amount would have constituted a capital gain of that trust had that trust been resident and that capital gain has not been taxed in South Africa under the Income Tax Act, then the amount must be taken into account by that South African resident for tax purposes.

Prior to 1 October 2012, Section 78 of the Act allowed the Commissioner to estimate the amount of foreign currency of funds or the market value of assets held abroad, in circumstances where it had reason to believe that a resident has not declared or accounted for such funds or assets outside the Republic, or alternatively, where the income or capital gains from any funds or assets outside South Africa could be attributed to a resident in terms of Section 7 or Part 10 of the Eight Schedule.²¹² An estimated taxable income would then derived by calculating the percentage equal to the official rate of interest to the estimated value of such funds or assets.²¹³ An Interpretation Note²¹⁴ was also issued wherein the background to these provisions were given. It recorded that with the relaxation of foreign exchange controls by Government in 1997, residents were allowed to invest funds offshore, subject to certain limitations, and consequently the Income Tax Act had to be amended to subject the income from such sources to tax. Following the change-over to a

²⁰⁹ Section 25B. Haupt P *Notes on South African Income Tax* 2013 (32nd ed) at 808.

²¹⁰ Haupt P *Notes on South African Income Tax* 2013 (32nd ed) at 808.

²¹¹ Haupt P *Notes on South African Income Tax* 2013 (32nd ed) at 808.

²¹² S78(1) and (1A). These sections have now been repealed by paragraph 64 pf Schedule 1 to the Tax Administration Act, 28 of 2011 which came into operation on 1 October 2012.

²¹³ S 78 (1B); Davis et al *Estate Planning* (May 2013) at 6-26(6). Official rate of interest as per par 1 of the 7th Schedule.

²¹⁴ SARS Interpretation Note no 23 "Estimated Assessment (Foreign Funds or Assets)" Issued 11 March 2004 and withdrawn with effect from 1 October 2012.

residence-based taxation in 2001, in addition to the substantive residence provisions then inserted, these administration provisions contained in Section 78 were introduced to regulate the reporting of foreign income derived and provide for non-compliance with such reporting requirements. The aim of these sections were expressly stated to ensure "compliance and provide a strong incentive for taxpayers to make full disclosure of their offshore assets and income in their returns."²¹⁵ Whilst non-compliance would be met with the punitive provisions, it was stated that such a consequence could easily be sidestepped should residents keep proper records of their offshore assets and income, disclose same fully in their returns and respond to revenue's queries timeously.²¹⁶ As Davis notes, this section acted as a "deterrent for those taxpayer with foreign income who fail to disclose it in the hope that the Commissioner will remain unaware of the foreign investment."²¹⁷

With the promulgation of the Tax Administration Act, 28 of 2011 these provisions were repealed and Section 95 of this Act now deals with estimated assessments. It provides that SARS may issue an original, additional, reduced or jeopardy assessment, based wholly or partly on an estimate, where the taxpayer failed to submit a return, or submitted an incorrect or inadequate return.²¹⁸ SARS is further required to make the estimate based on "information readily available" to it.²¹⁹ If the taxpayer is unable to submit an accurate return, a senior SARS official may agree in writing with the taxpayer as to the amount chargeable and issue an assessment accordingly.²²⁰ No mention is specifically made of foreign funds and assets in these sections. Having regard to these new provisions, it must be commented that notwithstanding an increased co-operation between the tax authorities of countries to exchange information,²²¹ it may still be extremely difficult for SARS to know about such investments offshore and secondly, to have such such information "readily available" as required by the provision. It may also be a protracted exercise to reach an agreement with the taxpayer in circumstances where an accurate return can not be completed. This detracts from the potential effectiveness of these provisions in relation to foreign assets, and it may be questioned whether the earlier provisions were not better equipped to ensure compliance, as well as the actual assessment of such assets and income.

²¹⁵ Par 2 of the Interpretation Note no 23.

²¹⁶ Par 8 of the Interpretation Note.

²¹⁷ Davis et al *Estate Planning* (May 2013) at 6-26(6).

²¹⁸ S 95(1). S91 deals with 'original assessments', S92 addresses 'additional assessments', S93 'reduced assessments' and S 94 'jeopardy assessments.'

²¹⁹ S95(2).

²²⁰ S95(3). Such an assessment is not subject to objection or appeal.

²²¹ See SAPA "Gordhan issues warning to tax dodgers" appeared 3 April 2012 wherein the former Commissioner of SARS, had boasted of the information exchange agreements which had been signed. Available at <http://www.southafrica.info/news/business/1851425.htm>— last accessed on 01/05/2013.

In light of the aforesaid discussion, it is however clear that the determination of a trust thus being resident under our income tax framework or not, is fundamentally important.

4 3 3 The liability of the founder of the trust or other donors to the trust

The last in the line of potential taxpayers under discussion here, is the donor whose liability may result through the operation of the anti-avoidance provisions of section 7 for income tax purposes²²² and in respect of capital gains, paragraph 68 – 73.

The term “donor” in the context of this section, has a wider meaning than what is usually understood of the term in the context of trust, where the term would refer to the person who evinces the intention of creating a trust and who donates a nominal amount when the trust is established, ie the founder.²²³ However, in this section the term refers to any person who makes a donation, settlement or other disposition and thus the term is of broader import. Furthermore as a “donation, settlement or other disposition” is required, these provisions are only applicable to *inter vivos* trusts and not to *mortis causa* trusts where such requirement is not met.²²⁴

It has been said in the introductory paragraph, that these sections are anti-avoidance provisions, and their underlying purpose is aptly explained by Corbett JA in *Estate Dempers v SIR*²²⁵ where he discusses section 9 of the SWA Ordinance (equivalent to the current section 7) –

“Generally speaking, a taxpayer is perfectly entitled to reduce the amount of his income and thereby the income tax payable by giving away income producing assets owned by him [see *CIR v King* 1947(2) SA 196 (AD) 108]. In section 9 of the Ordinance, however, certain limitations are placed upon the right to avoid in this way liability for the payment of tax. One is that a taxpayer cannot avoid such liability if he makes his minor child the beneficiary of the income to be derived from the assets so donated; nor can he avoid liability by achieving this in an indirect manner through the instrumentality of a third party....”²²⁶

So too, does Silke explain the application of this section in the context of trusts -

²²² It must be noted that s7 is not exclusively applicable to trusts but for purposes of the discussion here is only considered in this context. Olivier et al *Trust Law and Practice* (November 2011) at 7-16.

²²³ Olivier et al *Trust Law and Practice* (November 2011) at 7-16.

²²⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 133. Du Toit submits a possible exception to this statement, namely S 7(4) which could find application after the death of the disponer.

²²⁵ 1977 (3) SA 410 (A).

²²⁶ As quoted in Olivier et al *Trust Law and Practice* (November 2011) at 7-16.

“But the trust vehicle, particularly a discretionary trust, lends itself to various tax avoidance stratagems, thereby enabling a taxpayer to minimise his liability to income tax by disposing of income-producing property to trustees, while giving beneficial entitlement to other persons, usually a spouse or child. At the same time, effective control over the assets remains with the trustees. The scheme of the Act accordingly contains various statutory anti-avoidance rules, which provide that income that is the subject of a trust will in certain circumstances not be taxed in the hands of the trustee or of any beneficiary, but in the hands of the donor or creator of the trust.”²²⁷

This anti-avoidance goal is particularly achieved through the relevant sections whereby income and capital gains, which have resulted from a “donation, settlement or other disposition”, or “any transaction, operation or scheme, made or entered into mainly for purposes of reducing, postponing or avoiding the liability for tax, duty or levy which would otherwise have been payable”, is attributed to the person who made the disposition.

Section 7(1) provides that income shall be deemed to have accrued to a person, notwithstanding the fact that such income has been invested, accumulated or otherwise capitalised by such person or that such income has not been actually been paid over to such person, but remains due and payable to such person, or has been credited in account, or reinvested, or accumulated, or capitalised, or otherwise dealt with in his name or on his behalf.²²⁸ In the context of trusts, income which is retained in the trust for investment²²⁹, accumulation or capitalisation on behalf of beneficiaries who enjoy vested rights to such income, will be deemed to have accrued to such beneficiaries and will be taxable in their hands.²³⁰ Pace & Van der Westhuizen summarizes this section by stating that it will be applicable, where a trust beneficiary has a vested right to the income, that is the beneficiary is certain to get the income at some time in the future, only his enjoyment of it has been postponed.²³¹

The further subsections all refer to a “donation, settlement or other disposition”, which must be present for these sections to be applicable. Du Toit explains that the term “donation” and “settlement” are interpreted as disposition, involving at least an appreciable element of liberality or generosity and gives the examples of a direct donation, or a sale of an asset at a price below its market value on the date of sale.²³² The term “disposition” is further interpreted *eiusdem generis*

²²⁷ De Koker et al *Silke on South African Income Tax* available electronically on LexisNexis at 12.19.

²²⁸ S7(1).

²²⁹ For example in *CIR v Polonsky* 1942 TPD 249 income to which a beneficiary had a vested right but which had not been paid to him but instead invested was held to have accrued to him and thus be taxable in his hands.

²³⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 134.

²³¹ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.5.1 at 82.

²³² Du Toit F *South African Trust Law Principles and Practice* (2002) at 134.

with the first two concepts.²³³ Geach consequently notes that these sections will not be applicable where there was a commercial arms-length transaction or a transaction, that was entered into to extinguish a commercial or legal obligation.²³⁴ Section 7(9) was introduced on 1 January 2001 and provides that, where any asset has been disposed of for a consideration which is less than the market value of such asset, the amount by which the market value exceeds such consideration, shall be deemed a donation for the purpose of section 7. It must lastly be noted that the donation, settlement or other disposition must be causally related to the income derived therefrom.²³⁵

Sections 7(2) –7(4) is aimed at income splitting between members of a family unit. In terms of section 7(2), any income which has been received by, or which has accrued to a person in consequence of a donation, settlement or other disposition made by such person's spouse, will be taxable in the hands of the donor spouse, should the sole or main purpose of such donation, settlement or other disposition, either in itself or as part of a transaction, operation or scheme, have the purpose of reducing, postponing or avoiding the donor's liability for any tax, levy or duty under the Income Tax Act.²³⁶ The anti-avoidance objective of this section is thus, to prevent spouses from splitting income between them, so as to take advantage of their separate taxation and thereby reduce their combined tax liability.²³⁷ Honiball & Olivier give as example of the potential application of this section, a situation where a spouse donates income generating assets to a trust, of which his or her spouse has vested rights to the income of the trust, and thus should the sole or main purpose be the reduction of the tax liability, this provision may be invoked to tax the income in the donor spouse's hands.²³⁸

Section 7(3) has the effect, that income will be deemed to have been received by the parent of a minor child²³⁹ and will be taxable in his/her hands, if, in consequence of a donation, settlement or other disposition made by such minor child's parent, income is received by or has accrued to a

²³³ *Ovenstone v SIR* 1980 2 SA 721 (A). Also *Joss v SIR* 1980 1 SA 674 (T) where it was held that "other disposition" does not include transactions made for full value in money or money's worth and that there had to be an element of liberality. For a detailed discussion of the meaning of these terms as expounded by case law see Olivier et al *Trust Law and Practice* (November 2011) at 7-20.

²³⁴ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 245.

²³⁵ Du Toit F *South African Trust Law Principles and Practice* (2002) at 134.

²³⁶ S7(2)

²³⁷ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 84; Du Toit F *South African Trust Law Principles and Practice* (2002) at 135.

²³⁸ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 84.

²³⁹ Olivier notes that minority is not defined but will bear its usual meaning and thus refer to a person younger than 18. The term "child" is defined in s1 of the Act and includes legally adopted children, but not stepchildren nor grandchildren. Olivier et al *Trust Law and Practice* (November 2011) at 7-22.

minor child, or has been accumulated for the maintenance, education or benefit of such child. The anti-avoidance objective of this section is thus to prevent splitting between a parent and minor child in order to take advantage of the child's lower tax rate.²⁴⁰ In a trust setting, this provision could be applicable where a parent set up a trust for the benefit of his/her minor children, with the income resulting from the trust assets, being taxed in the hands of the parent and not in the trust nor the minor beneficiaries.²⁴¹ Section 7(4) is aimed at curtailing the circumvention of section 7(3) through the intervention of a third party.²⁴² Fundamentally this section renders income which has been received by, or which has accrued to a minor child in consequence of a donation, settlement or other disposition made by another person, taxable in the hands of such child's parent if the parent or his spouse has in turn made a donation, settlement or other disposition, or has given some consideration, whether directly or indirectly, in favour of the donor or his family.²⁴³ Essential to this section is an element of reciprocity, but the value of such reciprocal dispositions need not be equal in value.²⁴⁴ Also important is a causal connection between the disposition by the taxpayer to the other person and the disposition by the other person, which leads to the income for the children.²⁴⁵

In respect of capital gains, paragraphs 68 and 69 of the Eighth Schedule, contain the corresponding attribution rules to the aforesaid sections. In terms of paragraph 68, the capital gain of one spouse may in the circumstances set out therein be attributed to be that of the other spouse, whilst in terms of paragraph 69, the capital gain of a child can be attributed to the child's parent. To avoid duplication, due to their similarity to the income tax provisions, these provisions are not elaborated here further.

A very important section in the context of trusts is section 7(5), which will be applicable to a donation, settlement or other disposition where such donation, settlement or other disposition is subject to a stipulation or condition, whether made or imposed by the donor thereof or anybody else, to the effect that some or all of the beneficiaries shall only receive the income or a portion of the income upon the happening of some event, whether the event be fixed (certain) or contingent in nature.²⁴⁶ In such a situation, this section provides that so much of the income that would, but

²⁴⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 135.

²⁴¹ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 85.

²⁴² Du Toit F *South African Trust Law Principles and Practice* (2002) at 135. Olivier et al *Trust Law and Practice* (November 2011) at 7-23.

²⁴³ S7(4)

²⁴⁴ Olivier et al *Trust Law and Practice* (November 2011) at 7-23.

²⁴⁵ *COT v Paice* 25 SATC 385 at 388.

²⁴⁶ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 85.

for the stipulation or condition, have accrued to the said beneficiaries, will, until the happening of the event or death of the donor, whichever occurs first, be deemed to be income in the hands of the donor and thus be taxable. Critical to this section, is that the income does not vest in the beneficiaries, until the happening of some event. Geach notes the following as potential events: the death of a person, the attainment of a certain age, the conclusion of a marriage or in his view, the exercise by trustees of their discretion.²⁴⁷ This latter view is endorsed by Du Toit, who gives the practical example of a founder who has as made a donation towards the creation of a trust, of which the trust deed provides that the trust's beneficiaries are entitled to trust benefits only upon the exercise of a discretionary power in their favour by the trust's trustees, and thus by application of this section, all income on the initial donation will be taxable in the hands of the founder.²⁴⁸ But in the event that the trustees should exercise the discretion, and income originating from the initial donation is awarded to beneficiaries in the year of assessment, an event as envisaged by section 7(5) will have occurred and the distribution will be taxable in the hands of the beneficiaries in terms of section 25B, subject thereto that no other subsection of section 7 is applicable (which may dictate that someone other than the beneficiaries is to be taxed on such rewards.)²⁴⁹ Thus the section is only applicable to retained income. Such income that is not awarded will be deemed in this section to be taxable in the hands of the donor.²⁵⁰ Income that is deemed in terms of this section to be that of the donor, and consequently taxed, will not be liable again for taxation in the hands of the beneficiaries when it is later distributed to them.²⁵¹

In the context of capital gains, paragraph 70 contains corresponding provisions to this section and determines, that where a person has made a disposition which is subject to a stipulation or condition, that the gain shall not vest in the beneficiaries of such disposition until the happening of some fixed or contingent event, the gain is attributed to the person who made the donation, settlement or disposition.²⁵²

²⁴⁷ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 248. The author notes however that this view is not accepted by all.

²⁴⁸ Du Toit F *South African Trust Law Principles and Practice* (2002) at 136. Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.5.4 at 83.

²⁴⁹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 136.

²⁵⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 136. Also it is important to note that the donor's liability is capped at returns on his initial donation and all further returns which result from the trustee's management is not taxable in his hands but possibly in the hands of the trust itself.

²⁵¹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 249.

²⁵² Du Toit F *South African Trust Law Principles and Practice* (2002) at 161.

In terms of Section 7(6) if any deed of donation, settlement or other disposition contains any stipulation, that the right to receive any income thereby conferred may, under the powers retained by the person by whom the right is conferred, be revoked or conferred upon another, so much of any income as is the consequence of the donation, settlement or other disposition received by or accrues in favour of the person on whom the right is conferred, will be deemed to be the income of the conferrer of the right, so long as he retains those powers. In a trust setting, this section will consequently be applicable, if a person makes a donation to a trust and retains the powers to vary or change the beneficiaries who are entitled to receive income resulting from that donation, with the result that the income will be deemed to be that of the donor as long as he possesses such powers.²⁵³ The objective of this section is to combat tax avoidance schemes, whereby the founder on an annual basis, selects in whose hands the trust income will be taxed.²⁵⁴ It is important to note that for purposes of this section, the person need not actually exercise the powers, the mere capacity to do so is sufficient.²⁵⁵ However, also important is that this section will not be applicable where the powers to revoke, or to confer a benefit on another, cannot be exercised singularly by the donor, but requires the cooperation of others, for example where the trust instrument requires all trustees to unanimously exercise these powers.²⁵⁶

Paragraph 71 in the Eight Schedule offers similar directions in the context of capital gains and attributes the gain to the person retaining the powers of revocation.

Section 7(7) provides that a cession by a donor of the income from an asset, subject to the retention of ownership in the asset concerned, or the retention of a right in such asset, or the retention of a right to retrieve such asset in future, renders the income derived from the asset taxable in the hands of the donor.²⁵⁷ The objective of this section is to discourage arrangements, whereby a person would cede the right to income before the accrual thereof, so to lower his or her taxable income without foregoing control over the income or investment. According to Du Toit, it is particularly geared at combating schemes in terms of which a right to income is ceded to another for a limited period in order to impose tax liability on the cessionary and ensure concomitant tax

²⁵³ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 249.

²⁵⁴ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 85.

²⁵⁵ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 249; Du Toit F *South African Trust Law Principles and Practice* (2002) at 136.

²⁵⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 137.

²⁵⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 137.

relief for the cedent.²⁵⁸ In a trust setting, the provisions of this section would be applicable, where a trust engages in such a cession of where an individual cedes income to the trust.²⁵⁹

Section 7(8) is applicable where income is received by or accrues to a non-resident of the Republic (other than a controlled foreign entity as defined in section 9D) in consequence of a donation, settlement or other disposition (other than a donation, settlement or other disposition to a foreign entity of a public character as defined in section 9D) by a resident of the Republic, and renders such income taxable in the hands of such resident, to the extent that so much of the amount of the income can be attributed to such donation, settlement or other disposition. Davis notes that the section was inserted in the Act, due to the change by South Africa to a world-wide residence basis system of taxation and aims to counter the avoidance of tax where a South African taxpayer shift income into the hands of non-residents, in particular non-residents trusts.²⁶⁰ Consequently a practical example in the context of trusts, would be a resident taxpayer who establishes a non-resident trust and makes a donation to the trust. Any income which accrues in respect of this donation will be attributed to the resident taxpayer.²⁶¹

The corresponding provision to this section in the Eight Schedule is Paragraph 72 which requires that where a resident has made a donation, settlement or other disposition to any person (other than a public benefit organisation or a foreign entity of a similar nature), and a capital gain arises attributable to this donation, then the capital gains must be disregarded in the person in whom it vest and is instead attributed to the resident who made the disposition.

4 4 Conclusion

Reflecting upon the above attribution rules, Olivier warns that it “constitutes a minefield for the unenlightened and can easily convert a dream of tax saving into a nightmare.”²⁶² It is however hoped that the discussion above has given the necessary illumination on these rules, as well as the taxation framework applicable in South Africa to trusts in general. It has aimed to edify such features and principles most relevant to the study at hand. In particular this chapter has shown that

- (a) The trust through its statutory inclusion as a “person” in terms of the Income Tax Act,

²⁵⁸ Du Toit F *South African Trust Law Principles and Practice* (2002) at 137.

²⁵⁹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 93.

²⁶⁰ Davis et al *Estate Planning* (May 2013) at 6-22. Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.4.5 at 81

²⁶¹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 145.

²⁶² Olivier et al *Trust Law and Practice* (November 2011) at 7-4.

constitutes a taxable entity upon which taxes may be levied, and which further, and importantly to the study at hand, be a “resident” of a particular country.

- (b) That the Income Tax Act, through the definition of the terms “trust” and “trustee,” establishes a wider catchment area to not only include trusts complying with the definition of the local Trust Property Control Act, thus including *inter vivos* and *mortis causa* trusts, discretionary and *bewind* trusts, but also other entities, including oral trusts as well as foreign entities, that may not traditionally be perceived as trusts, yet nevertheless be regarded as such for purposes of the Income Tax Act. So too may it include trusts which are not regarded as valid trusts in terms of trust law, who fall short of the required *essentialia* or offend public policy, yet still constitute a 'trust fund administered or controlled by a person acting in a fiduciary capacity' and thus constitute a 'trust' as defined in Section 1.
- (c) That the requirement in the definition of a 'trust' that the person must administer and control the fund in a 'fiduciary capacity' may however set restrictions on how far-reaching the definition can be applied. Whether a 'trust' will fall foul of this implicit criteria, will depend on whether a narrow or wide interpretation of this phrase will be followed, and is much conditional upon the particular facts of the matter.
- (d) That the definition contained in the Act for a 'trust' requires refinement in respect of its drafting to eliminate certain inconsistencies. Specifically it should as per the definition of a 'trustee' also include a reference to trusts created by court order or operation of law, ie statute. It should also describe the trust fund in terms of both assets *and* liabilities, as per the common law understanding of a trust, which is more practical and in line with the Act's further provisions.
- (e) That as a taxable entity distinct from the parties to it, taxes may be imposed upon it. The imposition and extent of this tax liability is however fundamentally impacted by whether the trust is resident or non-resident. The specific rules and provisions relevant to a resident as well as non-resident trust have been discussed above. It is therefore of the utmost importance to establish whether the trust is “resident” in our tax jurisdiction or not, so as to determine the appropriate tax provisions applicable and the ensuing tax liability.
- (f) The extent of this tax liability is further affected by the fact, that the trust can act as a conduit in which income and capital gains can flow through the trust, and the tax liability follows through to the hands of the recipient who receive same (unless an attribution rule

determines otherwise). The statutory framework and rules regulating which of the parties will bear the tax liability have therefore been discussed and analysed. Such a discussion has again showcased the importance of the residence of the trust, as the latter has a profound impact on which rules are applicable and the eventual tax liability.

- (g) The proposed reforms as announced in the 2013 Budget Speech have been discussed and whilst these are still in infant form, their anticipated consequences on accepted and fundamental principles of the taxation of trusts have been considered.

Against this background, the next chapter therefore addresses the determination of the “residence” of the trust under the South African Income Tax Framework.

CHAPTER FIVE:**THE “RESIDENCE” OF TRUSTS UNDER THE SOUTH AFRICAN INCOME TAX FRAMEWORK:
“INCORPORATED, ESTABLISHED OR FORMED IN THE REPUBLIC”****5 1 Introduction**

Reflecting on trusts and particularly their taxation, Hausman appropriately remarks:¹

“For centuries the trust has been observed by jurists from outside the common law world with fascination, bewilderment and sometimes envy. The trust concept has served the tax planner well... Needless to say, the trust has been a particular source of frustration to the tax collector.”

In this chapter, this potential source of frustration and aggravation for the tax collector, the trust and in particular, the basis for its taxation, is considered from a South African vantage. In South Africa, since 2001, the basis for taxation of is primarily “residence” based.² Consequently it is the “residence” of a trust, as determined under the South African income tax framework that will be investigated here.

The structure of the chapter is as follows: it commences by reviewing the basis for taxation in South Africa. Thus the residence principle is discussed and the justification for the utilization of this principle traversed. Thereafter, the current rules for determining the residence of a trust under the South African Income Tax framework are discussed. The test in the Act comprises two criteria posed in the alternative: “incorporated, established or formed in the Republic” or “place of effective management in the Republic.” The former has been described as “a formal or *de iure* test”, more objective and certain in its application, whilst the latter has been described as a “less mechanistic, factual” measure to determine residence.³ The focus in this chapter is on the first, whilst the next chapter addresses the latter criteria.

¹ Hausman, JS “The Taxation of Trust and Beneficiaries of Trusts under the Canadian Income Tax Act” 1988 *Int'l Bus. L.J.* 935. Trusts have similarly been a thorn in the flesh of the South African Revenue Services - The Chief Policy director at Treasury, Prof Keith Engel has stated that “it is well known that Treasury and SARS have long disliked Trusts” – see Duncan, A ““The Hold Your Breath Budget” – available at http://www.walkers.co.za/index.php?option=com_content&view=article&id=247:the-hold-your-breath-budget&catid=26:financial-surveillance&Itemid=56. See also Van Gijzen, F “Where did the Trust Go?” Available at <http://www.accountancysa.org.za/resources/ShowItemArticle.asp?ArticleId=2626&Issue=1125>; Last accessed 05/05/2013.

² See Chapter 1 at footnote 4 where it was explained that South Africa applies a “residence minus” system – this is discussed further in this chapter.

³ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 121; Wesson N “Die Effek van die Internet op die Inwonerbeginsel, soos gedefinieer in Inkomstebelastingwet Nr. 58 van 1962.” 2002 (10) *Meditari Accountancy Research* at 244.

5 2 The basis of taxation in South Africa

It is accepted that every state has the right to choose the basis on which it will levy taxes (its tax base),⁴ as the right to tax after all forms part of a state's sovereign powers.⁵ Whilst in theory a state may therefore attempt to frame its taxation basis as wide as possible, practically, requirements of efficiency and enforceability will act as temperance in such endeavours.⁶ According to Danziger⁷ it is particularly this requirement of effectiveness, which causes states to levy taxes upon tax subjects (taxpayers) and tax objects (assets), only to the extent there is a link or connection which justifies the taxing of the tax subject or object in question. Whether such a connection exists between the income and the state, is a "fundamental question" in determining whether income is taxable in a particular country.⁸

These principles have been recognised locally. In the case of *Kergeulen Sealing and Whaling Co Ltd v CIR*,⁹ two possible connecting factors as the basis for taxation were identified – "source" and "residence."¹⁰ When "source" is used as a connecting factor, a connection arises when the activities that generated the income took place within the jurisdiction of the relevant state.¹¹ The justification for this basis of taxation is proposed by the court, as being that "a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live."¹² Olivier & Honiball explain it in practical terms, that a taxpayer "can be expected to share the costs of the infrastructure and the running of the country which makes possible the production of the income, its maintenance and investment, and its use through consumption."¹³

⁴ De Koker, A P *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 1 at 1.2 available electronically on LexisNexis.

⁵ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 1& 10 – The principle of sovereignty denotes that a nation has sole jurisdiction over its territory and/or subjects; Danziger *International Income Tax The South African Perspective* (1991) at 4.

⁶ De Koker, A P *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 1 at 1.2 available electronically on LexisNexis

⁷ Danziger E *International Income Tax The South African Perspective* (1991) at 4.

⁸ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 9.

⁹ 1939 AD 487 at 507.

¹⁰ These factors are not the only connecting factors– for example the USA imposes taxes on the basis of citizenship - Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 15.

¹¹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 11. The authors note that is also referred to as the territorial system of taxation and is currently applied in Hong Kong, Denmark and France.

¹² *Kergeulen Sealing and Whaling Co Ltd v CIR* 1939 AD 487 at 507.

¹³ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 9 & 19 – This is also referred to as a world-wide basis of taxation and is currently utilized in the United Kingdom, Canada, Germany, Belgium and Italy.

In contrast, where “residence” forms the basis for taxation, the connecting factor between the state and the taxpayer is based on the residence of the taxpayer within its jurisdiction, regardless of where the income is earned.¹⁴ In the aforesaid case the court offered a rationale for the application of this taxation basis, “a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him.”¹⁵

South Africa has in the history of its income tax applied both these bases for taxation. Until 2001, a primarily “source” basis of taxation was applied, thus income sourced within South Africa was subject to tax.¹⁶ Danziger traces the history of the source basis of taxation to 1904, in the Additional Taxation Act (Cape).¹⁷ This Act was the first Income Tax Act in South Africa.¹⁸ The adoption of the source basis of taxation was carried through the statute books of the Union of South Africa and even beyond South African’s attainment of Republican status.¹⁹ Its retention as basis for taxation was the focus of all four the fiscal commissions.

The 1951 Committee of Enquiry into the Income Tax Act (The Steyn Committee) acknowledged that the submissions received advocated preservation of source as the basis for taxation, but expressed the concern that persons who derived income from outside South Africa could reside within South Africa and enjoy the protection of the state without contributing to the states’ coffers.²⁰

The 1971 Commission of Enquiry into the Fiscal and Monetary Policy in South Africa (The Franzsen Commission) recommended a change-over to the residence basis finding that the “source-basis can no longer be reconciled with the economic interest of the Republic, especially in view of ever-growing international commerce and the realities of international tax arrangements.”²¹ Whilst this recommendation was accepted in principle by the Minister of Finance in 1971,²² it was not

¹⁴ De Koker, A P & A Lewis (*Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 2 at 2.1 available electronically on LexisNexis.

¹⁵ 1939 AD 487 at 507.

¹⁶ Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.24, available electronically on LexisNexis.

¹⁷ Danziger E *International Income Tax The South African Perspective* (1991) at 13. Particularly section 42 of that Act which defined “income” as “any gains or profits derived or received... from any source within this Colony.”

¹⁸ Meyerowitz D *Meyerowitz on Income Tax (2007-2008)* at par 2-1.

¹⁹ Danziger E *International Income Tax The South African Perspective* (1991) at 13.

²⁰ Danziger E *International Income Tax The South African Perspective* (1991) at 13.

²¹ The Franzsen Commission as quoted in Danziger E *International Income Tax The South African Perspective* (1991) at 14.

²² Danziger E *International Income Tax The South African Perspective* (1991) at 15.

executed at the time and would only be realized three decades later.

The 1986/1987 Commission of Enquiry into the Tax Structure of the Republic of South Africa (the Margo Commission) considered the benefits of a change to a residence based system as well as the retention of the source based system and recommended the latter, finding that the disruption arising from a change would not be justified by the potential benefits.²³

The first sign of possible change to come was in 1997 with the introduction of Section 9C which sought to tax residents on investment income (“passive income” such as annuities, interests, rental or royalty incomes and the like) from foreign sources.²⁴ This followed the submission of the Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa under the Chairmanship of Mr MM Katz.²⁵ This Report specifically reviewed the basis of the South African Income Tax System, in light of both the source and residence principle, and presented recommendations for reform.²⁶ In particular, the Commission drew a distinction between active income and passive income. In respect of the former, the Commission concluded that the administrative complexities militate against the change over from a source to a residence basis for taxation of active income.²⁷ In respect of passive income, it encouraged that such income should be taxed on a worldwide basis, which recommendation²⁸ was given effect to by the 1997 amendment.

In the Budget Speech of 2000, it was however announced that an all-out move to a residence-based system of taxation, with effect for the tax years commencing after 1 January 2001.²⁹ The then Minister of Finance, Trevor Manuel explained the motivating causes –

“Our tax system is currently based on the source principle. This is increasingly out of line with international practice and inappropriate for the circumstances of the South African economy. It creates considerable scope for tax structuring as taxpayers find ways to change income that would normally be taxed in South Africa into untaxed ‘foreign source’ income. The increased globalisation of our economy also creates opportunities for taxpayers to avoid tax by routing

²³ As per the Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa.

²⁴ Meyerowitz D Meyerowitz *on Income Tax (2007-2008)* at par 2-2.

²⁵ Available at <http://www.polity.org.za/polity/govdocs/commissions/katz-5.html> - last accessed on 05/05/2013.

²⁶ See the Executive Summary of the Report.

²⁷ See the Executive Summary of the Report as read with Chapter 9 of the Report.

²⁸ Chapter 9 of the Report.

²⁹ Manuel, T, Minister of Finance in the 2001 Budget Speech delivered on 21 February 2001 – Available at <http://www.treasury.gov.za/documents/national%20budget/2000/default.aspx> - last accessed on 05/05/2013.

transactions through countries with low or zero tax rates; or countries with generous tax incentives, such as tax holidays. “

This was echoed by Honiball who in an article prior to the changeover stated as follows³⁰ –

“...taxing on the basis of source is hopelessly inadequate in a global, electronic world. Countries that tax on this basis will lose out most in globalization because it’s becoming more difficult to determine source and it’s getting easier to shift the source.”

It was further stated that the changeover would have the following beneficial results: it would significantly broaden South African’s tax base, it would limit the opportunities for tax arbitrage and lastly, would bring South Africa’s tax system in line with international best practice.³¹ In essence its implementation was deemed necessary so that South Africa keeps pace with globalisation and to facilitate the integration of South Africa with the world economy.³² On a practical level, it simplifies the administration of taxes, as South Africa’s tax collector need only investigate and ascertain the “residence” of the person and/or entity, as opposed to examining each and every transaction to determine the location of the source its incomes derives from.³³

From 2001, South Africa therefore introduced a primarily residence basis of taxation. Thus it taxes South African tax residents on their worldwide income. The taxation base is sometimes referred to as a “residence minus” system, as whilst it taxes resident taxpayers on their worldwide income, certain specific categories of income and activities undertaken outside the Republic of South Africa is exempted from taxation.³⁴ The source basis of taxation however remains relevant: non-residents may be taxed on their receipts and accruals of income from sources in, or deemed to be within the South Africa.³⁵ South Africa is not unique in this respect, as most countries do not apply a particular basis to the exclusion of all influences and aspects of the other basis, it being generally accepted that states who have a residence basis of taxation will also tax non-residents on a source basis.³⁶

³⁰ M Honiball quoted in an article by McLeod, D “When Countries Lose The Power To Tax” Future Company (11 August 2000) at 8.

³¹ Available at www.treasury.gov.za/documents%20budget/default.aspx- last accessed on 05/05/2013, at 19.

³² Trevor Manuel, Minister of Finance in the 2001 Budget Speech delivered on 21 February 2001 – available at <http://www.treasury.gov.za/documents/national%20budget/2001/default.aspx> , last accessed on 05/05/2013.

³³ Goosen, C “International Tax Planning: The concept of Place of Effective Management” research dissertation submitted to the University of Cape Town on 15 February 2006 at 5.

³⁴ De Koker, A P & Williams, R C *Silke on South African Income Tax* at 5.1 available electronically on LexisNexis.

³⁵ S1 of the Act – see definition of “gross income”

³⁶ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 10 & 11. The authors note that the converse is also true – countries which impose source based taxation will attempt to

The Fifth Report of the Katz Commission summed it up: “nowhere in the world are either of these systems applied with any degree of purity.”³⁷

The legislative foundation to the change-over was *inter alia*, facilitated by an amendment to the definition of “gross income” in the Income Tax Act, so that in the case of “any *resident*, gross income denotes the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; alternatively in the case of “any person *other than a resident*, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic...”³⁸ The significance of the distinction between residents and non-residents is apparent from this definition.

In a fundamentally residence-based system of taxation, the term “resident” is therefore of crucial importance, and it is to this aspect we now turn.

5 3 Defining the term “resident”

As can be inferred from the above discussion, for the first 87 years of its existence, there was no definition for the term “resident” in the South African income tax legislation.³⁹ The term “resident” however was not completely unknown in the South African fiscal landscape at the time of its introduction. Prior to the change in the basis of taxation, “resident” was regarded as the most important secondary connecting factor and was of significance in the deemed source provisions of the Act.⁴⁰ Albeit there was no statutory definition in the income tax legislation at that time, the term had been considered by the courts and such case law was available for guidance.⁴¹

widen their tax base by also deeming income received outside their borders to be from a domestic source – this is known as the “source plus” system.

³⁷ Katz Commission “Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa” (7 March 1997) available at <http://www.polity.org.za/polity/govdocs/commissions/katz-5.html> - last accessed on 05/05/2013.

³⁸ S1 of the Act.

³⁹ Clegg, D & Stretch, R *Income Tax in South Africa* (Last updated March 2011) at 8.3 available electronically on LexisNexis.

⁴⁰ Danzinger E *International Income Tax The South African Perspective* (1991) at 33; See also Mazansky E “Residence blurs South African Rules” *International Tax Review* (June 1995) at 31 – “there are a number of types of income... which although taxable by virtue of deemed source provisions, in reality are taxable by virtue of the recipient’s residence in South Africa. As a result... South Africa has , in effect, a hybrid system. Under this the dominant connecting factors is source, but there are also a number of important areas where residence is the connecting factor.”

⁴¹ Mazansky E “Residence blurs South African Rules” *International Tax Review* (June 1995) at 33 states that “there are a few cases in South African law on the issue of residence of companies”; Danzinger E *International Income Tax The South African Perspective* (1991) at 33; *Rhodesia Railways and Others v*

Yet in relation to trusts, such judicial consideration appears to have been but a singular event.⁴² In the words of one author at the time, “rules for determining the residence of trusts have yet to be laid down by South African courts”,⁴³ whilst another commented that “it is here that South African law is most lacking, particularly in relation to trusts.”⁴⁴ Several options as to the meaning of “resident” in the context of trusts were advanced by commentators: “the country under whose laws the trust was established, the country in which the founder of the trust, the trustee and their beneficiaries or any of them were resident, the country in which the trust is administered and the country in which the trust assets are situated.”⁴⁵ The most preferred view was to have regard to the trust’s administration, and by analogy to the residence of companies, look to its management and control.⁴⁶ On this basis it is to be concluded that in the context of trusts, at that juncture, there was no unequivocally accepted definition for the term “resident” in the Income Tax Act, or conclusive judicial precedent.

It was therefore only upon the introduction of the residence basis of taxation, that a formal definition was inserted into the Act.⁴⁷ This statutory definition provides that “resident” means⁴⁸-

- (a) in relation to natural persons, a person who is
- ordinarily resident in the Republic; or
 - not ordinarily resident in the Republic, but physically present physically present for more than 91 days in the year concerned and physically present for an aggregate of more than 915 days in the preceding five years, including a minimum period of more than 91 days in each of those preceding years, subject to certain provisos.
- (b) in relation to persons (other than a natural person) which is
- incorporated, established or formed in the Republic; or

COT 1925 AD 439; Estate Kootcher v CIR 1941 AD 256; Boyd v CIR 1951 3 SA 525 (A); ITC 1054 26 SATC 260 (1964).

⁴² *Nathan’s Estate v CIR 1948 3 SA 866(N)* is often quoted as a trust example – it concerned the liability of a deceased estate held upon administration. A further example is *CIR v JW Jagger & Co Ltd 1945 CDP 331* which is regarded as authority that a trust has the capacity to have residence status per Danzinger E *International Income Tax The South African Perspective* (1991) at 51.

⁴³ Danzinger E *International Income Tax The South African Perspective* (1991) at 50.

⁴⁴ Mazansky E “Residence blurs South African Rules” *International Tax Review* (June 1995) at 33

⁴⁵ Danzinger E *International Income Tax The South African Perspective* (1991) at 50.

⁴⁶ Mazansky E “Residence blurs South African Rules” *International Tax Review* (June 1995) at 33

⁴⁷ Clegg, D & Stretch, R *Income Tax in South Africa* (Last updated March 2011) at 8.3.2 available electronically on LexisNexis.

⁴⁸ S1 of the Act. The Taxation Laws Amendment Act, 22 of 2012 assented to on 30 January 2013 amended the definition.

- which has its place of effective management in the Republic.

Trusts have not been specifically mentioned in the definition. As the discussion at paragraph 4 2 2 above indicated, a trust is however recognized as “person” for income tax purposes⁴⁹ and thus the definition will be applicable. As a trust is clearly not a natural person, it falls into the later category as “persons (other than a natural person)” and will be resident if compliant with the criteria set out in the definition. Based on this definition, a trust is therefore regarded as “resident” in South Africa should it be

- incorporated in the Republic,⁵⁰ or
- established in the Republic, or
- formed in the Republic,

alternatively

- have its place of effective management in the Republic
and is not deemed exclusively resident of another country for purposes of a double taxation agreement.⁵¹

Viewed from this perspective, it would appear that the definition of resident is broadly framed as the requirements are all stated in the alternative, in other words (leaving aside the proviso regarding double tax agreements), these requirements do not have to be present in conjunction with each other, but the presence of one such requirement is sufficient for residence to be established.⁵²

The definition for fiscal residence can therefore be said to comprise mainly two alternative tests.⁵³ A trust, if established or formed in South Africa will be regarded as resident, regardless of where it

⁴⁹ See the discussion above at paragraph 4 2 2 – following the case of *Friedman and Others NNO v CIR: In re Phillip Frame Will Trust v CIR* 1991 (2) SA 340 (W), the Income Tax Act was amended to include in its definition of “person” in Section 1 of the Act “any trust.”

⁵⁰ Technically this is not possible in the context of trust – see discussion below.

⁵¹ The Taxation Laws Amendment Act, 22 of 2012 introduced a further exemption in relation to companies, providing that companies established outside SA, but having their place of effective management inside SA, will not be included as resident provided that they meet the further requirements set out in the subsections and in particular, have a foreign business establishment and their aggregate amount of tax payable to a government of any country outside SA is at least 75 per cent of the amount of normal tax payable had it been resident. The Act also introduced two further proviso’s which is discussed in Chapter 6.

⁵² Huxham K and Haupt P *Notes on South African Income Tax 2011* at 27.

⁵³ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA Merc LJ at 329.

is, or becomes effectively managed (again leaving aside the proviso regarding double tax agreements). Conversely, a trust not established or formed here will only be regarded as resident if, and for the time being, it is effectively managed in South Africa.⁵⁴

It is therefore entirely possible that especially upon the application of the latter criteria, a foreign trust could potentially be tax resident in South Africa, should it be effectively managed in South Africa for a particular tax year. However the *caveat* must also be remembered, the definition expressly states that it does not include “any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation.”⁵⁵ The purpose of this proviso is said to avoid anomalies upon the treatment of an entity as dual resident.⁵⁶

With effect from 1 January 2013, further provisions were inserted to the definition of “resident” in Section 1 of the Act, as was stated in Chapter 1 of this study.⁵⁷ These amendments form part of government’s “Financial Centre of Africa initiatives” and is aimed at enhancing South Africa as a regional financial centre and port to the rest of Africa.⁵⁸ The stated objectives of these initiatives are to provide relief from double taxation and to facilitate expansion, global competitiveness as well as to eliminate perceived barriers.⁵⁹ Essentially the amendments seek to provide relief to high taxed controlled foreign companies, as well as to foreign investment funds (which are often housed in trusts), which utilise a South African local investment manager. For both these entities, it is a fundamental requirement that they be incorporated, established or formed *outside* the Republic in order for the relief to be available. In relation to the former, the relief is granted by specifically excluding such companies from being regarded as resident.⁶⁰ In relation to the latter, this has been

⁵⁴ De Koker, A P & Williams, R C *Silke on South African Income Tax* at 5.2E available electronically on LexisNexis.

⁵⁵ S1 of the Act - definition of “resident.”

⁵⁶ Clegg, D & Stretch, R *Income Tax in South Africa* (Last updated March 2011) at 8.3.2 available electronically on LexisNexis.

⁵⁷ The Taxation Laws Amendment Act, 22 of 2012 – in particular, section 2(w),(x) and (y). See Chapter 1, paragraph 1 2 above.

⁵⁸ National Treasury *Media Statement: Taxation Laws Amendment Bills, 2012: General Overview* issued on 5 July 2012 at page 4.

⁵⁹ National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* issued on 29 June 2012 at par 5.8 and 5.12.

⁶⁰ See Section 1(b) where it is stated that a resident “does not include any company if— (AA) that company is incorporated, established or formed in a country other than the Republic; (BB) that company has its place of effective management in the Republic; (CC) that company would, but for the company having its place of effective management in the Republic, be a controlled foreign company with a foreign business establishment as defined in section 9D(1); and (DD) the aggregate

achieved by inserting a specific definition of “foreign investment entities” to the Act and by then creating a particular carve-out from the place of effective management test in relation to them. Thus the proviso now inserted, dictates that when the place of effective management is determined for a foreign investment entity, no regard may be had to an activity which constitutes a financial service (as defined specifically in the Financial Advisory and Intermediary Services, Act 37 of 2002),⁶¹ or any service incidental thereto, should the service be in relation to a financial product exempted from the provisions of that Act,⁶² and is carried on by a financial service provider in terms of a license issued to it in terms of the Financial Advisory and Intermediary Services Act.⁶³ Consequently should it be established that the trust is a foreign investment entity and it be confirmed that it was “established, formed or incorporated” outside South Africa, in determining whether it is resident by applying the test of place of effective management, these provisions necessitate that the application of the test be modified, to exclude certain activities. In a sense there is therefore an interchange between the two criteria, with the first criteria, “established, formed or incorporated” will determine whether the relief is available (ie only if the result is that is *not* established in South Africa) and if so, the second criteria, “place of effective management” and its application is impacted. These provisions are further discussed in Chapter 6 where the test for place of effective management is considered.

The practical consequences of meeting the current definition of “resident” and being regarded as such, has already been extensively discussed in 4.2.3 above. From such discussion, it was apparent that the determination of the meaning of “resident,” is fundamentally important to the system of taxation.

The meaning of “residence” in relation to natural persons can be regarded as well documented, although neither voluminous⁶⁴ nor necessarily unambiguous, it comprises Interpretation Notes

amount of tax payable to all spheres of government of any country other than the Republic by that company in respect of any foreign tax year of that company is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that company had that company, but for this subitem (B), been a resident for that foreign tax year;”

⁶¹ Section 1 of that Act, 37 Of 2002.

⁶² As set out in section 1(2) of Act 37 of 2002.

⁶³ The term “financial service provider is defined in Section 1 whilst Section 8 provides for the issuing of licenses to financial service providers.

⁶⁴ Silke states that the fiscal jurisprudence on the meaning for purposes of the Income Tax Act is not extensive. In the UK, several helpful tests can be emulated from various cases, but a distinction between the meaning attributed by the courts in the UK and the meaning locally must be kept in mind. De Koker, A P & Williams, R C *Silke on South African Income Tax* at 14.41 available electronically on LexisNexis.

issued by SARS specifically addressing the topic⁶⁵ as well as judicial precedent⁶⁶ and various textbooks detail same comprehensively.⁶⁷ So too in relation to companies, the possible meaning and application of the statutory definition has received the attention of SARS⁶⁸ and several legal authors,⁶⁹ with guidance from historical court cases are available.⁷⁰ In relation to trusts, it can not be said to have received the same level of attention and the discussion that follows is aimed at addressing this lacuna. This is done by regarding the “incorporated, established, or formed” criteria firstly in this Chapter and then in the following chapter, “the place of effective management” criteria.

5 4 Incorporated, established or formed in the Republic

A trust is an artificial creation, similar in this respect to a company and by analogy then, “having no body to kick and no soul to damn.”⁷¹ In light of the aforesaid, difficulties in ascribing a humanlike concept⁷² such as residence to a trust is to be anticipated.

In relation to such artificial persons, and to overcome such difficulty, various connecting factors

⁶⁵ Interpretation Note 3 and 4 of 2002, Interpretation Note 25 issued 8 February 2006 available on the website of SARS – <http://www.sars.gov.za/Legal/Interpretation-Rulings/Interpretation-Notes/Pages/default.aspx>. Last accessed on 05/05/2013.

⁶⁶ *Cohen v CIR* 1946 AD 174; *Soldier v COT* 1943 SR 130; *CIR v Kuttel* 1992 (3) SA 242 (A).

⁶⁷ Huxham K and Haupt P *Notes on South African Income Tax 2011* at Chapter 2.5; Meyerowitz D *Meyerowitz on Income Tax (2007-2008)* at par 5-19. De Koker, A P & Williams, R C *Silke on South African Income Tax* at 5.2 available electronically on LexisNexis.

⁶⁸ SARS Interpretation Note 6 “Resident: Place of Effective Management (Persons other than Natural Persons)” issued on 26 March 2002. The Interpretation Note was predominantly aimed at companies – indeed there is only one reference which relates to trusts. See also the more recently issued Discussion Paper on the Interpretation Note – issued September 2011 by SARS.

⁶⁹ Van der Merwe BA “Residence of a Company – the Meaning of Effective Management 2002 (14) SA Merc L J at 79; Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA Merc LJ 121; Goosen, C “International Tax Planning: The concept of Place of Effective Management” research dissertation submitted to the University of Cape Town on 15 February 2006; Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at Chapter 19 Paragraph 19.4 and further dealing with the Residence of Companies under Domestic Income Tax Law ; Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 28; Fichardt, L & Delechat, A “Residence Revisited” September 2010 (1) Business Tax & Company Law Quarterly at 1; Anon “In what country does a company reside for tax purposes?” (February 2009) *Synopsis Tax Today* PriceWaterhouseCoopers.

⁷⁰ Although there have not been further cases since the change to residence based taxed, the following cases did address “residence” for tax purposes in relation to companies prior thereto: *Robinson v COT* 1917 TPD 542; *Rhodesia Railways v COT* 1925 AD 438; *Estate Kootcher v CIR* 1941 AD 256; *A Company v COT* 1941 SR 79; *ITC 1054* (1964) 26 SATC 260 (F).

⁷¹ *CIR v Richmond Estates (Pty)(Ltd)* 1956 (1) SA 602 (A) at 606.

⁷² Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA Merc LJ 121 at 121.

have however been identified, one such connecting factor being the *creation* of the entity.⁷³ The above stated criteria “incorporated, established, or formed”, appears to embody this connecting factor. As an entity has been created in a particular country, its existence is necessarily linked to such country. Albeit stated in relation to companies but equally applicable to trust, the following extract explains the rationale behind this factor –

“A company is a person created by the law, owing its existence to a contract which, entered into in accordance with legal forms in effect in the State in which it is created, renders it capable of acquiring rights and assuming obligations like a natural person. Thus, just as a natural person is tied to the State by nationality acquired through birth or naturalization, a tie from which rights and duties are derived, so a company is tied to the State in whose territory it is created and acquires rights and obligations.”⁷⁴

There is no definition in the Act of these terms of “incorporated, established or formed”, or any specific judicial pronouncements. Nor has the South African Revenue Services offered guidance in the form of an Interpretation Note or Discussion Paper regarding their approach. This is in contrast to the second part of the criteria (place of effective management), where they have done so.⁷⁵

Consequently the meaning of these terms must be determined in light of their ordinary meaning, in the context of the statute where they are encountered.⁷⁶ Meyerowitz states the rule as follows “the words must be read in light of their popular or ordinary and natural sense, carelessness in drafting notwithstanding and the context must not be ignored.”⁷⁷ It is this task which is embarked upon next.

5 4 1 Ordinary meaning of the words

To ascertain the ordinary meaning of these words, regard can be had to dictionary definitions to ascertain the generally accepted meaning:

Incorporated: (From Late Latin *incorporatus*: furnished with a body) formed into or constituted as corporation⁷⁸

⁷³ Behrens, P in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at 5.

⁷⁴ *Mexico Plantagen case 1931-32*. Ann. Dig. (No 135) (German-Mexican claims Commission, January 25, 1930)

⁷⁵ Interpretation Note No. 6: Resident: Place of effective management (persons other than natural persons) issued by SARS on 26 March 2002.

⁷⁶ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 332; Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at Chapter 19.4.2.

⁷⁷ Meyerowitz D *Meyerowitz on Income Tax (2007-2008)* at par 3.10; Also *Robinson v COT 1917 TPD* 542 at 544.

⁷⁸ Butterfield et al (eds) *Collins English Dictionary Complete and Unabridged* 6th edition (2003)

constitute as legal corporation⁷⁹; to form (as a business) into a legal corporation⁸⁰

In law, the formation of an association that has corporate personality and is therefore distinct from its individual members, who have no liability for its debts. Corporations (such as companies) can own property and have their own rights and liabilities in legal proceedings⁸¹

Established: set up, settle, achieve permanent acceptance for, place beyond dispute⁸²

to create or set up (an organization, etc.) on or as if on a permanent basis; to establish a company⁸³

to bring into existence: "found"⁸⁴

Formed: (form) make, be made, constitute, develop or establish as concept, practice⁸⁵

to make, produce, or construct or be made, produced or constructed; the particular mode, appearance etc in which the thing or person manifests itself⁸⁶

It is not equivalent to "registered"⁸⁷

In relation to trusts, the terms "established" or "formed" are relatively familiar terms in a trust setting, but "incorporated" is not. Reflecting on the meaning of "incorporated" as set out above in the dictionary definitions, it refers to the clothing of an entity with legal personality, to constitute an entity independent and distinct from its underlying members and its registration with a public authority. Whilst the term is appropriate in a company setting - it features as part of the definition of "company" under both the old⁸⁸ and new⁸⁹ Companies Act, in contrast, it is not suitable in a trust setting. The effect of incorporation is the vesting of a legal person.⁹⁰ As the discussion of the legal

⁷⁹ Waite, M (ed) *The Little Oxford Dictionary of Current English* (7th ed) (1994)

⁸⁰ *Merriam-Webster's Dictionary of Law* (1996) Merriam-Webster, Incorporated.

⁸¹ Available at <http://legal-dictionary.thefreedictionary.com/incorporate> -last accessed 05/05/2013.

⁸² Waite, M (ed) *The Little Oxford Dictionary of Current English* (7th ed) (1994)

⁸³ Butterfield et al (eds) *Collins English Dictionary Complete and Unabridged* 6th edition (2003)

⁸⁴ *Merriam-Webster's Dictionary of Law* (1996) Merriam-Webster, Incorporated

⁸⁵ Waite, M (ed) *The Little Oxford Dictionary of Current English* (7th ed) (1994)

⁸⁶ Butterfield et al (eds) *Collins English Dictionary Complete and Unabridged* 6th edition (2003)

⁸⁷ Claasen, RD *Dictionary of Legal Words and Phrases* (May 2011) – Available electronically on LexisNexis.

⁸⁸ S1 and 32 of the Companies Act, 61 of 1973; as well as the Close Corporations Act, 69 of 1984.

⁸⁹ S2 and S13 of the Companies Act, 71 of 2008.

⁹⁰ "The result of incorporation is that the subscribers to the memorandum and those who become members of the company constitute a body corporate having its own name, perpetual succession, the ability to exercise all the functions of an incorporated company and limited liability of its members to contribute to the assets of the company." Per Benade et al *Companies* (3ed)(2000) at Chapter 6 par 6.1 available electronically on LexisNexis, also at 5.02 "prior to incorporation the company is not a legal person." Under the new Companies Act, 7 of 2008, a company is incorporated by the adoption of the Memorandum of Incorporation and filing of the Notice of Incorporation with the CIPC – the latter then endorses the Notice and issues a Registration Certificate which in terms of

nature of a trust revealed in paragraph above 2 6, a trust is in terms of our common law not recognised as legal person, and despite its inclusion as a “person” in the Income Tax Act⁹¹ for taxation purposes, it is to be agreed with Du Plessis that a trust “is not a legal person...” and thus “the word 'incorporated' does not apply to trusts.”⁹² This is supported by Olivier & Honiball who state the mere fact that under Section 4 of the Trust Property Control Act, trustees are obliged to lodge the trust instrument with the Master, “it does not mean that the trust is incorporated.”⁹³ Lewis therefore emphasizes that the appropriate test must be identified applied in relation to entities other than companies, thus for example, in the case of a trust, the term “incorporated” is not applicable.⁹⁴

The remaining two terms “establish” or “formed”⁹⁵ appear from the dictionary definition to be somewhat similar in meaning. Both denoting an act of creation, but it could be argued that “establish” indicates a greater sense of permanency. In relation to trusts, both these words are generally used in everyday parlance and without distinction to describe the setting up of a trust. Consequently to determine whether a trust has been “established” or “formed”, an enquiry has to be made into how a trust is created.⁹⁶

In such an enquiry, regard must be had to the latter phrase of the criteria which requires such establishment or formation to be “in the Republic.” Until 2006 the term “Republic” was defined as “Republic of South Africa”, which Clegg & Stretch notes had the effect that “anything occurring outside the 12 nautical mile ‘territorial waters’, was not ‘in the Republic’.”⁹⁷ With effect from the commencement of the tax years of assessment ending on/after 1 January 2007, a new definition was inserted -

“**Republic**” means the Republic of South Africa and, when used in a geographical sense, includes the territorial sea thereof as well as any area outside the territorial sea which has been or may be designated, under international law and the laws of South Africa, as areas within which South Africa may exercise sovereign rights or jurisdiction with regard to the

S14(4) is conclusive evidence that the company is incorporated from the date set out in the Certificate.

⁹¹ See paragraph 4 2 2 above.

⁹² Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009(21) *SA Merc LJ* at 329.

⁹³ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 153.

⁹⁴ Lewis, A *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) at 17.3.1 available electronically on LexisNexis.

⁹⁵ The term “formed” is also used in the legislation pertaining to companies eg. Section 32 of the Act.

⁹⁶ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 332.

⁹⁷ Clegg, D & Stretch, R *Income Tax in South Africa* (Last updated March 2011) at 8.2 available electronically on LexisNexis.

exploration or exploitation of natural resources.’⁹⁸

Also in this respect, Du Plessis stresses that proper effect should be given to the word “in” and that specifically the use of the word connotes a *place within South Africa’s borders* (own italics).⁹⁹ An alternative would be to interpret it as meaning formed or established *in terms of the laws of South Africa* (own italics). Du Plessis considers such an interpretation as objectionable as the phrase ‘in the Republic’ is used elsewhere in the section as well as in the Act,¹⁰⁰ where the context clearly connotes a meaning of “within South Africa’s borders”. For example, the phrase ‘if that person was physically present in the Republic’ in par (a) (ii) of the definition of ‘resident’ in relation to natural persons.¹⁰¹ Moreover, she argues, should the legislature intended that meaning to be attributed it could have used such specific wording, as it had done in paragraph (a) of the definition of ‘company’ in section 1 of the Act, namely ‘under any law in force... in the Republic’.¹⁰²

On the other hand, the alternative interpretation, formation or establishment in terms of South African laws, can be supported by relying on the *noscitur a sociis* rule of interpretation, which requires that the meaning of a word be ascertained by reference with those associated with it¹⁰³ and thus the words ‘established or formed’, must be restrictively interpreted to bear a meaning similar to the associated word, ‘incorporated.’¹⁰⁴ Du Plessis submits that as the latter can only mean incorporated “in terms of the laws of the Republic,”¹⁰⁵ the phrase under consideration must also mean an entity formed or established “in terms of South African laws.”¹⁰⁶ Further support is to perhaps to be found in policy considerations: as residence-based taxation is underlain by the notion

⁹⁸ S 1 of the Act. For a detailed discussion regarding this definition see Clegg at the previous footnote.

⁹⁹ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA Merc LJ at 330.

¹⁰⁰ Du Plessis refers to s 31, s 35, s 35A of the Act.

¹⁰¹ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA Merc LJ at 330 fn 64.

¹⁰² Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA Merc LJ at 330 fn 64.

¹⁰³ Clegg, D & Stretch, R *Income Tax in South Africa* (Last updated March 2011) at 2.13 available electronically on LexisNexis – The authors explain that “where two or more words which are susceptible of analogous meaning are coupled *noscitur a sociis* they are understood to be used in their cognate sense. They take, as it were their colour from each other, that is, the more general is restricted to a sense analogous to the less general.” They further explain that the rule of construction – *eisudem generis* rule is sometimes expressed by this maxim.

¹⁰⁴ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA Merc LJ at 330 fn 64.

¹⁰⁵ Read with the definition of “company” in the Act. It is the public authority, the Registrar of Companies which will issue the Certificate of Incorporation. Under the new Companies Act, 71 of 2008, Section 14(1) it is the Companies and Intellectual Property Commission (CIPC) who issues a Registration Certificate which is deemed conclusive evidence of its incorporation under the Act.

¹⁰⁶ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA Merc LJ at 330 fn 64.

that residents should contribute to the fiscal coffers for their enjoyment of the protection of the state in which they reside, South Africa should only tax those entities formed in terms of its laws.¹⁰⁷ But this is not conclusive as it appears that the underlying approach to the taxation basis was “to cast the net widely to include as many entities and thereafter to grant exemptions.”¹⁰⁸ Based on the latter Du Plessis concludes that an interpretation including not only entities formed in terms of the laws of South Africa, but formed within our border appears favourable. However as both interpretations can be justified, certainty through legislative amendment should be sought.¹⁰⁹

The preference for a wider interpretation, could perhaps find further endorsement in the fact that the definition of “trust” in the Income Tax Act is broadly expressed. It would be recalled from the discussion in Chapter 4, that the definition in the Act is not a mere restatement of the definition of the Trust Property Control Act, nor does it make specific reference to any particular legislation in South Africa. If it had done so, a possible limitation to only trusts created in South African laws could be inferred. The definition of “trust” is phrased in such a way, and requires such general aspects, that foreign trusts, ie trust created in terms of other countries’ laws but for argument’s sake formed at a place in South Africa, would probably qualify and fall within its ambit.¹¹⁰ It must however be noted that the definition for a company is similarly regarded as being very wide.¹¹¹ Specifically the definition for a company includes ‘any association, corporation or company incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic any part thereof’ but also “any association, corporation, or company incorporated under the law of any country *other* than the Republic.”¹¹² Therefore it could be argued that the mere broadness of the definition of a trust or a company to include entities created in terms of local law as well as foreign laws, does not necessarily imply that upon the first leg of the test for residence, such entities would, by falling within the definition of the word “trust” or “company”,

¹⁰⁷ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 330 fn 64.

¹⁰⁸ This is based on the reasons put forward by SARS at the time of the changeover – namely that residence based taxation would ensure better protection to the South African tax base, and advance efficiency as exclusions are targeted. Moreover the tax base need not be continuously refined as deficiencies are found. Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 330 fn 64 – she refers to Anon Comments on representations to the PCOF on the Revenue Laws Amendment Bill, 2000 in par 3.1.

¹⁰⁹ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 330 fn 64.

¹¹⁰ See discussion above at paragraph 4 2 2 regarding the Definition of a trust in the Income Tax Act. Olivier & Honiball state that based on the Act’s definition it would be difficult to argue successfully that a relationship where assets or funds are controlled by one person for the benefit of another is *not* a trust for South African income tax purposes.

¹¹¹ S1 - Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 78.

¹¹² S1.

automatically be regarded as formed or established here as then the first criterion of the resident test, would be superfluous and thus offend the interpretation rule that words in the Act should not be construed as redundant.¹¹³ It should perhaps rather mean that 'formed or established' denote that our laws should be used as objective framework against which such creation may be measured.

The problematic side to a broad interpretation is further, that to include any trust formed or established at *any place in South Africa* as resident as opposed to trusts established *in terms of the laws of South Africa*, is that it will be difficult to determine whether such trust (if not created in terms of South Africa laws) has indeed been "formed" or "established" at all. It begs the question whether South African law or foreign law must be applied to determine whether a trust has been formed. To this, there appears to be no clear-cut answer. South Africa's uppermost legislation, the Constitution includes customary international law as a source of South African law and provides that in the interpretation of legislation, South African should follow an interpretation that is consistent with international law.¹¹⁴ Conversely, it has been noted it is a recognized choice-of-law rule that South African courts must apply South African domestic law even if the case involves a foreign element.¹¹⁵ Thus the uncertainty remains.

One may however ask why should it be necessary to establish whether a trust has been 'established' or 'formed' in accordance with any country's laws, as the definition for a trust contained in the Act is simply that it be a "trust fund consisting of cash or other assets, which are administered and controlled by a person acting in a fiduciary capacity appointed under a deed of trust, or by agreement or under the will of a deceased person." As was pointed out above, and in Chapter 4 this definition is wide enough to encompass constructions that technically do not constitute trusts per se, but none-the-less meet the particular requirements of this definition. Yet a technical argument may be made that when these two definitions are read together then what is required is a 'trust fund.... administered and controlled by a person appointed... under a deed of trust, agreement, or under the will' and 'formed in South Africa.' Thus the agreement, trust deed of Will must be formed in South Africa and therefore the ordinary rules relating to wills and contracts

¹¹³ Meyerowitz states that the construction rule 'The Act must be so construed that, if it can be prevented, no clause, sentence or word becomes superfluous, void or insignificant, but tautology in statutes being not very uncommon, it may well be that the one or other of the words used is tautological - Meyerowitz D Meyerowitz on *Income Tax (2007-2008)* at par 3.10

¹¹⁴ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 115.

¹¹⁵ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 115.

in South Africa would be applicable.¹¹⁶ Therefore whilst the definition of a trust is very wide, when it is read together with the first residence criterion of "formed or established in the Republic," it is tailored so that on this leg, entities created and owing their existence to our laws, is intended. A limitation that is not necessary for the second residence criterion of place of effective management. It must also be noted that even where a particular construction or contractual agreement is against or falls short of the law, it will not necessarily for tax purposes, be void of consequences. The words of Chief Justice Howie remain apt "an illegal contract is not without all legal consequences; it can indeed have fiscal consequences."¹¹⁷ So again, resort may be had to our laws so that where an entity is not strictly created in compliance, its existence or activities may still be recognised by our laws.

A further argument against a stance that the formation need *not* be in accordance with our laws for residence to be attributed, flows from the theoretical premise of this residence criteria, namely that it has as its basis that a resident is levied with taxes by its country of residence, but as *quid pro quo*, the country of residence offers its residents protection and moreover, acknowledges their existence and rights.¹¹⁸ The connecting factor arises between the resident and the country, from the fact that the country's laws gives it existence and acknowledges its rights and obligations. For example: if a blind trust with unknown beneficiaries¹¹⁹ is created at a place in South Africa, it is doubtful whether South African trust law will recognise such trust as valid, nor will our courts be inclined to give it *locus standi* to enforce its rights. As Hattingh had stated "tax residence... is an economic policy-based consideration ... whether the subject ... enjoys the protection of its armaments so that it justified to subject him to the most comprehensive form of taxation."¹²⁰ In order then to comply with this theoretical premise and also to overcome the aforesaid difficulty and ensuing uncertainty as to whether a trust has been formed or established, an interpretation meaning in "terms of the laws of South Africa" can be argued for. It is acknowledged that on a current reading of the Act and its provisions, such a deduction is not conclusive, and consequently it would require that it be a necessary read-in in respect of these two terms. This would enhance the certainty and simplicity of this test which are key features of it.

It must be noted that in our law, both trusts in a wide and narrow sense are recognised, with the

¹¹⁶ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B8.5 at 44(9)

¹¹⁷ *MP Finance Group CC (In Liquidation) v C:SARS 69 SATC 141* at 145.

¹¹⁸ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 135

¹¹⁹ See the discussion at par 2 7 6 where such trusts were discussed. It would be recalled that with such trusts structure itself, it is difficult, it not impossible to identify the true founder and beneficiaries of the trust.

¹²⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 643.

latter being a more specific genus of trusts in a wide sense.¹²¹ The definition in the Income Tax Act of a trust corresponds with trusts in a wide sense, and would therefore encompass trusts created in the narrow sense as well.¹²² Honoré states that to determine whether an enforceable trust can be said to exist, it will be essential to distinguish between trusts in a wide and narrow sense.¹²³ According to him, a trust in the wide sense will exist whenever someone is bound to hold or administer property on behalf of another for some impersonal object and not for his own benefit.¹²⁴ A trust in the narrow sense will exist when the founder of the trust has transferred or is bound to transfer control of the property which is to be administered by another for the benefit of some person other than the trustee as beneficiary.¹²⁵ Typically here the trustee will hold an office and be subject to public authority. Consequently when determining whether a trust has been formed or established in the Republic, then this distinction should be made to determine what principles our laws prescribe for such trust to be formed and exist. Yet this is not clear from the Act, nor whether a trust which fails in a narrow sense may still then be regarded as a trust in wide sense. It is therefore recommended that the legislature provides guidance and address these two categories separately.

It could be countered that such an interpretation requiring compliance with our laws, would severely limit the reach of the statutory provisions by limiting the application of residency then to only lawful trusts. For example if two smugglers, A and B, form a 'trust' by depositing monies with C, who is to administer such banking account, and the object of the trust is to act as vehicle to 'money-launder' the proceeds of human trafficking for A and B's benefit, the trust will not be regarded as a valid trust established in terms of our law as its objective is *contra bonos mores*¹²⁶ and

¹²¹ See the discussion at par 2 3 above.

¹²² See S 1. *Commissioner for Inland Revenue v Friedman and Others NNO* 1993 (1) SA 353 (A).

¹²³ Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 2.

¹²⁴ Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 2. He includes that the person has a minimum duty to keep the property separate from his own, and to avoid a conflict of interest with the trust object or beneficiary.

¹²⁵ Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 4-5.

¹²⁶ There is an argument to be made that the trust would not *per se* be invalid. In the case of *Peterson and Another NNO v Claassen and Others* 2006 5SA 191 (CPD) the court emphasized that a distinction should be made between the object and the purpose of a trust. Specifically it stated that at par 16 "Whilst it is correct that one of the essentials for the creation of a valid trust is that the trust object must be lawful, it does not follow, however in my view, that a trust is void if it is created with a fraudulent, illegal or immoral purpose.... There is, in my view, a material difference between the object of a trust and the purpose thereof." The Judge further remarked that the object of a trust is mostly openly proclaimed, but by contrast where a trust is formed for an illegal or unlawful purpose, this knowledge is "jealously guarded by those who harbours such purpose" and stands to reason why an illegal purpose can not be equated to the objective of the trust. It was further stated that trusts created for an unlawful purpose, would not automatically render it void. At par 21-22 the judge states "such an approach has anomalous and unfair results... To my mind, the better view is that,

as a trust in a narrow sense it would fail.¹²⁷ It must however be noted that the trust would not necessarily escape the tax net as fiscal consequences could still follow by reason of the fact that the income could be seen as sourced within South Africa¹²⁸ or accrued to, for example the settlor,¹²⁹ or it could be argued that it constituted another construction such as a partnership or association, and the income would then be regarded as accruing to the participants and taxable in their hands.

As an alternative, Du Plessis proposes that registration of the trust be required as criterion.¹³⁰ Trusts created in terms of South African law, would in most instances, once formed, apply for such registration as it is in law required that the "trust instrument" (defined to include a written agreement, or testamentary writing), be lodged with the Master upon the trustee's appointment taking force and prior to him taking control of the trust property, and the trustee is further obliged to apply for authorization prior to being allowed to act in the office.¹³¹ Only oral trusts are not required to be registered. Most trusts formed in South Africa, would in any event be registered and thus the function of this criteria, would be to simplify the enquiry process as it could easily be ascertained whether a trust has been registered. By stating this as requirement, it would obviate an enquiry as in terms of which country's laws the trust had been created.¹³² It must be noted that the registration of the trust does not require the trust to be valid, nor does the act of registration elevate an invalid trust, as the Master's office is simply an office of record keeping.¹³³ Thus it would also eliminate an enquiry as to the validity of the trust. To continue with the above example of the

where a trust is created for an illegal purpose, agreements which it thereafter purports to conclude may be void or voidable, in accordance with ordinary contractual principles and depending on the circumstances surrounding the conclusion of each such agreement."

¹²⁷ It could be argued that the arrangement still constitutes a trust in a wide sense. However as the wording of the definition of trust also requires that the appointment be made under, among other an agreement and an agreement must be lawful to be enforceable in SA, it would similarly fail.

¹²⁸ S 1 per the definition of Gross Income.

¹²⁹ Davis et al *Estate Planning* (May 2013) at 6-42(2). If the trust is regarded as a sham.

¹³⁰ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes " 2009 (21) *SA Merc LJ* at 334.

¹³¹ S1 of, S 4 iro the Lodgment of the Trust Instrument and S6 iro Authorization of Trustee of the Trust Property Control Act.

¹³² It may be questioned what the position would then be in relation to foreign trusts as their trustees may in terms of Section 8 apply to the Master for authorization. It is submitted that such trusts should not be regarded as now formed here through registration as their 'appointment' as required by the definition does not flow from the Master's authorization but still from the initial agreement in terms of which they were appointed. An analogy may be drawn to the position of external companies which may similarly be lodged with the CIPC for registration but it does not transform it into a local company.

¹³³ See also Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B8.5 at 44(9) who write that the legality of a trust is not determined by the Master, the State does not censor the trust's object but rather it depends on those with an interest in the matter to raise the unlawfulness or invalidity of the trust.

trust established for human trafficking, it is most likely that this trust will need to register so to obtain the necessary letters of authority as without it, it would be stymied in its operations – for example it would require such letters to open a banking account to channel the funds, to purchase immovable property for its premises, etc. Whilst in theory it may possible, to have a "trust fund controlled or administered" as per the definition of a 'trust', in the Republic, it would in practice necessitate that such letters be obtained to exert such control and administration. Thus, 'registration' would also comply with the rationale behind this residence criterion, as through registration and receipt of the letters of authority, the trust would be able to engage in the legal and commercial traffic, and thus enjoy such privileges as required by the criterion of residence. It has use of our infrastructure and resources, justifying that it be taxed fully. Here the connecting factor is the tie between the resident and the registration process whereby its existence is noted and is allowed to engage in the commercial arena. Du Plessis suggest that the wording be "if registration of the trust instrument and authorisation of trustees are required in the Trust Property Control Act." This would appear a sensible phrasing so as to also provide for those who failed to register, as the mere requirement to register would suffice. As stated above a trust will be required to register by lodging its trust deed upon the trustee's appointment coming into effect and before he assumes control of the trust property, whilst the trustee may not act in the office prior being authorized.¹³⁴ The only drawback appears that it is aimed at trusts in the narrow sense and created in writing – consequently it will require such a distinction to be made, as otherwise all trusts create orally and in a wide sense would fall outside the ambit of the Act. However this proposal to, would also call for the intervention of the Legislature.

It is therefore concluded that on a current reading of the Act and the definition of a 'trust', 'trustee' and the first leg of the test for 'residence' as contained therein, the tax nets are thrown wide. As such it may exceed the parameters set by the rationale underpinning the place of formation as connecting factor, and care must therefore be taken. It is necessary for the legislature to clarify this aspect so that certainty is reached. A distinction between trusts in a wide sense and narrow sense should preferably be made. In relation to trusts in a narrow sense, it may also be helpful to utilise a criteria "or required to be registered" for the reasons discussed above. Having now reviewed the ordinary meaning of this criterion in a literal and grammatical sense, its meaning in practical contextual setting must be ascertained.

¹³⁴ Sections 4 and 7 of the Trust Property Control Act.

5 4 2 Formation of a local trust

As has been stated previously, it would appear that for tax purposes, the definition of a "trust" in the Act does not necessitate that a trust in a strict sense be present for the entity to qualify as a 'trust.' As was also evident from the discussion above at par 5 4 1, it would also not appear necessary for the trust to be established in terms of our laws, for it to qualify as a resident here, but that it may be necessary for the Legislature to address this aspect. Therefore as there is no certainty that the above interpretations are correct, and the Legislature may yet intervene to clarify this aspect and opt for an interpretation favouring trust formed in our laws, or registered here, the manner in which trusts may be established locally and the requirements to do so, are discussed below. It is submitted that most trusts encountered in practice would be trusts established in terms of our laws and it has already been stated that the study would be dedicated to trusts in the narrow sense. The definition of a 'trust' requires that the appointment of the person in a fiduciary capacity be done under "a deed of trust or agreement or under the Will of a deceased person" and would consequently necessitate that regard be had to rules regulating same be reviewed to determine their impact on the place and time such trust is formed.

As was evident from the discussion in paragraph 2 7 1 regarding the classifications of trust based on their mode of creation, two types of trusts are recognized in South Africa. Firstly, a *mortis causa* trust (also known as a testamentary trust or will trust), which is principally created in terms of a Will,¹³⁵ becomes effective upon the testator's death¹³⁶ and is regarded as a *sui generis* institution.¹³⁷ Secondly, a trust *inter vivos*, which is generally deemed to be created by contract and although the subject of much controversy and opposition, has been characterized as a specific type of contract, namely a contract for the benefit of a third party (*stipulatio alteri*) by our Appellate Division.¹³⁸ Such a trust becomes effective whilst the founder is still alive.¹³⁹ Thus, whilst the law of succession may be relevant to the former, the laws of contract regulate the latter, and to determine whether a trust has been established or formed, regard must be had to such sources to confirm not only the requirements but also the place and time of the establishment and formation of the trust.¹⁴⁰

¹³⁵ As Olivier observes despite the prevalence of such trusts created by wills, it is in theory possible for such trusts to be created by other instruments such as antenuptial contracts. Olivier et al *Trust Law and Practice* (November 2011) at 5-3.

¹³⁶ See discussion at paragraph 2 7 1 - Olivier et al *Trust Law and Practice* (November 2011) at 5-5.

¹³⁷ *Braun v Blann and Botha NNO and Another* 1984 (2) SA 850 (A) at 859E.

¹³⁸ *Hofer and Others v Kevitt and Others* 1998 (1) SA382 (SCA); Olivier et al *Trust Law and Practice* (November 2011) at 5-5.

¹³⁹ It must be noted that the death of the founder will not transform an *inter vivos* trust into a *mortis causa* trust as the original source for the trust will still remain the agreement of trust.

¹⁴⁰ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes " 2009 (21) SA *Merc LJ*

It is therefore prudent to prior to such a discussion look back to the discussion at paragraph 2 5 where the *essentialia* for the creation of a trust in our trust law was enumerated as being: an intention on the part of the founder to create a trust, the expression of such intention in a mode capable of creating an obligation, a definition of reasonable certainty of both the property subject to the trust, as well as of the object of the trust, and the lawfulness of such object.¹⁴¹ Such *essentialia* must be present for a valid trust to come into creation in terms of our trust law. As one author expressed it "in the absence of any one or more of these elements, no valid trust comes into existence."¹⁴² In contrast regard must also be had to the factors *not* essential for the valid formation of a trust.¹⁴³ In paragraph 2 5 above, it was specifically noted that despite the Trust Property Control Act imposing certain requirements, such as the lodgement of the trust instrument, the authorisation of trustees by the Master and the furnishing of security by the trustees, it does not equate to the trust being formed thereby.¹⁴⁴ Du Plessis expresses it strongly "it does not mean that a trust is formed via the lodgement of the trust deed or authorisation by the Master or that the trust does not exist if these acts are not performed."¹⁴⁵ There is therefore a difference to the requirements for the trust to be able to engage lawfully in legal and commercial activities, and the requirements for its formation.

It would be recalled that this distinction was also present when the difference between the *essentialia* for the creation of the valid trust, and the *essentialia* at the commencement of the administration of the trust was discussed in par 2 5 2, and that the latter requires a duly appointed (not authorized) trustee and the transfer of ownership or control to the trust property to the trustee (or in a bewind, the beneficiary). These requirements are not essential to the creation of the trust but rather to the commencement of its administration. In relation to the first, Du Toit explains "the trustee is however the pivotal functionary as far as the administration of trust property is concerned and it therefore stands to reason that trust administration cannot commence in the absence of a trustee who has been appointed as such... and who has accepted appointment."¹⁴⁶ Yet he notes that even if upon creation the office of trustee is vacant, the Master,

at 330.

¹⁴¹ See discussion above at paragraph 2 5 ; also *Administrators, Estate Richards v Nichol* 1996 4 SA 253 (C); Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 117.

¹⁴² Du Toit F *South African Trust Law Principles and Practice* (2002) at 27.

¹⁴³ See "Factors not essential to the the formation of a valid Trust" - Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 176. Honore also list the designation and acceptance by a trustee in a testamentary trust and the actual transfer of the trust property as not essential factors.

¹⁴⁴ See discussion at paragraph 3 2 2 above.

¹⁴⁵ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* 325.

¹⁴⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 34. So too does Oliver state that

by way of statute, and the High Court, by way of its common law powers are empowered to appoint a trustee for the administration to commence.¹⁴⁷ It must also be noted that what is required is the appointment of a trustee, and not authorisation – the latter denoting the Master's authorization of the trustee in terms of Section 6 by issuing of the Letters of Authority. Thus the lodgement of the trust deed, the furnishing of security (if required) and authorisation by the Master – all such statutory duties and procedures are not essential to the administration of the trust when it commences.¹⁴⁸ However as Du Toit notes whilst "non-compliance with these duties does not prevent the commencement of trust administration, it will render continued administration extremely difficult."¹⁴⁹ He cites as example the trustee's inability then to validly conclude a contract and finds that non-compliance will therefore "impose a severe constraint on the effective execution." In respect of the second requirement, it would appear obvious that for the trust administration to commence, the trustee must either be vested or have control over the trust property. Du Toit states that this is "so basic a proposition to the commencement of the administration of the trust that it requires no further elucidation."¹⁵⁰

If regard is had to the definition of a 'trust' in the Income Tax Act, then what is required is a 'trust fund consisting of cash or other assets, which are administered or controlled by a person acting in a fiduciary capacity.' To therefore determine whether such a trust has been formed, it may be submitted that this definition looks to the moment when the trust administration has commenced, as opposed to when it is created. The definition requires a person acting in a fiduciary capacity already and presupposes the existence of the trust property. Consequently it may be argued that the relevant time and the essentialia applicable as to determine whether a trust has been formed for purposes of the Income Tax Act, may be to look at the moment when the trust administration commences.¹⁵¹

'at the moment when the trust has to start functioning, that is to say the moment when the trust has to be actively administered, a trustee is essential and is therefore a requisite part of the trust.' Olivier et al *Trust Law and Practice* (November 2011) at 5-3

¹⁴⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 35. For the Master, S 7 of the Trust Property Control Act provides such power.

¹⁴⁸ Du Toit F *South African Trust Law Principles and Practice* (2002) at 35.

¹⁴⁹ Du Toit F *South African Trust Law Principles and Practice* (2002) at 35.

¹⁵⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 35. He notes that it the common law duty of a trustee to obtain control of property subject to the trust as reasonably possible.

¹⁵¹ Thus to ascertain whether a trust has been formed, the essentialia will then only be whether there is a defined trust object (named/ascertainable beneficiaries/impersonal objective), defined trust property which is under the control of another, the presence of such other person as trustee acting in a fiduciary capacity as appointed under a deed of trust, Will or agreement. As Du Toit notes the founder's intention to create a trust, the mode of creation, a binding obligation to set up a trust and the lawfulness of the trust object are essential only to the creation of the trust.

It is with the aforesaid in mind that the the discussion is next directed to the rules regulating the formation of trusts as pertains to trust created in a narrow sense.

5 4 2 1 Trusts Mortis Causa

Most often it is said that such trusts are created by way of a Will. It would however be more accurate to refine the statement to state that the terms of such trusts are in practice predominantly set out in Wills, including codicils and other testamentary writings,¹⁵² yet may also be set out in other instruments such as antenuptial contracts.¹⁵³

Furthermore the trust itself is only formed upon the death of the testator and comes into existence upon such date.¹⁵⁴ The act of creation thus takes place within the testator's lifetime but is only effective from the moment of death.¹⁵⁵ From a practical point of view this is sensible. A Will can be revoked or varied at any time during the testator's lifetime and thus if such trusts were deemed to be in existence prior to death, a plethora of dormant trusts would exist whose lifespan would be dependent upon the fickleness of the testator.

There is a further view that a trust only comes into being upon the acquisition by the trustee of the trust property, but this is not supported as neither the transfer of the trust property nor the designation or acceptance by the trustee in a testamentary trustee are regarded as *essentia* to its formation.¹⁵⁶ Du Toit's explanation's demonstrates the fine distinction between the trust's coming into existence and its further administration: "although a testamentary *exists* from the moment of a testator's death, it only takes *operational effect* upon the transfer of the subject matter of the trust...only then is the trustee able to commence with the *administration* of the trust property." (own italics)¹⁵⁷ Thus, for our purposes, as a trust *mortis causa* is regarded as formed upon date of death of the testator, it is from this date that it is capable of being resident. This then addresses the question as to *when* a trust *mortis causa* is formed, but the place *where* it is formed

¹⁵² See definition of the term "Will" in the Wills Act, 7 of 1953.

¹⁵³ Olivier states almost all *mortis causa* trusts are created by last will and testament, but it is in theory possible to create it through other instruments- Olivier et al *Trust Law and Practice* (November 2011) at 5-3.

¹⁵⁴ Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 6; Olivier et al *Trust Law and Practice* (November 2011) at 5-4.

¹⁵⁵ Olivier et al *Trust Law and Practice* (November 2011) at 5-3.

¹⁵⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 27 ; Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 176; Olivier et al *Trust Law and Practice* (November 2011) at 2-6. See in particular the latter setting out the different viewpoints of authors.

¹⁵⁷ Du Toit F *South African Trust Law Principles and Practice* (2002) at 36.

must now be determined.

Due to the fact that one of the *essentialia* for the formation of a trust is that the “intention must be expressed in mode apt to create an obligation”, the instrument wherein the intention is contained must be validly executed.¹⁵⁸ Thus “it follows that the formalities necessary for the creation of a trust are those necessary for the creation of the obligation on which the existence of the trust depends.”¹⁵⁹ In the context of a trust *mortis causa* constituted in a Will, it must therefore be validly executed in accordance with the formalities prescribed for Wills. In South Africa, Section 2(1) of the Wills Act, sets out the formalities for wills executed in South Africa, including that the Will must be signed by the testator and two competent witnesses at prescribed places on the document.¹⁶⁰

In the event of non-compliance with the prescribed formalities, such deficiency may possibly be cured by application to court for condonation.¹⁶¹ Moreover, the Wills Act also provides that a Will will not merely be invalid, because of its form should such form comply with the “internal law”¹⁶² of the state or territory in which the Will was executed, or in which the testator was domiciled or habitually resident, either at the time of execution of the will, or at his death, or of which the testator was a citizen either at the time of execution of the will or at his death.¹⁶³ Insofar as immovable property is disposed therein, invalidity will further not necessarily follow if the form complies with the law of the state, or territory in which such property is situate.¹⁶⁴ An example from case law illustrates the possible application of these provisions: a Will executed in Austria which sought to govern property in South Africa, but which did not meet the prescribed formalities for Wills executed in South Africa, was held to be formally valid as it was executed in compliance

¹⁵⁸ Du Toit F *South African Trust Law Principles and Practice* (2002) at 27.

¹⁵⁹ Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 138

¹⁶⁰ If created by antenuptial contract it must comply with such formalities, ie notarial execution although it need not be registered to bind the parties to it. Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 139.

¹⁶¹ S2 (3) of the Wills Act of 1953, as amended – It provides for the court to order the Master to accept the document as a Will, although it does not comply with all the formalities imposed for execution should the court be satisfied that the document drafted or executed by a person who has since died was intended to be his Will.

¹⁶² “Internal law” means the law of a state or territory, excluding the rules of international private law of that state or territory – S 1 of the Wills Act. The effect of this definition is according to Pace that the state’s or territory’s rules of private international law may be disregarded and only the internal law is looked to determine the validity. Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – A21 at 45-46.

¹⁶³ S 3 *bis*(1)(a). Kahn states that his provision is applicable to any Will wherever and whenever executed provided it does fall within the prohibitions of S 3 (4). Kahn *LAWSA Conflicts of Laws* Vol 2(2) at 320 (last updated as at 30 June 2010) available electronically on LexisNexis.

¹⁶⁴ S 3 *bis*(1)(b).

with the internal law of Austria, the place of execution (*lex loci actus*).¹⁶⁵ Provision is also made for the execution of a Will on board a vessel or aircraft, in which event it will not be invalid because of its form, should it comply with the internal law of the state or territory in which such vessel or aircraft was registered at the time of such execution, or which it was otherwise most closely connected at the time.¹⁶⁶ It is not however required that the ship or aeroplane be in motion for these provisions to be applicable.¹⁶⁷ Thus for example should a person execute a Will on board the Symphony, a luxury cruise ship registered with the shipping authorities in Greece and not comply with South African formalities, the Will may still be formally valid in terms of this provision, should it be executed in compliance with internal law of Greece. These sections are however not applicable to a will made otherwise than in writing by a South African citizen.¹⁶⁸

These provisions are based on the Convention on the Conflicts of Laws, relating to the Form of Testamentary Dispositions of 1961, of which South Africa is a signatory party¹⁶⁹, but are also seen as a codification of our common law rules.¹⁷⁰ Essentially these rules from a South African perspective will come into effect, when wills are executed outside South Africa by persons who die in South Africa, or execute Wills in South Africa disposing of assets elsewhere.¹⁷¹

Having thus determined that the formation of the trust will depend on compliance with the prescribed formalities of Wills (which will not necessarily be those of South Africa), we focus now on the place of formation for which differing viewpoints exist. Is it the place of execution of the Will, the place where the Will is drawn up, the place where it is registered and is subjected to public authority ie the place where its administration commences, or the place where the testator died?

Place of execution of the Will

A Will has been described as –

“the unilateral and voluntary minute, executed in accordance with the prescribed formalities, of a testator’s wishes and directions regarding the disposal of his estate assets upon death.”¹⁷²

¹⁶⁵ *Tomlinson v Zwirchmayr* (1998) 2 SA 840 (T); Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – A21 at 45.

¹⁶⁶ S 3 *bis*(1)(e).

¹⁶⁷ Neels, J H “Private International Law of Succession in South Africa “ 2006 (4) TSAR at 710.

¹⁶⁸ S 3 *bis*(4).The common law rules will then prevail.

¹⁶⁹ Neels, J H “Private International Law of Succession in South Africa “ 2006 (4) TSAR at 708.

¹⁷⁰ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – A21 at 45.

¹⁷¹ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – A21 at 45.

¹⁷² Du Toit F *South African Trust Law Principles and Practice* (2002) at 37.

Consequently a trust *mortis causa* is regarded as the result of an unilateral act on the part of the testator.¹⁷³ Due to the importance of testator and the act of execution of the Will whereby the trust is created, one viewpoint is that the place where the testator executes the Will, is the place where the trust is formed. Du Plessis explains this theory as follows “Although the testamentary trust is formed only on the death of the testator, the Will is the instrument through which the trust is formed, and the *place of its execution* is therefore the pertinent place.”¹⁷⁴ (own italics) We first expand on this theory, prior to presenting our dissenting views.

The term “execution” is not defined in the Wills Act, but has been defined in case law as “comprising the performance of all formalities which are necessary for the Will to be valid.”¹⁷⁵ In light of the aforesaid requirement, that a Will will only be regarded as executed once *all* formalities have been complied. Du Plessis gives a practical example of a testator who signs a Will in South Africa without witnesses, thereafter travels outside South Africa and confirms his signature in front of two independent witnesses in such country. She submits that the trust is consequently formed in such country and not in South Africa.

A tricky situation could arise where not *all* the formalities are complied with. For example in the aforesaid example, the testator signs and travels outside South Africa and only confirms his signature to one witness who then signs, thus not complying with the prescribed formality as to two witnesses. Although the last formalities were therefore effected in such foreign place, application will need to be made to court for the condonation of the non-compliance of the formalities and such court may be situate locally. Essentially then if this theory requires all formalities to be complied with for the Will to be executed, it will fail in such a situation, unless the court’s condonation is deemed as compliance of the last outstanding formalities.

The writer is of the view that this theory can be criticized. The first such criticism being that trusts may then be formed and consequently be regarded as resident in a country with whom the trust only has a mere formal and superficial connection of signatures affixed to its trust instrument, but has no substantive connection in that the Will may not necessarily be lodged with such countries’ authorities nor may the trust be recognised under its laws. It may lead to inadvertent or haphazard

¹⁷³ Du Toit F *South African Trust Law Principles and Practice* (2002) at 37.

¹⁷⁴ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes” 2009 (21) *SA Merc LJ* 325.

¹⁷⁵ *In re Jennett NO* 1976 1 SA 580 (A) - Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – A15 at 33.

places of formation based on the testator's travel itinerary and be far removed in time and location from the place where trust becomes effective upon death of the testator. In today's globalized world, where travel and emigration is prevalent, many examples will come to the fore. One example being a testator who does not regularly update his Will, and dies with a Will executed many years ago in a country he has long since emigrated from and has no ties to any longer. A further example can be found in the occurrence of South Africans with assets in more than one jurisdiction who may execute a Will for every country in which such assets are held. This execution may take place in one sitting and at one place, for example in country A and according to this theory, then all such trusts formed, will be formed and resident in country A. Upon death however each of the original signed Wills is then submitted to the appropriate authority in each of the countries where the assets are held, and the respective trusts are then further registered or recognised in such countries, without the authorities in country A even perhaps aware of such trusts. Thus the Will for the South African assets will be submitted to our Master's office and the testamentary trust registered here, but in accordance with this theory the trust will be regarded as formed and thus resident in country A for tax purposes. This leads to an impractical situation as well as a competition for residence between the place where the Will was executed and the place where it is further registered and established, and will be operational.

It is also rather unworkable as the country where the Will was signed those many years ago and where the trust is now regarded to have been formed, may not necessarily be aware of its existence. A counterargument would be that to ensure the existence and location of a Will executed within South Africa is known, a central database can be instituted in South Africa, such as is prevalent in European countries. For example in France, the *Fichier Central des Dispositions de Dernières Volontés* (FCDDV) is a central database of wills recording the details of any Will held with a notary in France.¹⁷⁶ So too in Brussels, are international and notarial Wills registered with the Central Register of Last Wills and Testaments, and in the Netherlands, for a Will to be valid, it must be deposited with a notary, and it has been mandatory to register the Will since 1918.¹⁷⁷ On a more regional level, the European Network of Register of Wills comprises the wills registries of several subscribing European countries.¹⁷⁸ This initiative is a direct consequence of the *Basel Convention*

¹⁷⁶ It must be noted that the testamentary dispositions are not accessible by the public before the death of the testator, and only by his heirs/legatees after his death. Limmer, P et al "Comparative Study on Authentic Instruments" *2 Romanian Review of Private Law* (2010) 204-306.

¹⁷⁷ English Law Commission *Should English Wills be Registrable?* Working Paper 4 (1966) 7. They note that the notary holds a semi-official position and is subject to onerous disciplinary rules, including the duty to inform the central registry's custodian of the Wills deposited with him.

¹⁷⁸ See in particular the European Network of Registers of Wills Association's website available at

relating to the Establishment of a System for the Registration of Wills of 16 May 1972 which provided for the establishment of national registration schemes and sought to facilitate international co-operation between such national authorities.¹⁷⁹ In the Explanatory Report to the Convention the rationale for such a central registry is given—

"A growing number of persons make their wills in a place not their home and even in a foreign country. Since most member States do not require wills to be deposited with a court of law, a notary or another authority, and have no central register, the heirs are often unaware of the existence and the whereabouts of a will. It is therefore useful to establish a registration scheme, the aim being to make it possible to ascertain whether or not a deceased person has made a will and, if so, where this will can be found."¹⁸⁰

A sentiment which had expressed in the United Kingdom a decade earlier, when its Law Commission also contemplated the question as to whether English Wills should be registrable.¹⁸¹ The Commission was of the view that there were essentially two options – a registry of wills containing information regarding the details of the testator and where the Will is to be located, alternatively a dispository where originals Wills could be stored, either on a voluntarily or compulsory basis.¹⁸² It preferred the former - a scheme of registration and proposed that it be compulsory with a time limit which if not complied with, would render the Will invalid.¹⁸³

In South Africa there is no central dispository or database of all Wills executed in the country. The Administration of Estates Act¹⁸⁴ only requires the lodging of Wills with the Master of the High Court upon the death of the testator. It is interesting to note that in the previous Act of 1913,¹⁸⁵ provision had been made for any person to lodge a Will, either open or closed with the Master and the latter

¹⁷⁹ <http://www.arert.eu/Informations-EN,25.html> and <http://www.successions-europe.eu/en/home> Last accessed on 05/05/2013. They are described as an "international not-for-profit organisatio." Available at <http://conventions.coe.int/Treaty/en/Treaties/Html/077.htm>. The member states to the Convention was Belgium, Bulgaria, France, Hungary, Italy , Portugal, Romania and Slovenia

¹⁸⁰ Basel Convention – Explanatory report available at <http://conventions.coe.int/Treaty/En/Reports/HTML/077.htm>. – Last accessed on 05/09/2013.

¹⁸¹ English Law Commission *Should English Wills be Registrable?* Working Paper 4 (1966) at 8 where it concludes that "public opinion may come sooner or later to accept the need for the setting up of some machinery to ensure that wills are not overlooked, to diminish the chances of their being suppressed, and to do away with the time consuming and expensive searches and advertisements which solitctors now have to put in train."

¹⁸² English Law Commission *Should English Wills be Registrable?* Working Paper 4 (1966) at 8.

¹⁸³ English Law Commission *Should English Wills be Registrable?* Working Paper 4 (1966) at 10. In contradiction with such a compulsory system, British Colombia had in 1945 introduced a voluntary system or registering information regarding the location of a testator's Will with the government office and has according to Chalke become "one of the most utilized shcemes of its kind in the world... probably the most successful voluntary registration system in existence." See Chalke, D "Wills Registry of British Columbia" (1980) 38 *Advocate Vancouver* at 381-382.

¹⁸⁴ 66 of 1965.

¹⁸⁵ Administration of Estates Act, 24 of 1913.

was obliged to retain the Will until such time as the testator demanded redelivery or passed away.¹⁸⁶ A voluntary deposit of Wills during the lifetime of a testator did therefore exist in South Africa until this Act was repealed by the current Act in 1967. Notarial Wills were also allowed until 1954, and in such instances the original Will had to be retained in the Notary's Protocol.¹⁸⁷ It further appears that the South African Law Commission considered the issue of a central wills registry in 1991, and in particular deliberated the two proposals by which it could be implemented.¹⁸⁸ The first was to link it to the existing population registry so to allow for registration and custody of Wills, and the second, for a scheme of "wills notices" to be administered by local authorities.¹⁸⁹

Whilst the Commission recognized the value of a central registration system, it concluded that it was not convinced that the costs relating to the establishment of such a system was justified by its perceived advantages.¹⁹⁰ It may be worthwhile to reconsider whether the electronic age with its enhanced data processing abilities and accompanying reduction in costs to administer and store such information, has not voided such conclusion. So too, in light of various governmental departments having such databases, such as SARS¹⁹¹ and the Department of Home Affairs,¹⁹² it may be asked whether the state does not already have the necessary infrastructure, information technology and expertise to accommodate such a registry. For example, the Master's office now has an "Integrated Case Management System" which operates electronically, and connects over 400 Magistrate's offices and Deceased Estate Service Points as well as the fourteen Masters'

¹⁸⁶ Section 15 of the Administration of Estates Act, 24 of 1913.

¹⁸⁷ Corbett et al *The Law of Succession in South Africa* (2001) at 113. With the implementation of the Wills Act, 7 of 1953 only Notarial Wills executed on or before 1 January 1954 are recognized.

¹⁸⁸ SA Law Commission *Review of the Law of Succession (Project 22)* (1991) at 54-55.

¹⁸⁹ In respect of the first option, the Commission was of the opinion that it would necessitate substantial costs and adjustments to the population register. Also that it would not be able to address issues concerning the alteration and revocation by way of a codicils, and would necessitate the original Will be returned to the testator for destruction should he wish to destroy it. The second option would call for an entirely new system of record keeping for such authorities and was perceived to be dependent on efficient co-operation between such authorities and the various Master's offices as well as testator informing such authorities should he relocate from one province to another.

¹⁹⁰ SA Law Commission *Review of the Law of Succession (Project 22)* (1991) at 55.

¹⁹¹ SARS increased use of technology and modernisation of its systems has been extremely successful – so for example in 2006 1% of all taxpayers filed by way of electronic filing compared to 99% who did so manually, had by 2012 dramatically reversed, when an estimated 99% of all taxpayers e-file. This must serve as an indication of the effectiveness of its databases - see Odendaal, N "SARS to launch e-filing app" available at <http://www.polity.org.za/article/sars-to-launch-e-filing-app-2012-07-02>, last accessed 05/09/2013.

¹⁹² For example it is already possible to run a search on the population registry with the name and identity number of a person to ascertain whether he is deceased/alive and married or not. Available at the website of Department of Home Affairs - http://www.dha.gov.za/enquiry/living/status/living_status.asp – last accessed 05/09/2013.

offices.¹⁹³ Through its web portal, the public is able to access information regarding deceased estates, trusts, curatorships and insolvencies from data originating after 2008. Consequently it may be possible for the Master to, in conjunction with the databases maintained by SARS and the Department of Home Affairs, to expand its capabilities to offer this function. There are indications that already private persons/institutions regard themselves as having the necessary capacity as recently, electronic websites offering such a service, has become available in South Africa.¹⁹⁴ Yet the fact that they have neither official endorsement nor accreditation detracts from their usefulness and integrity.¹⁹⁵ It must however be noted that the mere recordal of the location of the Will, will not necessarily be a guarantee of the Wills' validity or its originality, or that the Will so recorded is indeed the last Will of the Testator. Until however such a registry is operational, and it is compulsory for Wills executed within our borders to be lodged or be given notice of, there is no certainty that Wills executed here, will be known to the authorities.

A third point of criticism arises from the fact that it is not in South Africa a prescribed statutory formality that the place (nor the date) where the Will was executed is recorded in the Will itself to render it valid. Whilst it is usually done in practice, a Will wherein a trust is created, and whose content does not contain the place of execution, is still enforceable. It will therefore be a matter of evidence as to where the Will was in fact executed, which may be uncertain and cause a protracted enquiry.

In our view, the Will is merely the recordal of the testator's instructions of establishing a trust to house certain assets, and the place where such recordal takes place should be irrelevant – rather the attention should be on where the trust comes into operation practically and the obligation to house and administer the assets performed. Whilst the Will can be recognised as a indispensable *causa causans* to the formation of the trust, being the immediate link between the testator and the trust which is formed upon his death, its place of execution should not be conclusive in determining the residence of the trust. However on a strict literal interpretation of the relevant law and despite

¹⁹³ See "Master of the High Court's Integrated Case Management System (ICMS) Web Portal" http://www.justice.gov.za/master/m_main.htm - last accessed 05/09/2013.

¹⁹⁴ A "South African Registry of Wills and Testaments" can be found at <http://sarwt.org/> - last accessed on 05/09/2013. The website records that the registry was created by a group of legal professionals, who had identified a vacuum in the current system and provides a service of recording details iro the testator, executor and the location of the Will. It is indicated to be free to both the public and professionals.

¹⁹⁵ There would for example be no indemnity fund to appeal against where for example the data was incorrectly captured, stored, or an error crept in the retrieving of such information, yielding an incorrect search result which may have severe repercussions for interested parties relying on such information.

the impracticalities associated with this approach, it is submitted that it would appear correct that in law, a trust *mortis causa* is regarded to be formed where it is executed.

Place where the will is drawn up

Du Plessis cites Oliver & Honiball as authority for the view that the place of execution of the Will is also the place where the Will is formed, and thus resident, but in both their previous and current edition of their book, their view is expressed as follows- “it may therefore be argued that such trust will be resident if the Will under which the trust is created was *drawn up in South Africa*.” (own italics).¹⁹⁶ “Drawn up” is not necessarily equivalent to execution.¹⁹⁷

The “drawing up” of a Will usually connotes the process of preparing the Will prior to its execution, which can be done either personally by the testator, or through a third party i.e. by taking instructions from the testator and documenting same for approval and signature by him. On this basis, it would therefore appear that it is the location where the drafting is effected, that is the connecting factor for residence. A myriad of questions then arises: the first being as to how one would one know where the drafting was effected. Unlike the place of execution, in practice, the place of drafting is not necessarily indicated on the document,¹⁹⁸ nor does it necessarily involve further parties who could confirm the location (unlike the place of execution which could be confirmed by the witnesses).¹⁹⁹ Especially where it is done by the drafter personally, it would not be readily known e.g. the testator could draft the Will in South Africa upon holiday and sign it upon returning home outside South Africa, without ever advising anyone as to where it was drafted. Moreover if seen as a process, does “drawn up” indicate that the whole process, from taking instructions to the final editing, must take place within South Africa and consequently the input of other parties, such as possibly the testator himself and/or his legal and financial advisers, who may

¹⁹⁶ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 153.

¹⁹⁷ Neither the word “drawn up” or “executed” is defined in the Wills Act. “Executed” appears frequently in the Act. The words “drafted” or “executed” and “drafting” or “execution appear most notably in the rescue provision of S2(3) where a body of case law has developed addressing the meaning of these words. See Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – A7 at 15 – 19. Whilst it is submitted that Honiball & Olivier did not use the word in its strict technical sense, regard may be had to such cases to illustrate the substantial differences between drafting and execution.

¹⁹⁸ It is not a prescribed formality or *essentia* that the place of execution is recorded on the Will but in practice this is usually done.

¹⁹⁹ Execution of a Will requires two independent witnesses in whose presence the testator must affix his signature or confirm same and in whose presence, and the presence of each other, they must affix their signature. Such witnesses could be consulted to determine the place of execution.

respectively all be in different places outside South Africa, be disregarded or will such comments, instructions and additions, if substantial, relocate the place of drafting to such countries? Will a document still be regarded as drafted in South Africa if the drafter, situate outside South Africa, originates the contents from South Africa? Aside from these practical difficulties, from a policy perspective it appears to be rather a weak connection, to ascribe residence based upon the location where the assimilation of the contents of the trust instrument took place. It is therefore our view that this may have been an error in expression on behalf of the learned authors, especially as they noted in paragraphs preceding such comment, that “the place where the trust deed is drafted does not necessarily equate to the place where the trust is established or formed”.²⁰⁰

Place where the testator dies

A further possibility is that the trust can be regarded as being formed at the *place where the testator dies*. As was evident from the discussion above, the trust only comes into existence upon such date, and thus one could assume that the trust would be formed at the place where the trust’s existence begins. This would be simpler to ascertain as there would only be one such place. Du Plessis dismisses such view, stating simply that such place is “irrelevant.”²⁰¹ The latter would appear to be correct, as it is not the place of death that contributes to the formation of the trust, but the happening of the event of death that acts as catalyst to its formation, regardless of the actual location of death.

Place where subjected to public authority/becomes operational

A further viewpoint can be identified in Olivier & Honiball’s book, *The Taxation of Trusts in South Africa*, where without drawing a distinction between trust *mortis causa* and trust *inter vivos*, they state as follows²⁰²:

“... it is clear that a trust formed in South Africa, in other words a trust instrument signed and executed in South Africa and registered with the Master of the High Court, would be a South African tax resident.”

From the aforesaid, it may therefore be inferred that they equate “formed” to “signed, executed in South Africa and registered with the Master.” The Master in the aforesaid sentence may be

²⁰⁰ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 153.

²⁰¹ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 334.

²⁰² Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 68.

substituted by any public authority under which the trust becomes operational and where its administration commences. Du Plessis however reminds that a trust is not ‘established’ or ‘formed’ through registration of the trust instrument, or authorisation by the Master, and thus such official acts are immaterial to the question of residence.²⁰³

Yet from a practical viewpoint this basis makes sense. If a trust is regarded as formed at the place where the Will is drawn up, or executed or even where the testator dies and such place happens to be in South Africa, South African authorities will not necessarily be aware that a testamentary trust has been formed in South Africa, and is thus potentially tax resident here, nor will the further details of the trust such as who the trustees are and what type of trust it is (discretionary/vested) be ascertainable. As set out above, with trusts *mortis causa* the trust instrument is the Will, but the Will will not necessarily or statutorily be required to be lodged with the authorities in South Africa.

It is so that the death of a person must be reported to the Master should the person die within South Africa and leave any property or any document purporting to be a Will therein.²⁰⁴ Should a person die outside the Republic and leave property or a document purporting to be a Will in South Africa, then the person having possession or control of the property or Will is obliged to report the death to the Master.²⁰⁵ The Will itself must be transmitted or delivered to the Master,²⁰⁶ and usually this is done simultaneously with the reporting of the death. The Master is further empowered to release the Will for purpose of liquidating and distributing the estate of the deceased person, should he be satisfied that the person has not left any property in South Africa.²⁰⁷ Thus, in an example where a person from England draws up and executes a Will, whilst on holiday in South Africa and dies upon returning home, and had neither left the Will in South Africa for safekeeping nor has any property in South Africa, the death need not be reported to the Master nor the Will lodged. Thus the testamentary trust formed in such a Will may never come to the attention of the South African authorities.

Consequently the basis that a trust will only be regarded as conclusively formed at the place where

²⁰³ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 333.

²⁰⁴ S7(1) of the Administration of Estates Act, 55 of 1965.

²⁰⁵ S7(2) of the Administration of Estates Act, 55 of 1965.

²⁰⁶ S8(1) requires that the document being or purporting to be a Will must be transmitted or delivered to the Master as soon as the person in whose possession, learns of the death. The Will need not necessarily be the original – should a person have been nominated as executor in a Will which is not in the Republic the Master is empowered to accept a copy thereof certified by a competent public authority in the relevant country.- S14(1).

²⁰⁷ S8(5) of the Administration of Estates Act, 55 of 1965.

it is subject to public authority, or becomes operational may be supported. It is a practical approach, as the trust will only then be able to engage in the commercial traffic, to receive the assets bequeathed to it. Moreover, it guards against a reputation of the South African tax authorities to be seen levy taxes in situations where there is no real connection to South Africa. Nor does South Africa wish to tax that, which it has no means of collection.²⁰⁸ However it would then require that a trust be regarded as only conclusively formed at the place where it becomes operational, an interpretation that is not supported by the relevant legal framework in terms of our succession laws. However if Du Plessis' earlier proposal is carried through and registration is added to the requirements, this basis would then be accommodated, as prior to assuming control of the trust property, the trust must be lodged and authorization received. Whilst it may be argue that such an interpretation would restrict the interpretation of the test, it must be noted that these trusts are generally not used for tax avoidance or evasion.²⁰⁹

Conclusion

In conclusion to this section, it has been said that this criteria – “incorporated, established or formed”, is one where there is no grey areas of dispute,²¹⁰ but in relation to trusts *mortis causa* and particularly the place where the trust will be regarded as formed, this may not entirely be accurate as some greyscales in the differing viewpoints regarding the possible places of formation are evident from the discussion above.

The two most favoured views is that it is (a) the place where the Will is executed in compliance with all the formalities alternatively (b) the place where the Will is executed and subjected to public authority i.e. in South Africa, with the Master of the High Court so as to be operational and where its administration commences.

Whereas with the former, some practicality difficulties may be experienced in respect of enforcement and awareness of the existence of the Will. This may be cured by the introduction and implementation in South Africa of a central database of Wills, such as is found in some European countries where after execution, the Will is registered and in some instances also, retained in a central registry. However in South Africa this may be countenanced by a lack of infrastructure,

²⁰⁸ Implicitly it is necessary that South African courts have jurisdiction over such persons or entities which it seeks to tax.

²⁰⁹ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 315.

²¹⁰ Goosen, C “International Tax Planning: The concept of Place of Effective Management” research dissertation submitted to the University of Cape Town on 15 February 2006 at 7.

administrative capacity and funding to implement. Yet, in today's electronic era where various governmental departments appear to have the technological capacity to collect and retain vast amounts of data, the validity of such an argument wears thin.

Yet, even where the Will is executed here and registered in such database, it does not obviate the fact that South Africa may have no substantive interest in its functioning and apart from perhaps initially allowing it, the protection of its laws to confirm its valid formation, provides no further shelter to it as required by underlying notion to the residence based taxation.

Thus the second stated alternative with its continued protection to the entity conforms most with the justification of this basis of taxation. This would however require that it be read in to the definition, that in relation to *mortis causa* trusts, such a trust is conclusively formed where is subjected to the public authority and becomes operational.²¹¹ This would appear to be a practical approach, but would be out of kilter with the strict tenets of succession law, though the Income Tax Act indirectly provides support for this contention, and would again underscore Du Plessis' proposal for this criterion to include a registration-element.

Although some greyscales do exist, does it then open the door for exploitation by which the place where the trust is formed can be manipulated? Although potentially this may be so, in reality such manipulation is probably negated by the very nature of *mortis causa trusts*. They are created in the Will of the founder who would be the most likely to manipulate same, but the least likely to benefit therefrom. Upon the establishment of the trust, he is after all deceased and has no interest; also, the actual creation of the trust remains tentative and uncertain as it could be revoked till date of demise. The exact time when the trust will come into existence is not known and at such date, the laws may have changed and countered such manipulation. Furthermore, these trusts are mostly used for benevolent reasons such as to offer protection till a certain age (in the event of minors) or an event such as death/remarriage (in the event of a trust created to provide for life of the spouse and thereafter devolve upon the children) as opposed to "tax avoidance for which they are seldom used."²¹²

Advent of the electronic age

²¹¹ This view is also endorsed by Du Plessis I "The Residence of a Trust for South African Income Tax Purposes " 2009 (21) SA Merc LJ at 334.

²¹² Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 315.

A last consideration in this respect is the advent of the electronic era which could in the future lead to the identification of further places of formation for trust *mortis causa*. In today's world, technology is ever advancing and developing, and already there is a vast range of electronic mediums, which could be applied to document the last wishes of a testator, be it visual, audio, text or a combination of the aforesaid.²¹³ Van Staden & Rautenbach²¹⁴ note that "in recent times the use of electronic media has grown with an alarming rate. More often than not people use some sort of electronic medium, to draft a document or to pass information to one another." Rautenbach²¹⁵ comments further that "not even the law of succession, and especially the area of testamentary succession, has escaped the influence of the ever-increasing use of modern technology."

In the particular context of Wills, Rautenbach states for example that "latest trend in the law of testamentary succession, is for a prospective testator to make use of the internet to find sites to assist him in the drafting of his will."²¹⁶ This is done by either providing a pro forma Will for downloading, or requesting the client to provide information whereupon a draft Will is then prepared.²¹⁷ Faber & Rabie²¹⁸ note that whereas previously a document had to be printed to be signed, it is now possible to write on a computer screen with an instrument and affix an electronical signature to it. A technically valid Will could thus be drafted and executed on computer, without a single piece of paper being touched. This would greatly then impact on the current perceptions on where and when a trust created in such a Will would be formed. But although technically possible, it is as yet not legally acceptable. At present, only a Will in writing complying with the prescribed formalities, is recognised.²¹⁹

Some authors therefore lament that the law has not been able to keep pace with technological advances.²²⁰ However certain aspects of electronic Wills have been considered. In the early 1990's

²¹³ Eg. video recordings, cd's, dvd's, photographs, cellphone communications), computer storage or email to mention but a few.

²¹⁴ Van Staden, A R & Rautenbach, C "Enkele gedagtes oor die behoefte aan en toekoms van elektroniese testament" 2006 *De Jure* at 586.

²¹⁵ Rautenbach, C "Formalities of 'foreign' internet wills in South Africa and the Netherlands: A storm In a tea-cup?" 2009 (72) THRHR at 241.

²¹⁶ Rautenbach, C "Formalities of 'foreign' internet wills in South Africa and the Netherlands: A storm In a tea-cup?" 2009 (72) THRHR at 242.,

²¹⁷ Rautenbach, C "Formalities of 'foreign' internet wills in South Africa and the Netherlands: A storm In a tea-cup?" 2009 (72) THRHR at 242.

²¹⁸ Faber JT & Rabie, PJ "Van tikmasjien tot rekenaar: 'n ondersoek na die ontwikkeling van die Suid-Afrikaanse erfreg in die tegnologiese era" 2005 (4) TSAR at 767-768.

²¹⁹ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – A7 at 26.

²²⁰ Cornelius, S "Condonation of Electronic Documents in terms of Section 2(3) of the Wills Act, 7 of 1953" 2003 (1) TSAR at 1; Van Staden, A R & Rautenbach, C "Enkele gedagtes oor die behoefte aan en toekoms van elektroniese testament" 2006 *De Jure* at 587.

the South African Law Commission was requested to consider the possibility of video Wills, but at that juncture, was not prepared to award statutory recognition to such Wills.²²¹ Corbett advances possible reasons for their rejection: it “was regarded as too revolutionary at the present time” and would be out of kilter with the current procedure followed in the Master’s office, as to the registration of Wills and administration of estates.²²² The Commission remarks more glibly in their Report “that testators whose sense of the dramatic moves them to record testamentary wills on video can be expected to also properly execute a written will” and hence concluded that the “time for statutory recognition of video Wills has not yet arrived.”²²³ In the present age with thousands of video’s recorded and posted to internet and websites (such as for example the popular video-sharing website ‘YouTube’) on a daily basis, it may be asked whether the time has not now arrived. In respect of the execution of Wills in electronic format, the Electronic Communications and Transactions Act (hereafter ECTA)²²⁴ is potentially of relevance. Pace & Van der Westhuizen²²⁵ summarizes the objects of the Act as including:

“the removal and prevention of barriers to electronic communications and transactions in the Republic of South Africa; to promote legal certainty and confidence in respect of electronic communications and transactions; to promote the development of electronic transaction services which are responsive to the needs of users and consumers; and to develop a safe, secure and effective environment for the consumer, business and government to conduct and use electronic transactions.”

The sphere of application of ECTA is set out in section 4 and applies in respect of “any electronic transaction or data message.”²²⁶ Despite this potentially wide ambit, subsection 3 then goes on to exclude the operation of certain sections of ECTA to the Wills Act and subsection 4 goes further and specifically states that ECTA, must not be construed as giving validity to any transaction in Schedule 2. In the latter “the execution, retention and presentation of a will or codicil as defined in the Wills Act” is then listed. Consequently the Act does not authorize the execution of Wills in electronic form.²²⁷ Thus neither the Wills Act nor ECTA makes provision for electronic Wills, and hence trusts *mortis causa* can not yet be formed in this fashion.²²⁸ Yet this may not remain the *status quo* for long, as Pace & van der Westhuizen remark “undoubtedly the rapid development of technology will

²²¹ SA Law Commission *Review of the Law of Succession (Project 22)* (1991) at 166-167.

²²² Corbett et al *The Law of Succession in South Africa* (2001) at 57.

²²³ SA Law Commission *Review of the Law of Succession (Project 22)* (1991) at 55-56.

²²⁴ 25 of 2002 - the Act came into operation on 30 August 2002.

²²⁵ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – A4 at 6(10). The objects of the Act is set out in s 2 of ECTA.

²²⁶ S4(1).

²²⁷ Wood-Bodley, M C “Wills, Data Messages, and the Electronic Communications and Transactions Act” (2004) SALJ 526.

²²⁸ Van Staden, A R & Rautenbach, C “Enkele gedagtes oor die behoefte aan en toekoms van elektroniese testament” 2006 *De Jure* at 586.

evoke pressure for the legislature to amend both the ECT Act and the Wills Act in order to legalise wills which are produced electronically.”²²⁹ This may in turn facilitate the establishment of a central database for the storage of Wills, which could be electronically stored as opposed to physically.

The various authors suggest the following ways in which electronic wills can be recognized: the current formalities for a validly executed will as set out in the Wills Act could be amended to provide for electronic wills;²³⁰ alternatively the prescribed formalities need not be changed but the condonation provision in the Wills Act, could be amended to expressly allow for the condonation of electronic wills by the court;²³¹ the condonation provision could be interpreted more liberally so as to encompass technological developments²³² alternatively ECTA could be extended to encompass wills but “careful treatment” in such an extension of ECTA would be required.²³³

Such electronic Wills have already realized in everyday life and required the court’s adjudication. In *MacDonald v The Master*²³⁴, a document stored electronically on a computer hard drive, unprinted and thus unsigned by the deceased and witnesses, had been condoned as a valid Will by the court. More recently, in *Van der Merwe v Master of the High Court and another*,²³⁵ a document sent by email, unprinted and thus unsigned by the deceased and witnesses was also condoned by the court. In the *MacDonald*-case the court drew attention to the utilization of such electronic mediums –

“this approach is also in accordance with modern and accepted technology. Information is typed and stored in computers and only when a document is physically needed is this information printed by the computer. Written documents barely exist and the ordinary typewriter has also ceased to exist, in which event all typing is done on a computer, stored in the computer’s memory and printed when and if needed.”²³⁶

²²⁹ Pace RP & Van der Westhuizen WM *Wills and Trusts Wills and Trusts* (October 2012) – A7 at 26.

²³⁰ Van Staden, A R & Rautenbach, C “Enkele gedagtes oor die behoefte aan en toekoms van elektroniese testament” 2006 *De Jure* at 604.

²³¹ Van Staden, A R & Rautenbach, C “Enkele gedagtes oor die behoefte aan en toekoms van elektroniese testament” 2006 *De Jure* at 604.

²³² Faber JT & Rabie, PJ “Van tikmasjien tot rekenaar: ‘n ondersoek na die ontwikkeling van die Suid-Afrikaanse erfreg in die tegnologiese era” 2005 (4) TSAR at 783..

²³³ Wood-Bodley, M C “Wills, Data Messages, and the Electronic Communications and Transactions Act” (2004) SALJ 528.

²³⁴ *MacDonald v The Master* 2002 5 SA 64 (N). According to Pace & van der Westhuizen this case was the first example of modern technology’s implications on the execution of wills. Pace RP & Van der Westhuizen WM *Wills and Trusts Wills and Trusts* (October 2012) – A7 at 26. Interestingly in that case a testamentary trust was created for the deceased’s daughter as residuary heiress of his estate and would terminate upon her attaining the age of 25.

²³⁵ (2011) 1 All SA 298 SCA.

²³⁶ At 71 F-G.

These cases can perhaps be seen as an indication that whilst the era of pen and paper²³⁷ may not yet have passed, the increased utilization of electronic mediums to create and store documents is prevalent in society, and that society is becoming more and more comfortable and familiar with such mediums with the distinction between paper and electronic documents fading away.²³⁸ Cognizance of the realities and impact of the technological world must therefore be taken by the South African legislator as has been done in other jurisdictions.²³⁹ These developments may in time, overthrow existing formalities²⁴⁰ for Wills, which in turn will require that the place and time of formation of trusts *mortis causa*, and consequently the residence of the trust, be reviewed and reassessed.

5 4 2 2 Trusts Inter Vivos

A trust *inter vivos* has been typified as a contractual arrangement, more specifically as a *stipulatio alteri*.²⁴¹ In the context of trusts, a *stipulatio alteri* denotes a “contract between a trust founder (the *stipulans*) and a trustee (the *promittens*), for the benefit of a trust beneficiary (the third party).²⁴² Due to this classification as a contract, it is argued that if the contract whereby the trust is created is concluded in South Africa, it will be regarded as “formed” here and thus tax resident.²⁴³ To then determine whether the trust contract has indeed been concluded in South Africa, regard must be had to the rules of contract law.

Christie states as starting point that “in order to decide whether a contract exists, one looks first for the agreement by consent of two or more parties.”²⁴⁴ As was said at paragraph 2 7 1, in a trust context, this agreement may be in the form of an oral agreement, but most often it will be in a

²³⁷ Faber JT & Rabie, PJ “Van tikmasjien tot rekenaar: ‘n ondersoek na die ontwikkeling van die Suid-Afrikaanse erfreg in die tegnologiese era” 2005 (4) TSAR at 783.

²³⁸ Van Staden, A R & Rautenbach, C “Enkele gedagtes oor die beoefte aan en toekoms van elektroniese testament” 2006 *De Jure* at 603, 604 & 609.

²³⁹ Van Staden, A R & Rautenbach, C “Enkele gedagtes oor die behoefte aan en toekoms van elektroniese testament” 2006 *De Jure* at 609.

²⁴⁰ Pace RP & Van der Westhuizen WM *Wills and Trusts* Pace RP & Van der Westhuizen WM *Wills and Trusts Wills and Trusts* (October 2012) – A7 at 26.

²⁴¹ *Crookes v Watson* 1956 (1) SA 277 (A); *Hofer and Others v Kevitt and Others* 1998 (1) SA 382 (SCA). This approach has “evoked considerable criticism” in the words of the Law Commission – see the list of articles cited by them at fn 67. Despite such criticism the Law Commission concluded that it is opposed to drastic changes to the law of trust and would furthermore not wish to regulate the basis of trusts *inter vivos* by statute. South African Law Commission *Report on the Review of Law of Trusts* (Project 9)(June 1987) par 23.29-23.33..

²⁴² Du Toit F *South African Trust Law Principles and Practice* (2002) at 23.

²⁴³ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 153.

²⁴⁴ Christie, RH & Bradfield, GB *The Law of Contract in South Africa* (6th)(2011) at par 2 available electronically on LexisNexis.

written instrument (i.e. trust deed), as only trusts in writing or reduced to writing are subject to the Trust Property Control Act.²⁴⁵ Furthermore in the trust setting, the agreement is between the founder and the trustee/s.²⁴⁶ This was affirmed in the case of *Crookes NO v Watson*,²⁴⁷ which held that the beneficiary obtains no right upon the mere execution of the agreement between the founder and the trustee. Thus the beneficiary is not at the time of execution a party to the contract. A trust *inter vivos* thus exist from the moment of execution of the contract (or entering into an oral agreement) by the founder and the trustee, regardless of the beneficiary's acceptance.²⁴⁸ The *essentialia* that an intention to create a trust must be present, must therefore be shared by the founder and the trustee.²⁴⁹

As there is more than one party involved, the formation of a trust *inter vivos* is therefore described as bilateral (or multilateral) act.²⁵⁰ Whilst this may be correct theoretically, in practice the formation of the trust is effected in a more unilateral fashion: it is the founder who determines whether he wishes to create a trust, decides the identity of the beneficiaries of the trust and the extent of their rights, determines the trust property and the trustees, as well as their powers, when the trust is due to terminate, the process for decision making and settles the contents of the trust deed.²⁵¹ Alternatively Du Toit submits, it is the family members who as the future trustees of the trust determine the contents of the trust deed or, the contents of the trust deed is drafted unilaterally by a professional based upon the particular requirements and circumstances of the clients.²⁵² There is therefore not a process of negotiation and agreement upon the terms between the founder and the trustee as is customary with parties to conventional contracts.²⁵³ The trustee's role is restricted to accept the office of trustee and subsequent acceptance of the trust property.²⁵⁴ Should the trustee not be willing to accept the terms of the trust, the founder may either resume his search for a willing trustee, alternatively may amend such terms and should the trustee be agreeable to same,

²⁴⁵ This can be in the form of an antenuptial contract or a contract between the relevant parties termed a trust deed -Olivier et al *Trust Law and Practice* (November 2011) at 2-5.

²⁴⁶ Olivier et al *Trust Law and Practice* (November 2011) at 1-21.

²⁴⁷ *Crookes v Watson* 1956 (1) SA 277 (A) at 288A.

²⁴⁸ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* at 330.

²⁴⁹ Cameron et al *Honoré's South African Law of Trusts* 5th Ed (2002) at 119.

²⁵⁰ Du Toit F *South African Trust Law Principles and Practice* (2002) at 37; Olivier et al *Trust Law and Practice* (November 2011) at 2-9.

²⁵¹ Olivier et al *Trust Law and Practice* (November 2011) at 2-9.

²⁵² Du Toit F *South African Trust Law Principles and Practice* (2002) at 37.

²⁵³ *Crookes v Watson* 1956 (1) SA 277 (A) at 305; Du Toit F *South African Trust Law Principles and Practice* (2002) at 37.

²⁵⁴ Du Toit F *South African Trust Law Principles and Practice* (2002) at 37; Olivier et al *Trust Law and Practice* (November 2011) at 2-9.

a true contract can then be said to come into being.²⁵⁵ This discrepancy between theory and practice, is however subject to the positive law, which has firmly entrenched a trust *inter vivos* as a contract and which thus prevails.²⁵⁶

As a bilateral (or even multilateral) act, and thus having several contractual parties, the respective parties need not all be simultaneously in one place where the contract, namely the trust instrument, is concluded. However differing locations complicates the place where the contract is then regarded to be concluded at.

To determine the place where the trust deed is concluded regard may be had to the rules governing the place of formation of a contract. The general principle applied to determine the place of formation of contracts is based on the information theory. The theory is explained in *LAWSA*²⁵⁷ as follows –

“The conscious agreement (consensus) between the offeror and the offeree, which is the basis of a contract, cannot exist until the offeror *knows* that the offer has been accepted by the offeree. Logically, therefore, a contract can come into existence only when the offeree’s acceptance is communicated to the offeror, and this is indeed the general rule. It is known as the “information theory”.

There are also other theories which find application in certain circumstances²⁵⁸: the “declaration theory” holds that the contract is concluded when the offeree manifests his acceptance to the offer.²⁵⁹ The “expedition theory” regards the contract as concluded when the offeree sends off his acceptance, whilst the “reception theory” is the opposite thereof, stating that the contract is concluded when the offeree receives the acceptance and also regardless of whether the offeror reads it or learns of its contents.²⁶⁰

The information theory is applied subject to certain exceptions.²⁶¹ For example the offeror may

²⁵⁵ Olivier et al *Trust Law and Practice* (November 2011) at 2-9.

²⁵⁶ Du Toit F *South African Trust Law Principles and Practice* (2002) at 37.

²⁵⁷ Joubert (ed) *LAWSA Contract Vol 5 (1)* at 381 (last updated as at 30 June 2010) available electronically on LexisNexis; *The Fern Gold Mining Company v Tobias* (1890) 3 SAR 134; *Dietrichsen v Dietrichsen* 1911 TPD 486.

²⁵⁸ The information theory may be displaced by the further theories when factors, such as the geographical separation of the parties, the nature of the contract, the commercial *savoir faire* of the parties to the contract or an execution clause regulating same, are present - Van der Merwe, Van Huyssteen, SLF; Reinecke MFB & Lubbe, GF *Kontraktereg: Algemene beginsels* 2 ed (2004) at 66.

²⁵⁹ Joubert (ed) *LAWSA Contract Vol 5 (1)* (30 June 2010) available electronically on LexisNexis at 381.

²⁶⁰ Joubert (ed) *LAWSA Contract Vol 5 (1)* (30 June 2010) available electronically on LexisNexis at 381.

²⁶¹ Joubert (ed) *LAWSA Contract Vol 5 (1)* (30 June 2010) available electronically on LexisNexis at 381.

dispense with the requirement of notification of acceptance.²⁶² The contract will then be deemed as concluded when the offeree manifest his acceptance.²⁶³ The medium of communication may also influence which theory will be applied. Should postal communication be used, the contract is deemed to come into existence based upon the expedition theory, thus when the acceptance is posted.²⁶⁴ Should a medium be used which is regarded as sufficiently similar to contracts made in the presence of the contracting parties (*inter praesentes*), such as by telephone, telex or telefacsimile, then the information theory becomes applicable again.²⁶⁵ There is however nothing preventing the parties from agreeing upon the particular mode the acceptance must be communicated.²⁶⁶ Nor from agreeing in the contract upon the particular place the contract will come into being, which would then obviate the application of any of the above theories.²⁶⁷ It must be noted then that the intention of the parties should still be ascertained and if different from these theories, it will prevail, as the court will not seek to enforce a theory oblivious to the parties' intention.²⁶⁸

Applied to trusts, under the general application of the information theory, and in the absence of the parties agreeing otherwise, a trust will be regarded as formed when the founder is informed of the acceptance by the trustee²⁶⁹ and in the event of more than one trustee, when informed of

²⁶² Christie writes that almost all the case law after stating the general rule, immediately go on to point out that the offeror may expressly or impliedly dispense with the normal requirement that the offeree's acceptance be communicated to him. This is a natural consequence of the rule that the offeror may prescribe the method of acceptance. Christie, RH & Bradfield, GB *The Law of Contract in South Africa* (6th)(2011) at 72 available electronically on LexisNexis.

²⁶³ Joubert (ed) LAWSA Contract Vol 5 (1) (30 June 2010) available electronically on LexisNexis at 382.

²⁶⁴ *Cape Explosives Works Ltd v South African Oil & Fat Industries Ltd; Cape Explosives Works Ltd v Lever Brothers (SA) Ltd* 1921 CPD 244; Joubert (ed) LAWSA Contract Vol 5 (1) (30 June 2010) available electronically on LexisNexis at 382. The reasoning of the rule may be based upon the allocation of risk. One explanation is that at the time of the development of the expedition theory in English law, the circumstances were such that it was felt fair to place the risk on the person who initiated the communications by post. Van der Merwe, Van Huyssteen, SLF; Reinecke MFB & Lubbe, GF *Kontraktereg: Algemene beginsels* 2 ed (2004) at 68.

²⁶⁵ *Jamieson v Sabingo* 2002 4 SA 49 (SCA). at 54 "Parties who communicate by telephone, telex or telefacsimile transmission are 'to all intents and purposes in each other's presence'; Christie notes that it only holds true should the parties applied the chosen technology to put themselves in a conversational situation, but should they have treated their communications more like posted letters, then it will be more appropriate to apply the postal rules - Christie, RH & Bradfield, GB *The Law of Contract in South Africa* (6th)(2011) at 81-82 available electronically on LexisNexis

²⁶⁶ Christie, RH & Bradfield, GB *The Law of Contract in South Africa* (6th)(2011) at 67 available electronically on LexisNexis.

²⁶⁷ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* at 330.

²⁶⁸ *Kergeulen Sealing and Whaling Co Ltd v Commissioner for Inland Revenue* 1939 AD 487; . Christie, RH & Bradfield, GB *The Law of Contract in South Africa* (6th)(2011) at 75 available electronically on LexisNexis.

²⁶⁹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 153 referring to Van Niekerk & Schulze *The South African Law of International Trade: Selected Topics* (2000) 45-46.

acceptance by the last trustee.²⁷⁰ Should the founder therefore be in South Africa upon the latter happening, the trust will be regarded as formed in South Africa. In light of the aforesaid theories and their possible application, Du Plessis gives the following interesting examples:²⁷¹

- (a) In the first scenario, a founder wishes to form a trust of which the trustees will be A, B and C. The first two trustees, A and B sign the trust deed and the founder is notified of their signature whilst present in South Africa. However when notified of C's signature he is outside South Africa. Du Plessis submits that based upon the information theory, the place of acceptance by the trustees is irrelevant, and the trust will not be resident in South Africa as the Founder was outside South Africa when notified.
- (b) In the second scenario, the facts remain the same but the trust deed is posted and thus the expedition theory is applicable. In this scenario the place where the C posts the trust deed, is the place where the trust is formed.

It is lastly clear that as trust *inter vivos* are formed by agreement, the parties to such agreement will be able to decide where the agreement will be concluded and can therefore chose the place quite arbitrarily, and be regarded as 'resident' accordingly to their preference. If however, the definition of a trust of the Act with its emphases on the control of the trust property, is taken to mean that the place where the trust takes operational effect, should be regarded, then such arbitrariness may be countered. Practically to be in a position to administer or control the trust property locally, such parties will effectively need to register the trust in South Africa. Consequently there is again support for Du Plessis that the trust be regarded as 'resident should registration and authorization of its trustees' be required.²⁷² This will eliminate the argument by its founding parties that the trust had been formed by their agreement and hence resident at any random place.

Advent of the electronic age

The advent of the electronic age and its impact must also be considered. However whereas other branches of law may have welcomed its technological advancements and introduced measures to

²⁷⁰ Du Plessis submits that one would need to ascertain the intention of the parties and should the intention of the parties be that all trustees must accept the offer before a valid trust is created, as it would be in most instances, the trust is formed upon notification of the acceptance of the last party. - Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* at 332.

²⁷¹ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* at 332.

²⁷² This was discussed in detail at par 5 4 2 1.

integrate and accommodate such developments,²⁷³ in the area of trusts formed *inter vivos*, the many years of pen and paper remain firmly embedded in practice and endures to date. Being by nature a contract, a trust *inter vivos* could potentially be concluded electronically in which event ECTA²⁷⁴ (as also discussed regarding trusts *mortis causa*) would be relevant. It is the objective of ECTA to promote the utilisation and legal validity of agreements concluded electronically.²⁷⁵

ECTA is applicable to any electronic transaction or data message.²⁷⁶ A “transaction” is defined as including a transaction of either a commercial or non-commercial nature, whilst a “data message” denotes electronic representations of information in any form that is generated, sent, received or stored by electronic means and includes voice, where the voice is used in an automated transaction; as well as a stored record.²⁷⁷ These definitions are therefore sufficiently broad to include a trust formed by agreement via an electronic medium such as email. The Trust Property Control Act does not contain any prohibitions for such conclusion (having been promulgated in an era prior to electronic communications), nor does the Act prescribe any formalities, not even stating as requirement, the signatures of the parties or witnesses to the trust deed.

In respect of contracting, and the traditional rules relating the time and place, Pistorius²⁷⁸ explains the difficulties:

“The principles of contract law are old - they were formed in a world that ran on paper and ink. The meeting of minds in cyberspace was never envisaged and the validity and effect of the use of electronic messages in commercial communications were never contemplated...Electronic communication techniques make the determination of the time and place of dispatch and receipt of data messages difficult to ascertain.”

ECTA however addressed same and regulates the time and place where such an agreement is concluded. This is done as a default, thus when the parties themselves have not agreed and determined otherwise. Only in the event that they have *not* done so, the agreement will be regarded as concluded at the time when and the place where the acceptance of the offer was

²⁷³ See Tladi, S “Electronic Communications in the Companies’ Registrar Office” 2004 (16) SA Merc LJ at 389 where he discusses the amendment of the old Companies Act already in 2001 to provide for electronic communications between the Companies Registrar’s Office and corporations, and between corporations and their members; The *Films and Publications Act* 65 of 1996, was amended in 1999, to address publications by internet; more recently, in the lodging of its returns, SARS allows for e-filing and in respect of transfer duty, for electronic payment.

²⁷⁴ Electronic Communications and Transactions Act, 25 of 2002.

²⁷⁵ Collier D “SMS and E-mail Contracts” *Juta Business Law* (16) 1 at 20.

²⁷⁶ S2.

²⁷⁷ S1 of the Act – definitions of “data”, “data message” and “transaction.”

²⁷⁸ Pistorius, T “From snail mail to e-mail- a South African perspective on the web of conflicting rules on the time of ‘e-contracting.’ 2006 (39) CILSA at 179 & 186.

received by the offeror.²⁷⁹ Section 23 contains certain deeming provisions, which regulate when a data message will be regarded as being received.²⁸⁰ It provides that a data message must be regarded as having been received by the addressee, when the complete data message enters and an information system, designated or used for that purpose by the addressee and is capable of being retrieved and processed by the addressee.²⁸¹ Thus the reception theory is applied²⁸², and regardless of whether the person knows, or actually retrieves the message, upon entry of the complete message, the contract is deemed concluded.²⁸³ It is further deemed to have been received at the addressee's usual place of business or residence.²⁸⁴ The fact that the agreement may have been reached in part (as opposed to wholly) by such data messages, will not affect the formation and validity of the agreement.²⁸⁵ Thus in a trust context, should the trust instrument be concluded via email, the trust will be regarded as formed at the place where the offeror (founder) receives the acceptance (of the trustee), which place is deemed to be where he is resident, or has his usual place of business. Should these locations be within South Africa, the trust will be regarded as formed here.

It is particularly the deeming provision which is problematic, Du Plessis²⁸⁶ raises several concerns regarding its application -

²⁷⁹ S 22(2) of ECTA.

²⁸⁰ S 23(1) furthermore states when data messages are used in the conclusion of an agreement, it must be regarded as having been sent by the originator when it enters an information system outside the control of the originator or, if the originator and addressee are in the same information system, when it is capable of being retrieved by the addressee

²⁸¹ S 23(b) of ECTA

²⁸² The reasons for the reception theory is explained in the case. The choice is endorsed by several authors, Stoop, Pistorius. See the latter at 213 where she states as follows "... the rules on contract formation were devised in an era when 'mail' only meant one thing: 'snail mail'. Contract law has developed over hundreds of years without any notion of the 'electronic wizardry' to come.... Existing law is ill-suited to deal adequately with this issue as it was devised when tangible pieces of paper were used as the medium of communication. The approach followed in the ECT Act to adopt the reception theory for electronic contracts was a brave step in the right direction." Pistorius, T "From snail mail to e-mail- a South African perspective on the web of conflicting rules on the time of 'e-contracting.' 2006 (39) CILSA..

²⁸³ *Jafta v Ezemvelo KZN Wildlife*[2008] 10 BLLR 954 (LC) at par 79-81, 91. Thus the expedition theory applies to postal contracts ,the information theory to telephone contracts and contracts generally, whilst the reception theory applies to contracts via email. Stoop explains it as follows: "The crux of the reception theory is that the data message must enter an information system outside the sender's control (ie, the sender must lose control of the message and the recipient must acquire control) in order to be regarded as having been received." Stoop, P "SMS and E-Mail Contracts: *Jafta v Ezemvelo KZN Wildlife*" (2009) 21 SA Merc LJ 110 at 123.

²⁸⁴ S 23(c) of ECTA. It is further not necessary that the [a25y2002s26]an acknowledgement of receipt of a data message

is not necessary to give legal effect to that message in terms of S26(1).

²⁸⁵ S 22(1) of ECTA

²⁸⁶ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) SA Merc LJ at 331.

“It is unclear whether the phrase ‘usual place of . . .’ qualifies only the word ‘business’ or whether it also qualifies the word ‘residence’. Clearly, ‘residence’ and ‘usual place of residence’ could potentially be interpreted differently. The two places of receipt – ‘usual place of business’ and ‘residence’ – seem to be alternatives, and this invites the question which one will prevail if they are not in the same place. One possible interpretation could be to apply the criterion of ‘usual place of business’ to businesses and the criterion of ‘residence’ to individuals, but the Act gives no indication that this was the legislature’s intention. Nor does the ECTA define the terms ‘usual place of business’ or ‘residence.’

In light of these difficulties, Du Plessis proposes that parties consider specifying in a trust instrument which is sent electronically, exactly where the agreement will be concluded.²⁸⁷

However as indicated in the introductory sentence to this discussion, the author is not aware²⁸⁸ nor could find examples in trust literature, or judicial precedent where a trust has been wholly formed by email or other forms of electronic communications. Whilst email is utilised to circulate the trust deed, the latter is in the form of an attachment to the email and thus the emails between the respective trustees will not be the agreement itself, rather the trust deed will still be required to be printed and signed, and form the constituting document. Often a standard clause in such trust instruments, is that the trustees by their signature of the trust deed, indicate their acceptance to the office. Implicitly then a prescribed a mode of acceptance by signature is laid down.

The reasons why the electronic age may be slow to overtake current practice, is potentially due to a number of reasons: perhaps firstly out of habit/custom, having for decades followed a particular written process to form the trust, the concerned role-players are slow to adopt a different procedure.²⁸⁹ A second reason is perhaps one of trust. A signature is seen to “confirm or endorse the intent, identify the signatory, and authenticate and confirm the integrity of the document signed.”²⁹⁰ Whilst ECTA provides for electronic signatures²⁹¹ and advanced electronic signatures²⁹² (which signature is the only acceptable signature when the law specifies that a signature is

²⁸⁷ Self-regulation was promoted by the court in *Jafta v Ezemvelo KZN Wildlife*[2008] 10 BLLR 954 (LC) at par 91.

²⁸⁸ Discussions with persons in the fiduciary services industry and an enquiry to the Cape Town Master’s office resulted in similar results.

²⁸⁹ Particularly since the promulgation of the Trust Property Control Act in 1988.

²⁹⁰ Tladi, S “Electronic Communications in the Companies’ Registrar Office” 2004 (16) *SA Merc LJ* at 595. This description is not exclusive to ink signatures.

²⁹¹ ‘Electronic signature’ is defined in S 1 of ECTA as meaning data attached to, incorporated in, or logically associated with other data and which is intended by the user to serve as a signature.

²⁹² ‘Advanced electronic signature’ is also defined in S1 and denotes an electronic signature which results from a process which has been accredited by the Authority as provided for in section 37.

required)²⁹³, and their recognition as the functional equivalent of ink signatures,²⁹⁴ a preference to an ink signature still prevails. This preference was eloquently expressed by the Discussion Paper²⁹⁵ albeit in the context of commerce:

“Hand-written signatures have been universally accepted for centuries as binding evidence of commitments – an essential pillar of business dealings. The notion of “digital signatures” in which a commitment is sealed via an imprint of electronic bits rather than pen and ink, involves more than just a shift in habits.”

Also, practically in the case of advanced electronic signatures, according to the website of South African Accreditation Authority (SAAA) who must accredit a service provider, before a signature can be regarded as an advanced electronic signature, the latter being the only legal recognised electronic signature where the law requires a signature, the notice on the website records that only two service providers have been accredited, thus the Act’s application is stymied by lack of such service being available generally.²⁹⁶ Recently the LAWTrust company announced that they have been accredited as an Authorised Service Provider and thus have made history as the first accredited service provider of advanced electronic signatures in South Africa.²⁹⁷ Their spokesperson stated that “The advent of AeSigns is a major milestone, and organisations and individuals now need to understand and embrace this ‘new world. Change is often a stumbling block, but since this one has very few, if any negatives, taking advantage of the positives will rapidly prove beneficial.”²⁹⁸ It remains to see whether it will receive a welcome reception, and whether more accreditations will

²⁹³ S 13(1) provides that where the signature of a person is required by law (legislation/common law) and such law does not specify the type of signature, that requirement in relation to a data message is met only if an advanced electronic signature is used.

²⁹⁴ The Act does not prescribe the technology that must be used and a signature could include the name of the contracting party typed in at the end, a scanned in copy of the signature embedded in the document or a digitally created signature. Michalson, L “Guide to the ECT Act” available at <http://www.michalsons.co.za/guide-to-the-ect-act/81> – last accessed 05/05/2013.

²⁹⁵ See South African Department of Communications *Discussion Paper on Electronic Commerce* – July 1999 at 15.

²⁹⁶ See website of South African Accreditation Authority (SAAA) records that Law Trust Party Services(Pty) Ltd (“Lawtrust”) and South African Post Office Ltd (“Sapo Trust Centre”) have been accredited as per their website at http://www.saaa.gov.za/accreditation_ProductsServices.htm - last accessed on 05/05/2013; See also Snail, S “Electronic Signatures in South Africa” *De Rebus* (2009) August at 51. This is despite the SAAA already inviting in 2007, Authentication & Certification Service Providers to apply for accreditation of their products and services so to change the status of their electronic signature to that of advanced electronic signature, emphasizing that “advanced electronic signatures will become the preferred form of electronic signature” – at <http://www.info.gov.za/speeches/2007/07062110451002.htm> -last accessed 05/05/2013.

²⁹⁷ Global Research Partners “LAWtrust makes history as the first accredited SA provider of advanced electronic signatures” Press release issued on 23 March 2012 – Available at http://www.itweb.co.za/index.php?option=com_content&view=article&id=52874:lawtrust-makes-history-as-the-first-accredited-sa-provider-of-advanced-electronic-signatures&catid=234. Last accessed on 05/05/2013.

²⁹⁸ Maherry, M “ The implications of LAWTrust’s accreditation in a Press release issue on 23 April 2012 by Global Research Partners. Available at http://www.itweb.co.za/index.php?option=com_content&view=article&id=53748. Last accessed on 05/05/2013.

follow.

A further reason may be one of convenience: to enable the registration of the trust, several documents must be submitted to the Master of the High Court, including an original or notarial certified copy of the trust deed,²⁹⁹ as well as an original acceptance of trust form signed by each trustee³⁰⁰, a statement of case containing the prescribed information,³⁰¹ as well as Annexure A signed by the Donor for payment of the Master's fees. Due to the fact that the respective parties in any event need to sign same, all documents including the trust deed may therefore be signed simultaneously, as opposed to in a piecemeal fashion consisting of electronic unsigned documents and the signed prescribed documents. As stated above ECTA makes provision for signatures, but moreover, also addresses the situation where documents are required in their original form or notarially. This is one of the objectives of ECTA: to provide for functional equivalents to paper-based concepts such as "writing", "original", etc as is encountered in many legislation drafted in periods prior to the technological age.³⁰² Section 12 of the Act states that where a document is required by law to be in writing, this requirement will be met if it is in the form of a data message, and accessible in a manner usable for subsequent reference.³⁰³ Furthermore Section 14 provides that where a law requires information to be presented or retained in its original form, that requirement is met by a data message, if the integrity of the information from the time when it was first generated in its final form as a data message, or otherwise has passed assessment in terms of the certain criteria.³⁰⁴ In respect of notarization, Section 18 (1) provides that where a law requires a signature, statement or document to be notarized, that requirement is met if the advanced electronic signature of the person authorised to perform those acts is attached to, incorporated in or logically associated with the electronic signature or data message. Lastly Section 19 provides in

²⁹⁹ S 4(1) of the Trust Property Control Act requires that the trust instrument must be lodged with the Master or a copy thereof certified as a true copy by a notary or other person approved by the Master. A trust instrument is defined in S1 as a "written instrument."

³⁰⁰ This is not required in the Trust Property Control Act itself but is in practice required by the Master's office and the prescribed forms can be found on their website – www.doj.gov.za. Last accessed on 05/05/2013.

³⁰¹ This is the so-called JM21 requirements or stated case which sets out the information necessary to enable the Master to exercise his discretion in respect of the furnishing of security. Last accessed on 05/05/2013.

³⁰² Michalson, L "Guide to the ECT Act" states that the Department of Communications had identified over 300 pieces of legislation that contained paper-based concepts in 1999 in the research period when ECTA was drafted and developed. Available at <http://www.michalsons.co.za/guide-to-the-ect-act/81> – last accessed 05/05/2013.

³⁰³ S12.

³⁰⁴ These criteria are: whether the information has remained complete and unaltered, except for the addition of any endorsement and any change which arises in the normal course of communication, storage and display and taking into account the purpose for which the information was generated; as well as all other relevant circumstances -S14(1) and (2) read together.

general terms that where an expression in a law, whether used as a noun or verb, including the terms 'document', 'record', 'file', 'submit', 'lodge', 'deliver', 'issue', 'publish', 'write in', 'print' or words or expressions of similar effect, it must be interpreted so as to include or permit such form, format or action in relation to a data message unless otherwise provided for in this Act.³⁰⁵

Despite these accommodating provisions, it appears that either unfamiliarity with these provisions, or perhaps a distrust of electronic transacting,³⁰⁶ fear of invalidity, or simply an unwillingness to change, prevents their application in a trust setting currently. Of late the Master has commenced with certain electronic reforms, such as the introduction of a public portal, with information on the Master's Office integrated case management system and in particular, information regarding trusts, such as the name, reference number and specific Master's office, is available online.³⁰⁷ Earlier this year it has also released an electronic "Integrated Case Management System for Trusts" in Pretoria which aims for the trust registration process to be electronically enhanced. It is currently in its pilot phase, and is applicable only in the Pretoria region and only to new trusts.³⁰⁸ However whilst the forms are to be completed electronically, they must still be printed and signed, and must be lodged manually with the trust deed. Whilst information will therefore be recorded electronically, it has not yet provided for a complete digitalizing of the system for registration of the trusts.

Yet despite the current practices, it is submitted that a trust could be formed via electronic forms and if so formed, it appears that South African courts will not shy away from applying ECTA.³⁰⁹ In *Jafta v Ezemvelo KZN Wildlife*, the court stated³¹⁰

“The ECT Act takes its cue from the resolution adopted by the General Assembly of the United Nations Commission on International Trade Law regarding the Model Law on Electronic

³⁰⁵ S 19.

³⁰⁶ This is not unique to trusts – in the Discussion Paper it was stated that “a healthy sense of caution, if not outright distrust has prevailed in the evolution of many aspects of e-commerce.” See South African Department of Communications *Discussion Paper on Electronic Commerce* – July 1999 at 9.

³⁰⁷ FISA “Welcome development from the Master's office” Released 02/09/2011. Available at <http://fidsa.org.za/press-release-welcome-development-from-masters-office/>. Last accessed on 05/05/2013.

³⁰⁸ See Chief Master "Trust Registrations and Amendments at Pretoria Masters Office Notice." Issued 4 July 2013 and available with the E-forms at http://www.justice.gov.za/master/m_main.htm – last accessed 05/09/2013.

³⁰⁹ Collier D “SMS and E-mail Contracts” *Juta Business Law* (16) 1 at 22 where she states the judgement can be seen as an indication that our courts are “reaching a certain level of maturity in the general attitude toward electronic communications.”

³¹⁰ [2008] 10 BLLR 954 (LC) at 62-66. It has been said that the Model Law Convention formed the blueprint for most jurisdictions' e-commerce laws- Pistorius, T “From snail mail to e-mail- a South African perspective on the web of conflicting rules on the time of ‘e-contracting.’ 2006 (39) CILSA at 178.

Commerce (“UNCITRAL Model Law or Model Law”). UNCITRAL is a subsidiary of the General Assembly of the United Nations. ...As one of 60 member States of UNCITRAL, South Africa, like many other “implementing States”, aims to give effect to the Model Law by enacting the ECT Act based on the Model Law.The significance of the first lesson of the comparative enterprise for this case is that South Africa has incurred international law obligations and, in its judgment, this Court must give effect to them.”

In its judgement the court noted specifically that even though emails and SMS’s and the language used therein may appear informal, it will be a mistake to treat them as having no legal effect.³¹¹ Section 11 of the Act expressly states that that information is not without legal force and effect simply because it is in the form of a data message. This is reaffirmed by Section 22 which acknowledges agreements formed from data messages have legal effect, as well as section 24 that holds an expression of intent or other statement is not without legal force and effect merely because it is in the form of a data message.³¹²

The Act does not however force anyone or any entity to communicate electronically. Its objective is merely to facilitate and give legal effect to “to new ways of transacting in the information age to those who do choose to communicate electronically.”³¹³ Furthermore, ECTA does not eradicate the common law right of the parties to regulate themselves, they may stipulate their own conditions regarding transmission and receipt, or agree that electronic communications will not give rise to contract.³¹⁴ The court explained why self-regulation is encouraged:

“When commercial practice is international and borderless, predictability and certainty of the law is all the more imperative. Self-regulation accomplishes this objective more easily than legislation. In addition, to ensure that our systems remain efficient, competitive, familiar and easy to implement so that it attracts favourable international attention, our courts should, as far as possible, promote self regulation. In that way, e-commerce and communication law can also keep up with e-commerce and communication practice.”³¹⁵

The court also concluded that “electronic communications systems are now standard forms of transacting in the information age”³¹⁶ and that “internationally, the shift towards paper-free communication is irreversibly underway.”³¹⁷ Whilst locally and in a trust setting this revolution may not yet so apparent, it may only be a question of time. With the disappearance then of paper and ink based concepts, the place of formation of a trust (and hence the residence of a trust) being

³¹¹ Par 78. For a discussion of the case see Stoop, P “SMS and E-Mail Contracts: *Jafta v Ezemvelo KZN Wildlife*” (2009) 21 SA Merc LJ 110 -125.

³¹² Par 73.

³¹³ Par 95.

³¹⁴ Par 98.

³¹⁵ Par 99.

³¹⁶ Par 98.

³¹⁷ Par 71.

based on contract law and its rules and theories, will be affected and it will at such time be necessary to re-evaluate and refine the current theories and provisions regulating it.

5 5 Conclusion

The consequences of being regarded as “established or formed in the Republic”, is that the trust will meet the first criteria of the test posed for residence and thus be regarded as “resident” in South Africa and be taxed on its worldwide income and capital gains. This is the basis for taxation which as per the introductory paragraphs of this chapter, South Africa has chosen as the connecting factor to exercise its fiscal jurisdiction.

Once resident the trust will remain so resident, unless the proviso' to the definition of residence is triggered, and it is deemed an exclusive resident of another country for purposes of the application of any double tax agreement. Honiball and Olivier disagree with Williams' statement that a trust established in South Africa will be “immutably and permanently resident even if it thereafter severs all links with the Republic.”³¹⁸ They submit that thus a trust so formed, regardless of the fact that it has no South African trustees, or was not effectively managed in South Africa would remain resident, unless the tie-breaker clause of a tax treaty caused it to be tax resident elsewhere.³¹⁹ The consequences of being so formed and established within South Africa, is therefore not only profound in respect of the tax liability it may attract, but also as to its potential enduring status.

Employing the *creation* of the entity as the connecting factor for jurisdiction such as through the criteria of “incorporated, established, or formed”, is often praised for its simplicity and promotion of certainty.³²⁰ Oguttu & Van der Merwe describes these as “technical requirements” which are easily verifiable.³²¹ This is said to be the primary advantage of this criteria, it is easily and objectively

³¹⁸ Williams, RC *Capital Gains Tax – A Practical Manual* (2005) (12) as quoted in Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 68.

³¹⁹ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 68.

³²⁰ Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 18 where they submit this is so for both the government and the taxpayer.

³²¹ Oguttu A W & Van der Merwe, B “Electronic Commerce: Challenging the Income Tax Base?” (2005) 17 *SA Merc LJ* at 311. Also Oguttu in *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 77 this is because a company must apply to the Registrar of Companies for its incorporation and must place on record with it a postal address and registered office – these are then factual matters which can easily be ascertained. The new Companies Act, 71 of 2008 similarly requires for the formation of a company, that a Memorandum of Incorporation must be adopted and filed together with a Notice of Incorporation at the CIPC, who thereafter issues a Registration Certificate deemed conclusive evidence of the companies' incorporation. (S13 & 14 read together). It must also register the address of its office- S23(3). Companies legislation therefore set out the necessary for the valid formation and incorporation of a company, on the other hand, the Trust Property Control

determined and does not necessitate a factual investigation and evaluation of all the activities and factual circumstances of the entity.³²² Basu terms it a “bright line rule that is easily understood and furthermore, enjoys the advantages of certainty and requires minimal cost for compliance.”³²³

In relation to trusts, it has been pointed that there are certain instances where it is not as straightforward to determine. This is complicated by the distinction between trusts in a wide sense and narrow sense. The discussion regarding the possible places of formation for testamentary trusts, the contractual theories applicable to trust *inter vivos* and the impact of the electronic age has reference. To address such difficulties, it has been called upon for the Legislature to intervene and to clarify whether “formed or established in the Republic” denotes that the act of creation must take place in South Africa or whether it must be in accordance with our laws. A further submission was made that the criteria also state that in relation to trusts in a narrow sense, the requirement should include ‘registered with the Master of the High Court,³²⁴ a proposal which is put forward by Du Plessis, and endorsed by Olivier and Honiball.³²⁵ It would appear to be in line with the underlying premise to this criteria, that the connecting factor here is the country whose laws gives it existence and acknowledges its rights and obligations. As South Africa requires (in relation to written trusts) that such registration and letters of authority are obtained prior to taking part in commercial and legal activities, or incurring obligations on behalf of the trust, it appears to be a necessary read-in to the definition in the Act.³²⁶ This would give the test the advantages Basu

Act does not set out the form or formalities applicable for establishment of a trust. Consequently there may be great uncertainty as to whether a trust has actually been formed. Geach WD & Yeats J *Trusts Law and Practice* (2007) at 162.

³²² Hessellund, J “ Incorporation theory v Real Seat theory” available electronically at...

³²³ Basu, S *Global Perspectives on e-commerce taxation law* (2007) at 38.

³²⁴ The term “registered” is used in the sense “to lodge and obtain authorization of the trustees.” Previously registration was required by the Trust Monies Protection Act, but the Trust Property Control Act follows an authorization process.

³²⁵ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 68; see discussion above at “Place where subjected to public authority.” This is also endorsed by Du Plessis, I in “The Residence of a Trust for South African Income Tax Purposes” 2009 (21) *SA Merc LJ* at 334 proposing the amendment of the Act to provide that a trust will be resident in SA if registration of the trust instrument and authorization of trustees are required in terms of the Trust Property Control Act.

³²⁶ It is possible for foreign trusts to be registered with the Master’s office – see S8 which allows for a trustee who was appointed outside South Africa to administer or dispose of trust property in the Republic to apply for authorization in terms of S6 (Letters of authority) but regardless of whether the trustee does so, the Act’s provisions will apply to such trustee in respect of the property. This was in more detail discussed at par 2 7 6. This provision was introduced due to the fact that the Master is a creature of statute and therefore had no power in general to recognize or appoint a foreign trustee. Yet as stated in *Zinn v Westminster Bank Ltd* 1936 AD 89 at 99, “Now when a foreign representative, whatever name he may be given elsewhere claims property in this country, by virtue of his foreign authorization, he requires recognition by a court of law or person of competent jurisdiction in South Africa. To address this lack of machinery to issue formal authority, the Act was consequently amended. A crucial phrase in this section is that it requires the trustee to have “appointment

describes above, namely that of simplicity and certainty, attracting no additional costs in respect of compliance and is easily verifiable. Yet it may also severely restrict the reach of the residency test and therefore is suggested that the Legislature intervenes to clarify this aspect.

The criteria of “incorporated, established, or formed” as basis for taxation is however not without its drawbacks, one such criticism is that it is too easily open to manipulation.³²⁷ This is as the place of formation can initially be chosen quite arbitrarily, the founder enjoying the freedom to choose any place based on his own preferences, be it convenience or tax efficiency, in which latter case tax havens or other low-tax jurisdiction may be particularly alluring.³²⁸ It is further feared that such place could also be easily changed through a mere mechanical process, without really changing in substance.³²⁹ Thus when the taxation or laws or political circumstances of a particular country is no longer desirable, the trust may, if the trust deed allows for same and there are no adverse tax consequences, accelerate the benefits and distribute its assets to a new trust formed in the state of its then preference.³³⁰ In substance then it is the same trust with same objectives and assets but now “reborn” and with a new tax residence. Thus, based solely on this criterion, the founder can strategise the formation of the trust so that it is not formed and hence not resident within South Africa’s tax net.

The advent of the electronic age has been considered above and although its impact in relation to

outside South Africa” and thus implicitly the laws of another country must have first have recognized such entity, presumably the country where it was formed. However it is submitted that by analogy to companies, registration on its own should not equate to residence, but should include formation in terms of our laws as well. For example, it is similarly possible to register a foreign company as an ‘external company’ for Companies Act purposes but it does not amount to incorporation, formation or establishment - See De Koker, A P & Williams, R C *Silke on South African Income Tax* at 8.3.2 available electronically on LexisNexis.

³²⁷ As per the Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa at 6.1.2; Goosen, C “International Tax Planning: The concept of Place of Effective Management” research dissertation submitted to the University of Cape Town on 15 February 2006 at 7.

³²⁸ Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 18.

³²⁹ This will most probably only be tax efficient to do should there not be capital gains tax consequences. Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* 121 at 122 give an example in relation to companies “it is easy to change residence by creating a new entity and transferring the business to it (tax consequences/exchange control?) by re-registering in another country.” With trusts it seems to be even easier, as one could effect a pour-over, or in light of *ITC 1829 (70) SATC 106* be deemed to have formed a new trust by simple substituting all the beneficiaries – for a discussion of the case see Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 230.

³³⁰ See the aforesaid footnote, as well as the discussion of *ITC 1829 (70) SATC 106* at Chapter 3 1.3. In light of the aforesaid case, it seems a new trust is formed and recognised by our courts when a complete changeover of the beneficiaries is effected, and its assets thus transferred without a formalistic legal processes. This is said with due caution as to the particular application of that case.

the creation of trusts in South Africa have as yet not been felt, it may in due course be a substantial contributor (although not necessarily the cause) to this manipulation, as it may arguable enhance such location and relocation, and facilitate the methods of circumvention.³³¹ Electronic mediums are said to present the information, tools and opportunities to make residence a “more deliberate choice than mere fate.”³³² In relation to this criteria of establishment or formed, the taxpayer and the relevant parties may through electronic mediums such as the internet and other technological communications devices, establish or form a trust in the country of their choice, without themselves or the substantial assets of such entity being physically present.

A further major criticism against this criterion is then that it is essentially based on a purely formal connection to a state, whilst the entity has no economic substantial connection to it, thus not representing economic reality.³³³ It is said to be “artificial and formalistic” as it only looks to appearance and requires but simple acts of signature and filing, rendering an actual presence unnecessary.³³⁴ The test for residence as set out in the Income Tax Act however does not only contain this formalistic test but also one that is “a less mechanistic, factual measure”³³⁵ and which looks to such economic connections.³³⁶ It is to the latter fiscal test for residence that we now turn.

³³¹ Oguttu A W & Van der Merwe, B “Electronic Commerce: Challenging the Income Tax Base?” (2005) 17 *SA Merc LJ* at 311.

³³² Kohl, U “The Horror Scope for the Taxation Office: The Internet and its Impact on Residence” (1998) 21 *University of New South Wales LJ* at 436.

³³³ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 25; Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* 121 at 122.

³³⁴ Basu, S *Global Perspectives on e-commerce taxation law* (2007) at 38.

³³⁵ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* 121 at 122

³³⁶ Van der Merwe BA 2006 (18) *SA Merc LJ* 121 at 122.

CHAPTER SIX:**THE “RESIDENCE” OF TRUSTS UNDER THE SOUTH AFRICAN INCOME TAX FRAMEWORK:****“PLACE OF EFFECTIVE MANAGEMENT IN THE REPUBLIC”****6 1 Introduction**

The second test, by which fiscal “residence” in South Africa is determined, is the “place of effective management.”¹ This term was introduced into the Act through the Revenue Laws Amendment Act, 59 of 2000 which inserted the definition of “resident” and included it as one of the test for persons other than natural persons. Thus its introduction coincided with the change-over of South Africa to a residence-based system of taxation.²

The Act did not, however, provide the term with a statutory definition of its own. Nor as a newcomer to legislation, had it been judicially considered by our courts. It could thus not have been said to have acquired an established meaning in South African domestic tax law.³ But it had surfaced on a previous occasion. The Katz Commission had recommended its inclusion as the basis for persons other than natural persons in its Fifth Interim Report.⁴ It regarded it as “more substantial expression,” one which had the advantage of being employed internationally and thus more commonly understood.⁵ Indeed, internationally the term is well-known as many countries throughout the world use it in their tax systems,⁶ and it appears in the Model Convention of the Organisation for Economic Co-operation and Development (OECD) on which most countries base their double tax agreements.⁷ Even so, an universally accepted meaning to the term does not prevail, and amongst the various countries, different meanings are attributed to it.⁸

¹ S1 of the Act, per the definition of “resident.”

² Du Plessis I “The Residence of a Trust for South African Income Tax Purposes” 2009 (21) *SA Merc LJ* at 334.

³ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes” 2009 (21) *SA Merc LJ* at 334.

⁴ Katz Commission “Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa” (7 March 1997) available Available at <http://www.polity.org.za/polity/govdocs/commissions/katz-5.html> - last accessed on 05/05/2013.

⁵ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002) at par 2.

⁶ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002) at par 2.

⁷ The Katz Commission specifically referred to the OECD Model Tax Convention and its tie-breaker provision, Article 4(3). A tie-breaker is aimed at addressing situations where a person/entity appears to be a dual residence, in which case the application of the provisions of the tie-breaker will result in the taxing authority being granted to one country. This is mostly done on the basis that the “place of effective management” of such entity is in that country. See Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 76.

⁸ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes” 2009 (21) *SA Merc LJ* at 334; SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002) at par 2.

The meaning of this term, “place of effective management”, and its application is described as raising “many questions and creates great uncertainty amongst taxpayers”⁹ or more diplomatically, “it is a topical and at times controversial matter in the South African tax community.”¹⁰ Applied to trusts, the determination of the residence of a trust based on the term, is described as being “not entirely clear”¹¹ and “not an easy task.”¹²

However, this is the task that is embarked upon in this chapter: to determine the meaning of this term in South Africa’s domestic tax framework, but from a trust vantage. Thus the term in the Income Tax Act is analyzed, the local approach advanced by the South African Revenue Service considered, firstly in the Interpretation Note¹³ and then later as refined in the subsequently published Discussion Paper.¹⁴ The viewpoints of legal and academic writers are also reviewed. The value of the historical approach is assessed and guidance is sought from related judicial precedent. A discussion of the recent case of the *Oceanic Trust Co Ltd No v Commissioner of SARS*¹⁵ is also included. The legislative amendments to the definition, which creates a carve-out for foreign investment entities, then follow.¹⁶ Whilst international precedent and interpretation is important to the forming and understanding of this term, this is discussed in the next chapter. On the whole, this chapter aims to provide a thorough overview and understanding of the potential meaning that may be attributed to this term domestically in a trust contextual setting.

6 2 Ordinary meaning of the term in the Act

The first step in arriving at such a meaning is to ascertain the ordinary grammatical meaning of the words in the Act, taking into account the context in which they are used.¹⁷ This ordinary and popular meaning is to be ascertained from the dictionary meaning, unless the context indicates it is used in a special context.¹⁸ It must also be interpreted in such a way that no word, clause or

⁹ Goosen, C “International Tax Planning: The concept of Place of Effective Management” at 8.

¹⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.

¹¹ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 68.

¹² Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 338.

¹³ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

¹⁴ SARS “Discussion Paper on Interpretation Note 6” September 2011.

¹⁵ Decided on 14 June 2011. (2012) 74 SATC 127.

¹⁶ Taxation Laws Amendment Act, 22 of 2012.

¹⁷ Also *Robinson v COT* 1917 TPD 542 at 544; *ITC 1396* 47 SATC 141 “This must be done, in the first instance, by having regard to the words used in the statute in question and giving them, unless they have been specifically defined, their ordinary grammatical meaning.”

¹⁸ Clegg, D & Stretch, R *Income Tax in South Africa* (Last updated March 2011) at 2.6 available electronically on LexisNexis.

sentence becomes superfluous, void or insignificant, although the incidence of “tautology is not uncommon in legislation.”¹⁹

In various dictionaries the words comprising the term, are defined as follows:

- Effective:** Origin: late Middle English from Latin *effectivus, efficere* ‘accomplish’:1 (a) producing a decided, decisive, or desired effect, (b) impressive, striking
2. ready for service or action <effective manpower> 3. actual< need to increase effective demand for goods> 4 : being in effect; operative <the tax becomes effective next year>²⁰
successful or achieving the results that you want;²¹
successful in producing a desired or intended result;[*attributive*] existing in fact, though not formally acknowledged as such²²
(Adj.) productive of or capable of producing a result; in effect operative, producing a striking impression, actual rather than theoretical, real²³
- Management:** the control and organization of something; the group of people responsible for controlling and organizing a company²⁴
the act or art of managing: the conducting or supervising of something (as a business) ; judicious use of means to accomplish an end; the collective body of those who manage or direct an enterprise²⁵
the process of dealing with or controlling things or people; the people managing a company or organization, regarded collectively²⁶
the members of the executive or administration of an organization or business, managers or employers collectively, the technique, practice or science of managing, controlling or dealing with²⁷
- Place:** A particular point or part of space; a geographical point²⁸
A particular position, point, or area in space; a location²⁹

Goosen points out that the word “effective” is a subjective term as personal viewpoints as to when

¹⁹ Meyerowitz D *Meyerowitz on Income Tax (2007-2008)* at par 3.10

²⁰ Merriam-Webster Online Dictionary – available at <http://www.merriam-webster.com/dictionary/effective> (last accessed on 06/05/2013).

²¹ Cambridge Dictionaries Online – available at <http://dictionary.cambridge.org/dictionary>. (last accessed on 06/05/2013).

²² Oxford Dictionaries – available at <http://oxforddictionaries.com> (last accessed on 06/05/2013).

²³ Butterfield et al (eds) *Collins English Dictionary Complete and Unabridged* 6th edition (2003)

²⁴ Cambridge Dictionaries Online – available at <http://dictionary.cambridge.org/dictionary>. (last accessed on 06/05/2013).

²⁵ Merriam-Webster Online Dictionary – available at <http://www.merriam-webster.com/dictionary/effective> (last accessed on 06/05/2013).

²⁶ Oxford Dictionaries – available at <http://oxforddictionaries.com> (last accessed on 06/05/2013).

²⁷ Butterfield et al (eds) *Collins English Dictionary Complete and Unabridged* 6th edition (2003).

²⁸ Butterfield et al (eds) *Collins English Dictionary Complete and Unabridged* 6th edition (2003)

²⁹ Oxford Dictionaries – available at <http://oxforddictionaries.com> (last accessed on 06/05/2013).

“the desirous or intended results” have been reached may differ.³⁰ Furthermore it is also context specific, as it would depend on the particular circumstances and facts of the matter whether the term “effective” is really an appropriate description.³¹ The dictionary meaning of the word does however offer important guidance in that it requires an “actual rather than theoretical”, a “real”, “existing in fact”-meaning: thus substance is required, not mere form.³² By use of this adjective, realistic and positive management, instead of mere official formal management is thus required.³³ Further, in line with the interpretation rule that words in statutes have not been used tautologous, the meaning of “effective” must always be taken cognisance of so as not to render the word redundant. It must therefore be assumed that it contributes in meaning, “even though it may simply focus on one aspect or emphasize a certain shade of meaning.”³⁴

The word “place” appears to indicate that it is essential that there is a specific location where the effective management is found. Hattingh explains that this differs in a residence investigation for domestic tax purposes or treaty purposes. In the former, the necessity would be to show that the residency is *not* within such country and accordingly not liable for taxes, whereas in treaty situations where dual residency occurs, it is necessary to show *positively* where the entity resides.³⁵

The word “management” appears to have more than one meaning.³⁶ It denotes on the one hand, the *activities* associated with the word managing, supervising, and administration. Whilst on the other hand, it refers to *those* who carry out these functions –the collective body who manages, controls, organizes. On reflection of previous chapters it would be remembered that essential to the trust idea is the separation of management and/or ownership of the trust property from the enjoyment thereof. Based thereon, one could assume that management in a trust setting refers only to the managing of the *trust property* i.e. the assets, but it is submitted that management has a wider meaning, including the duties and tasks that are statutorily, in common law or by way of the trust instrument prescribed. Honoré³⁷ for example uses the words “management” and administration interchangeably (although his preference appears to be the latter) and states, that

³⁰ Goosen, C “International Tax Planning: The concept of Place of Effective Management” at 10.

³¹ Van der Merwe, BA “Residence of a Company – The Meaning of ‘Effective Management’ (2002) 14 SA Merc LJ at 80; Goosen, C “International Tax Planning: The concept of Place of Effective Management” at 10.

³² Goosen, C “International Tax Planning: The concept of Place of Effective Management” at 11.

³³ Goosen, C “International Tax Planning: The concept of Place of Effective Management” at 10.

³⁴ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.

³⁵ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.1.

³⁶ Goosen, C “International Tax Planning: The concept of Place of Effective Management” at 11.

³⁷ Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 17.

“administration comprises whatever the trustee is required to do in the execution of the trust...”³⁸
 If management is similarly interpreted, this supports the argument that “management” in a trust includes a wider array of management functions than just asset management.

Based on these dictionary definitions there is as yet no straightforward answer as to where the place of effective management of a trust is. If the meaning of effective is “to produce a desired effect” then in a trust setting this would relate to the achievement of the trust objectives which would in most instances, either be to administer the trust property for the benefit the beneficiaries or further an altruistic goal. If these various definitions are then read together, a possible meaning to the term “place of effective management”, is the “point or position” where either the actual (effective) managing, organizing and control of the trust (not only the trust property) is carried out in the achievement of the trust objects, or where the persons responsible for managing the trust in achievement of its objectives are located.

The term “place of effective management” is therefore criticized as being ambiguous - “describing either the nature of management, or the level of management and management decisions” whilst the word, effective, “imports a test that is difficult to apply” as it requires an evaluation of the distinctive facts and circumstances of each case.³⁹ To assist with these interpretational difficulties, SARS issued an Interpretation Note in 2002 and a further Discussion Paper on the Interpretation Note in 2011. The Interpretation Note⁴⁰ endorses the ascertainment of the meaning of the term through the ordinary meaning of the words, stating as follows:

“The term “place of effective management” is not defined in the Act and the ordinary meaning of the words, taking into account international precedent and interpretation⁴¹, will assist in ascribing a meaning to it.”

The Interpretation Note further attempts to assist with the attribution of such meaning, by setting out the viewpoint of SARS through a general approach, a practical application and a list of relevant facts and circumstances. It is to the Interpretation Note we firstly turn.

³⁸ Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 669.

³⁹ Van der Merwe, BA “Residence of a Company – The Meaning of ‘Effective Management’ (2002) 14 SA Merc LJ at 80.

⁴⁰ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

⁴¹ This is discussed in the next chapter. Hattingh welcomes this approach of expanding the general interpretive approach by acknowledge of the usefulness of international precedent on the issue - Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.1.

6 3 Approach by the South African Revenue Services

At the outset, it is necessary to reflect on the status and value of an Interpretation Note issued by SARS. Firstly it is not to be equated with legislation or as forming part of the statute books, nor as an administrative guideline.⁴² It is not binding on taxpayers, on the courts or on SARS.⁴³ Consequently it can not create rights for a taxpayer, but a taxpayer may argue that it had legitimate expectation based thereon and is consequently prejudiced by its non-application.⁴⁴ It does however serve as a useful function to show SARS' viewpoints on a specific topic. Hattingh states that taxpayers may "accept that an Interpretation Note embodies the views of the head office personnel of the South African Revenue Service, who are responsible for drafting same."⁴⁵ Thus, SARS' view in relation to the "place of effective management" is discussed in the paragraphs below, following the structure in the Note.

6 3 1 General Approach and Introduction

SARS records its general approach as to "place of effective management" in the Interpretation Note by first stating that it is not equivalent to shareholder-control, or control by the board of directors. Instead that "management" is centred upon the company's purpose and business.⁴⁶ In determining this place, a distinction must be made between:

- the place where central management and control is carried out by a board of directors;
- the place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day/regular/operational management and business activities;
- the place where the day-to-day business activities are carried out/conducted.

Olivier & Honiball refer to the first as "*policy making*", the second as "*policy execution*" and the last as the place where the "*administrative tasks are performed*."⁴⁷ The first tier is often equated to be a board-centric approach and is applied in the 'central management and control' test (discussed in

⁴² Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.2.

⁴³ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.2.

⁴⁴ Meyerowitz D *Meyerowitz on Income Tax (2007-2008)* at par 3.4.

⁴⁵ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.2.

⁴⁶ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

⁴⁷ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 25.

the next chapter), where the focus is on the management by the board or similar body, and the place where they *make* decisions irrespective of where such decisions are implemented.⁴⁸ It is labelled the Anglo-Saxon approach, and it said to differ from the Continental approach which looks to the second level where the senior management operates.⁴⁹

SARS then concludes that the place of effective management is where the company is managed on a regular or day-to-day basis by the directors or senior managers, regardless of where its board of directors meets or the overriding control is exercised – thus, the second level of management.⁵⁰ To elaborate its view on the relevant “management” level, SARS states that management by these directors, or senior managers denotes *the execution and implementation* of the policy and strategic decisions made by the board of directors.⁵¹ It could be equated to the “place of implementation of the entity’s overall group vision and objective.”⁵² In essence then, SARS looks to where the management decisions are *implemented* and looks to a lower level of management. It therefore differs from the Anglo Saxon approach, which looks to a higher level of management, and focuses on the making of decisions.

Unfortunately the whole of SARS’ viewpoint as conveyed through the Interpretation Note, is expressed in terminology entirely unfamiliar and quite inappropriate to trusts. A trust does not have shareholders, nor a board of directors, it may not even have operations conducted on a day-to-day activity level, or a hierarchy of managers, executives and directors. It is therefore to be agreed with Du Plessis who remarks -

“Plainly the drafters of the note had companies in mind when compiling the note, and paid little attention to other entities such as trusts. It therefore remains for taxpayers to translate SARS’ view to trust.”⁵³

To effect such a literal translation it may be appropriate to look as to whom/what may be the

⁴⁸ Van der Merwe, BA “Residence of a Company – The Meaning of ‘Effective Management’ (2002) 14 SA Merc LJ at 122. See also further footnote 143.

⁴⁹ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 5.

⁵⁰ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

⁵¹ This must be contrasted to their more recent view and the intended revisions to the Interpretation Note as set out in the Discussion Paper. Instead it is to be modified that the focus will fall on the place of the decision-making and not the implementation of policy and strategy, with references to the latter to be deleted. – see SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.1.

⁵² Clegg comments that it is uncertain what term means but in the context submits that it could be a reference to board control or shareholder influence -Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (3 June 2011)

⁵³ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA Merc LJ at 335.

functional equivalents of these terms in a trust setting:

(a) *The board of directors*

In company law it is the board of directors upon whom the powers of management of the company are conferred.⁵⁴ They play “the chief and overriding role in the management of a company and are “principally entrusted with the responsibility to manage all the affairs of the company.”⁵⁵ This is affirmed by Section 66 of the new Companies Act⁵⁶-

“The business and affairs of a company must be managed by or under the direction of its board, which has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that this Act or the company’s Memorandum of Incorporation provides otherwise”

The term “board” is regarded as a collective term to designate the directors when they act together as such.⁵⁷ As was evident from the discussion in Chapter 3, in a trust setting, of all the possible role-players, it is the trustees who appear to be most similar to the board of directors, as they are tasked with the responsibility to administer the trust in accordance with the objectives of the trust and for the benefit of the beneficiaries.⁵⁸ In so doing, they are under a duty to act jointly.⁵⁹ As stated there they are the “management” of the trust and are burdened with the obligation to administer the trust.⁶⁰ Olivier states that the administration of the trust revolves around the trustees, who are actively in control of the trust for its duration.⁶¹ Van Winsen sums up the management of a company as opposed to a trust, by stating that “a company is owned by its shareholders and managed by its board of directors... In a trust, its assets and operations must be managed by the trustees as provided in the trust instrument.”⁶²

⁵⁴ Van der Merwe, BA “Residence of a Company – The Meaning of ‘Effective Management’ (2002) 14 SA Merc LJ at 79.

⁵⁵ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.3.2.

⁵⁶ Act 71 of 2008; See also King III: Report on Governance for South Africa (Ed. King, M) at Chapter 2 “Companies should be headed by a board that directs, governs and is in effective control of the company.”

⁵⁷ *R v Kritzinger* 1971 (2) SA 57 (A) at 59 per Meskin, PM (Ed) et al *Henocheberg on the Companies Act* at par 17 available electronically on LexisNexis. Also Hattingh who states that “the power to manage a company vests in the directors acting collectively as a board and not generally in the directors individually, unless specifically so determined in the company statutes.”-at par 19.3.2.3.

⁵⁸ See discussion at chapter 3 3 above.

⁵⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 72 and 76. *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) at 85A.

⁶⁰ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 251.

⁶¹ Olivier et al *Trust Law and Practice* (November 2011) at 3-3.

⁶² Van Dorsten JL *South African Business Entities – A Practical Guide* 3rd Ed (1993) at 12.

SARS' view in the Interpretation Note is that the place where the board of directors meet, or exercise their overriding control, is not necessarily the place of effective management. Similarly then, the mere place where the trustees convene their meetings or exercise their overriding control, is not be equated as the trust's place of effective management and thus its residence.

(b) *Directors or senior managers*

It is axiomatic that as a corporate and thus artificial entity, a company's functions and activities must necessarily be performed by human functionaries.⁶³ The identity of these may be, amongst others, the board of directors, committees of directors, executive committees, a managing director, the company secretary, employees of the company, etc.⁶⁴ Whilst the board is usually charged with the duty of managing, it is also a basic principle that it can delegate its powers, provided it does not relinquish *all* control over the company affairs.⁶⁵ Accordingly a factual enquiry must always be made as to the person or body of person who is actually managing the company.⁶⁶ In accordance with this principle of delegation, certain aspects and powers of management may therefore be exercised by an individual director or a group of directors. The level of participation and authority of a director differs in each circumstance, for example in large public companies, the director only attends board meetings and participates in the decisions, but does not take part in the running of the affairs of the company. In private companies, the director, in addition to attending such meetings will actively be involved in the day-to-day affairs of the company.⁶⁷

The term "manager" has an ambiguous meaning. In general parlance a variety of personnel in a company may be described by "managerial titles" i.e. a financial manager, human resource manager, branch manager etc who need not necessarily be a director of the company. Yet in strict company law they are not regarded in a true sense as managers of the company, as they are not

⁶³ Benade et al *Companies* (2000) at par 7.1 available electronically on LexisNexis.

⁶⁴ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.3.7.

⁶⁵ Benade et al *Companies* (2000) at par 7.1 available electronically on LexisNexis at par 4.09.

⁶⁶ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.3.4.2.

⁶⁷ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.3.4.2, see *R v Mall* 1959 (4) Sa 607 (N) – "Directors are required by statute, they are essential to a company and their functions and duties are defined by law. They are appointed by the shareholders and are vested with them anagement and control of a company.... A manager, on the other hand, is an employee of the company and his services are engaged by the directors, he is not legally essential to the company, his contract may be of formal nature or otherwise, his position may be inferred from his conduct... His position is not defined by law, indeed he may be a general manager, manager of a department, office manager or whatsoever. It is always a question of fact of what he is and what his functions are."

directors and are subject to the directions of the directors/board etc.⁶⁸ However it is submitted that where these managers are delegated such powers, their role must be taken cognizance of in tax law in determining who manages the company.

So too in a trust settings, as was discussed in Chapter 3 is it possible for the trustees to delegate their powers, subject to the *caveat* that whilst a delegation is permissible, an abdication is not allowed.⁶⁹ Pace & van der Westhuizen⁷⁰ expresses the applicable principles as follows:

“A trustee who was chosen by virtue of some special quality could not delegate his powers, authority and duties to anyone else. In all other cases a trustee could delegate his powers provided that he (1) did not thereby free himself from liability for the conduct of the person appointed to act for him, or the general body of trustees and (2) could at any time freely revoke the appointment”

Honoré⁷¹ gives the following examples-

"A trustee can employ subordinates to attend to humdrum aspects of trust administration, and even pass on everyday aspects of running the trust to an outside agency or company... This may be to a co-trustee, to a firm in which the trustee is or is not a partner, to a relative, to a suitably qualified professional person or even to a management committee."

In addition, the trustees may consult professionals or employ experts in matters requiring specialized skill or knowledge.⁷² For example in the *Oceanic Trust Co Ltd No v Commissioner of SARS*,⁷³ the trustee had appointed a local South African company as its asset manager and investment advisor. Alternatively the trustees may appoint a third party to act as their agent, or even authorise one of the trustees to act on behalf of the others, or appoint a managing trustee, but in such situations the authority of the person must be established factually and does not necessarily flow from law.⁷⁴ Very important, is the principle stressed in *Hoosen NO v Deedat*⁷⁵ that whilst delegation is allowed, it must be noted that it is still the trustees who must *make* the fundamental decisions relating the trust, whilst the *implementation* of such decisions may be

⁶⁸ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.3.4.2.

⁶⁹ The trustee has the primary responsibility to the trust beneficiaries by virtue of his office and can not relieve himself of this responsibility -Pace RP & Van der Westhuizen WM *Wills and Trusts Wills and Trusts* (October 2012) – B16.1 at 60.

⁷⁰ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B16.1 at 60

⁷¹ E Cameron, M de Waal, B Wunsh & P Solomon *Honoré's South African Law of Trusts* (2002) at 327.

⁷² E Cameron, M de Waal, B Wunsh & P Solomon *Honoré's South African Law of Trusts* (2002) at 328.

⁷³ Decided on 14 June 2011. (2012) 74 SATC 127.

⁷⁴ “... the fact that trustees have to act jointly does not mean that the ordinary principles of the law of agency do not apply. The trustees may expressly or impliedly authorise someone to act on their behalf and that person may be one of the trustees. There is no reason why a third party may not act on the ostensible authority of one of the trustees, but whether a particular trustee has the ostensible authority to act on behalf of the other trustees is a matter of fact and not one of law” - *Nieuwoudt v Vrystaat Mielies (Edms) Bpk* 2004 3 SA 486 (SCA) at 494I–J.

⁷⁵ 1999 (4)SA 425 (SCA) at para 24.

delegated to others. In Chapter 3, mention was also made of the fact that, in some instances certain other parties to the trust, such as the Founder and in relation to foreign trusts, the Protector or enforcer, may also exert control, and it is therefore submitted that these parties must also be concluded in the review, as to where the trust is effectively managed.

It is therefore concluded that when SARS refers to “directors and senior managers” in a trust setting, it refers to either the trustees, or a trustee (authorised by the others), or other functionaries as may implement decisions and attend to the day-to-day or regular management activities of the trust.

(c) Shareholder control

The shareholders own the shares in a company, and it is in the company which in turn holds the assets.⁷⁶ Dependent on the type of share a shareholders holds, certain rights are attached thereto, such as the right to dividends, to voting etc.⁷⁷ With the entry of the shareholder’s name to the share registry, the shareholder becomes a member of the company.⁷⁸ The general meeting of the members is one of the ways in which a company can act, a further way is through the board of directors as described above.⁷⁹ Hattingh⁸⁰ describes their function:

“A company’s general meeting is the company’s parliament... The general meeting must either itself take major decisions or approve such decisions as regards the fate of the company. Typically such decisions include the alteration of the company’s memorandum or articles, increase or reductions in its capital, variation of shareholders’ rights, disposal of the company or its major assets, compromises with creditors, amalgamations, restructures or the winding – up of the company.”

Normally the board would delegate the management of a company exclusively to the board of directors, who then has the duty of managing the company and the sole authority to deal with

⁷⁶ Geach WD & Yeats *J Trusts Law and Practice* (2007) at 164. A shareholder is defined in the new Companies Act as meaning “the holder of a share issued by a company and who is entered as such in the certificated or uncertificated securities register, as the case may be.”-S1 of the Companies Act, 71 of 2008.

⁷⁷ A distinction must therefore be made between the share as incorporeal movable property (which has value and can be sold, mortgaged, donated etc) and the bundle of rights to which the share gives rise – Geach WD & Yeats *J Trusts Law and Practice* (2007) at 164-165.

⁷⁸ It is ordinarily the shareholder whose name is entered upon the registry and thus the member but it is possible for the registered member not to be the beneficial owner of the shares, but instead hold it as a nominee or representative of someone else. The company need only concern itself with the name in its registry - Geach WD & Yeats *J Trusts Law and Practice* (2007) at 164.

⁷⁹ Benade et al *Companies* (2000) at par 7.1 available electronically on LexisNexis.

⁸⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.3.1.

those matters.⁸¹ Can the general meetings' control be such that they may appropriate such management functions that fall within the exclusive jurisdiction of the board? Benade submits that there does not appear to be case law directly on this point, but is of the opinion that the South African courts would likely adopt the approach of the English Courts where it has been held that⁸² –

“[The general body of shareholders] cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders.”

However there appear to be instances where the general meeting may have the “final say over the board of directors”,⁸³ in that it has certain residual and default powers of management.⁸⁴ In such instances they may be said to have the power to manage the company. Van der Merwe⁸⁵ states that the control exercised by the shareholders may in the last resort prevail over the management by the company's directors and managers. However in such instance, the management of the company is still not the same as shareholder's control, and in support of this submission quotes the dictum from *American Thread Company v Joyce*⁸⁶–

“the shareholders can, no doubt, by virtue of their votes control the corporation, they can compel directors... to do their will, but it does not follow that the corporators are managing the corporation. The contrary is the true, they are not. It is the directors who are managing the affairs of the corporation...”

In a trust setting, there does not appear to be an exact equivalent to the shareholders. Geach compares shareholders to beneficiaries and notes various similarities and differences of which the following are the most important in this context: (1) similarly to shareholders, beneficiaries do not own the assets of the entity (unless it is a *bewind* trust), such assets are owned by the trustees in their capacity as such and administered for the beneficiaries' benefit; (2) unlike a shareholder who has real rights of ownership in the shares and which give rise to voting rights and even a default statutory power to remove directors, a beneficiary does not have a real right but instead only a

⁸¹ See Benade et al *Companies* (2000) at par 7.4 – 7.10 available electronically on LexisNexis.

⁸² *John Shaw & Sons (Salford) Ltd v Shaw* (1935) 2 KB 113 at 134 per Benade et al *Companies* (2000) at par 7.08 available electronically on LexisNexis.

⁸³ Benade et al *Companies* (2000) at par 7.10 available electronically on LexisNexis.

⁸⁴ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.3.1 who refers to the power to resolve to remove the directors from the office or decline to re-elect the board. Other instances include when the board of directors refuses or is unable to institute action on behalf of the company, where they cannot or will not exercise powers reserved for them, etc. He states it to be an extraordinary situation and not the default position.

⁸⁵ Van der Merwe, BA “Residence of a Company – The Meaning of ‘Effective Management’ (2002) 14 *SA Merc LJ* at 80.

⁸⁶ (1911) 6 TC 1 at 163 per Van der Merwe, BA “Residence of a Company – The Meaning of ‘Effective Management’ (2002) 14 *SA Merc LJ* at 80.

personal right against the trustees⁸⁷ they have no rights to vote in respect of how trust assets are managed and controlled, or (generally) to remove the trustees.⁸⁸

The issue of control by the beneficiaries over the trustees is considered by Olivier and Honiball, as in the case of *Goodricke & Son v Registrar of Deeds, Natal*,⁸⁹ a similar question arose. In that case the four founders of the trust were also the beneficiaries, and were further appointed as trustees.⁹⁰ A fifth trustee, Goodricke & Son was appointed as executive trustee, but in terms of the trust provisions could be removed by majority vote of the trustees and substituted with another. The court found that the beneficiaries could not be said to have control over the trustees on the basis of this power of removal.⁹¹ Olivier & Honiball submit a different conclusion may have been reached, had the beneficiaries and trustees all been the same.⁹² They further make a noteworthy point in that the substance-form-principle could be applied in such situations: although the trustees have to act independently in form, it must be ascertained whether they are in substance the mere puppets of the beneficiaries.⁹³

SARS concludes that the effective management is not the same as shareholder control. Similarly, Du Plessis stresses that in determining the place of effective management of the trust, the residence of the beneficiaries of the trust is irrelevant “because they do not make the key decisions of the trusts.... If a beneficiary can indeed make the key decisions of a trust, the vital issue of separation of ownership and control... becomes a matter of concern.”⁹⁴ Certainly if reflecting back on the essence of the trust idea as discussed in Chapter 2, such a situation would be an affront to the whole premise underlying the trust structure.

Perhaps when SARS so emphatically states that the concept of effective management is not the same as shareholder control, it is a potential reflection that in instances where a person or organ can exercise control over the board, it does not necessarily equate to “management” of the entity. Thus in a trust setting, if for example the founder (or Protector) reserves in the trust deed the right

⁸⁷ This is so whether the beneficiary has a vested or discretionary right – the personal right can be used to force the trustee to act in accordance with the trust objectives and to the benefit of the beneficiaries - Geach WD & Yeats J *Trusts Law and Practice* (2007) at 165.

⁸⁸ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 164- 168.

⁸⁹ 1974 (1) SA 404 (N).

⁹⁰ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 127.

⁹¹ At 410 B-D.

⁹² Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 127.

⁹³ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 127.

⁹⁴ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA *Merc LJ* at 341.

to nominate trustees, or remove them, to appoint beneficiaries, to require his consent to amendments of the trust deed or its termination, such default instances of control does not necessarily equate to the management of the trust. Obviously on the other end of the spectrum is a trust deed, which endows the founder with such control or a factual situation, where the founder through his actions is the real force of management in the trust, despite the “form” of the trust deed. In these latter instances it is submitted that it may well be that the management of the trust is indeed conducted by such party.

(d) Day-to-day activity

This term is not defined nor explained in the Interpretation Note. Ernst and Young offer their viewpoint on its meaning,—

“term bears a largely temporal meaning, that is regular or frequent, and possibly also including the connotation of an event that is unexceptional in character.”⁹⁵

As was evident from the discussion in chapter 2, regarding the classifications of trust based on the purpose for which they had been created and particularly in reviewing business trusts, a potential difference in the level of activities, duties and obligations of the trustees in various trusts became apparent. Reference was also made to the distinction made in American law between active and passive trusts.⁹⁶ In the case of a passive trust, the trustees’ activities are focused on the preservation of the trust assets and the transfer of the assets at the appropriate intervals to the beneficiaries. In such a trust there may not be regular or even day-to-day activities. In an active trust, such as a business trust, the position is more akin to companies. Thus the term calls for an factual investigation to the type of trusts, its assets and operations and activity level.

Having now provided a trust perspective on the terminology used in the expression of SARS’ view in the Interpretation Note, perhaps their approach can be summarized as being that –

1. The concept of effective management is not necessarily equivalent to place of overriding control by the trustees of the trust, for example where the trustees would meet, nor by such parties as may enjoy default control powers.

⁹⁵ Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (3 June 2011).

⁹⁶ Olivier et al *Trust Law and Practice* (November 2011) at 5-17. Geach also makes a distinction between business trust and passive trusts. The latter he indicates are trusts that are merely formed as part of an estate duty plan or formed to protect assets by ensuring that the assets are placed out of reach of the beneficiary’s creditors/claimants. Geach WD & Yeats *J Trusts Law and Practice* (2007) at 23. However a firm distinction between active and passive trust is not made.

2. Management is focused on the trust's purpose and business and therefore necessitates a factual review of its trust deed and objectives as a whole.
3. The place of effective management is where the policy and strategic decisions made by the trustees are executed upon and implemented by either the trustees, a trustee to whom this function is delegated or by other functionaries. [as identified per the discussion at (b)]
4. Neither the residence of the individual trustees or of the respective beneficiaries can necessarily be equated to the place of effective management of the trust.

6 3 2 Practical Application - The Rules

In the Interpretation Note, SARS elaborates upon its general approach by also providing insight as to the practical application thereof, by outlining a three stage enquiry. Although not expressly stated, Van der Merwe is of the view that the purpose of this practical application is to identify a single place of effective management, and thus of residence.⁹⁷

(a) *The first rule – “pure norm” test*

Firstly it states the seemingly obvious: “where such management functions are executed at a single location, that location will be the place of effective management.”⁹⁸ Thus when the predominant factors⁹⁹ evincing management, the execution and implementation of policy decisions are conducted in one place, this is the place of effective management. This location may or may not coincide with the place where the day-to-day business operations/activities are actually conducted from/carried out.

Whilst this may appear to be straightforward on paper, factually it may not be as easy to determine that it was only one location that featured in the implementation of a decision. This is affirmed by Honiball & Olivier who express their concern about what constitutes “implementation” and that it is not necessarily obvious in all instances.¹⁰⁰ They illustrate this with an example in a company context: A South African resident director decides locally to raise finance from a foreign bank and arranges it telephonically whilst in South Africa, but travels to such foreign destination to sign the

⁹⁷ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA *Merc LJ* at 127.

⁹⁸ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

⁹⁹ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA *Merc LJ* at 127.

¹⁰⁰ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 26.

agreement.¹⁰¹ The exact location of the “implementation” is therefore not clearcut.

An example in the trust context would be an offshore trust, which owns a local property in South Africa. The trustees meet in London and decide to lease the South African property, which is confirmed by a resolution signed in the UK, and later by execution of the lease agreement, signed last by the trustees of the trust as landlord in London. The marketing of the property and sourcing of a suitable tenant was done by a local authorised agent, the rental is collected to a local banking account and the duties of the trust as landlord in respect of the property such as repairs, payment of the property rates locally rendered. Whilst the decision was taken in London, was it implemented in London by the signature of the lease agreement there, or in South Africa where the tenant took occupation and through the marketing and local rental collection as well as ongoing activities in relation to the property?

(b) The second rule – “deemed” place of effective management

The possible impact of distance communication (telephone, internet, video conferencing, etc) is considered by SARS.¹⁰² It is recognised that through the use of these communications, the management functions exerted by the directors or senior managers need not be executed at a single location.¹⁰³ In such instance, the place of effective management would according to SARS best be reflected where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented, in other words, the place where the business operations/activities are actually carried out or conducted.¹⁰⁴ Thus where the pure norm rule does not conclusively indicate a single place of residence, then this deeming rule would be activated.¹⁰⁵

The trigger for this rule appears to require management to be conducted or affected by distance technology, which limitation Van der Merwe regards as not desirable and recommends that this possibility should also be recognised in more traditional operations.¹⁰⁶ Ernst and Young express their disagreement with SARS’ view, that where such a variety of locations is utilized, one looks

¹⁰¹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 26.

¹⁰² SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

¹⁰³ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

¹⁰⁴ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

¹⁰⁵ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA *Merc LJ* at 128.

¹⁰⁶ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA *Merc LJ* at 128.

down to the most economically important location.¹⁰⁷ In their opinion where such circumstances are present, the effective management would more likely migrate upwards in the corporate hierarchy.¹⁰⁸

(c) The third rule – strongest economic nexus

Where however the nature of the entity is such that its business operations/activities are conducted from various locations, the place to which it has the strongest economic *nexus* must be determined.¹⁰⁹

The first point of criticism against the utilisation of this test is that unlike the first two rules, it is not expressly linked to effective management and it may be inferred that instead of being a means to determine the place of effective management, it is an alternative test for residence.¹¹⁰ This, Van der Merwe, states would affect its usefulness, as the Act only defines residence with reference to two alternative places (place of incorporation, formation, establishment *or* effective management), and does not list “economic nexus” as a further separate test.¹¹¹ She argues that only if it is intended to be a deemed place of effective management does it have legal standing, but then this should be clarified.¹¹²

Unfortunately the interpretation note also offers no explanation of this term. As one author puts it “one can only guess what this statement seeks to achieve.”¹¹³ Guidance may be sought from OECD documents where the term has been used and in this regard, reference can be made to the discussion below at paragraph 6.9 and in Chapter 8.¹¹⁴ Its application appears to be questionable on two grounds, firstly whether it is appropriate to be used as a determinant to effective management as elsewhere it functions as an independent separate rule, and secondly whether it is not more

¹⁰⁷ Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (3 June 2011).

¹⁰⁸ Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (3 June 2011).

¹⁰⁹ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

¹¹⁰ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 128.

¹¹¹ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 128.

¹¹² Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 128.

¹¹³ Hattingsh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.3.

¹¹⁴ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 129.

suitable to a source-based jurisdiction than a residence-based.¹¹⁵ In a source –based jurisdiction, the state asserts tax on the rationale that it may share in the wealth generated by the *economic activities* within its jurisdiction, to which an economic nexus criteria would relate.¹¹⁶ Van der Merwe explains that residence based taxation is justified by the shelter and privileges the country allows its residents, and thus she explains that if the economic nexus to a jurisdiction can be characterized with reference to the facilities and infrastructures used and consumed in producing its income, the entity could be regarded and taxed as resident.¹¹⁷ Or as Goosen explains: the justification for residence based taxation may lie therein, that the state needs to raise finance for its public goods and social infrastructure and this forms a nexus to the consumption of such public goods and infrastructure, by persons and entities that are resident with the capacity to pay for same.¹¹⁸

The economic connection is described with the adjective “strongest” and therefore implies that there must be a consideration and a comparison (weighing up) of various factors in determining this place and assessing it as having greater economic ties than the others. Yet no such factors, weight allocations or guidelines to conduct such a comparison are provided in the Interpretation Note. Van der Merwe therefore concludes, that this test “will probably be as just as difficult to apply in practice as the ‘pure’ test for effective management, which also involves subjective comparisons.”¹¹⁹

6 3 3 Relevant facts and circumstances

SARS also emphasizes that it is not putting forth a set of rigid rules, stating that it is not possible to lay down absolute rules - “it is an intensely factual question for which no definitive rule or bright line test can be laid down.”¹²⁰ Moreover, that a factual enquiry in each and every case will be necessary as “management structures, reporting lines and responsibilities vary from entity to entity, depending on the requirements of the entity.”¹²¹ A list of relevant facts and circumstances to

¹¹⁵ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA *Merc LJ* at 129.

¹¹⁶ *Kergeulen Sealing and Whaling Co Ltd v CIR* 1939 AD 487 at 507.

¹¹⁷ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA *Merc LJ* at 128.

¹¹⁸ Goosen, C “International Tax Planning: The concept of Place of Effective Management” research dissertation submitted to the University of Cape Town on 15 February 2006 at 5.

¹¹⁹ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) SA *Merc LJ* at 130.

¹²⁰ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 5.

¹²¹ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

be examined in such a case-by-case analysis is then provided, but is not intended to a closed list. It is duplicated here:

- “(a) where the centre of top level management is located;
- (b) location of and functions performed at the headquarters;
- (c) where the business operations are actually conducted;
- (d) where controlling shareholders make key management and commercial decisions in relation to the company;
- (e) legal factors such as the place of incorporation, formation or establishment, the location of the registered office and public officer;
- (f) where the directors or senior managers or the designated manager, who are responsible for the day-to-day management, reside;
- (g) the frequency of the meetings of the entity’s directors or senior managers and where they take place;
- (h) the experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity;
- (i) the actual activities and physical location of senior employees;
- (j) the scale of onshore as opposed to offshore operations;
- (k) The nature of powers conferred upon representatives of the entity, the manner in which that powers are exercised by the representatives and the purpose of conferring the powers to the representatives.”

This list is also met with criticism. Ernst & Young submit that in so doing, SARS took “a ‘scatter-gun’ approach to the analysis”, which cannot be supported in many instances.¹²² It is questioned why factors more appropriate to the Anglo-Saxon approach is included, for example, the inclusion of the location of the centre of top level management and its headquarters.¹²³ Silke is also doubtful about the list’s efficiency, concluding that it rather “... amounts to a spectrum of potentially competing factors or criteria that may be encountered in practice, but seemingly fail to come to grips with the problem itself.”¹²⁴ Hattingh states that it appears to take account of “related at times less important factors and contains everything but the crucial factors.”¹²⁵ He elaborates on this by stating that none of the factors require an investigation into the detail: i.e. into the statutes of the company, the management powers of its organs, the manner in which it operates, the authority conferred on its managing director or chairman, the influence on the board by any one person, the extent to which directors are independent or are “puppets.”¹²⁶

Again it is clear from this list, that trusts were not at the forefront of the drafters’ minds when compiling it and one could either adopt an approach to interpret the respective factors as not

¹²² Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (3 June 2011).

¹²³ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 131.

¹²⁴ De Koker, A “Silke on South African Income Tax” Lexis Nexis online per Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.3.

¹²⁵ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.3.

¹²⁶ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.3.

appropriate to a trust and therefore irrelevant, or endeavour to find an analogy in a trust setting. For example following the sequence of the above list, for (a) to look to where the trustees reside, for (c) to look to where its assets manager are located, for (d) to look towards the founder or protector are located etc. This last approach is advocated by Cohen & Kruger who state that these factors should be taken into consideration, as they provide a “useful touchstone for ensuring compliance with SARS’ general approach.”¹²⁷

Only one factor in this list does contain trust terminology and is a singular reference in the whole of the Interpretation Note to trusts, namely, “the experience and skills of the ...trustees who ...purport to manage the entity.” Perhaps it is a call to look at the proficiency and capabilities of those formally in office and whether they are indeed competent to conduct the trust’s management. Should they be ill-equipped, it could be an indication that they are mere puppets of others under whose control they are and who is actually managing the trust.

There is no guidance in the note as to whether all these factors are to be viewed as equally important, or whether one may be more conclusive than the others. In line with the factual approach advanced by SARS, it is agreed with Van der Merwe who concludes that the “factors should not be individually decisive and that the answer should be gleaned from the totality of the facts.”¹²⁸

6 3 4 Conclusion

One author praises the interpretation note for its “valuable guidance” and laments the fact that it does not have the force of law and could therefore be challenged, thus necessitating that it should be transposed to legislation.¹²⁹ However, reflecting upon contents of the Interpretation Note, Honiball & Olivier conclude “this Interpretation Note is not very helpful in interpreting this phrase in relation to trusts...”¹³⁰ Indeed the Interpretation Note not only appears to have been written for a target audience consisting only out of companies, and disregarded trusts, but it also appear to have been oblivious to the fact that some entities do not operate actively, but are passive in nature, and have made no provision for such category into which trusts would often fall.

¹²⁷ Cohen T & Kruger D “Offshore Trusts: Many Dragons wait in Ambush “ 2010 (1) (3) *Business Tax & Company Law Quarterly* at 24.

¹²⁸ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 125.

¹²⁹ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 340 arguing that it should be refined and introduced into the Income Tax Act.

¹³⁰ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 69.

It is however possible to extrapolate certain general premises from the Interpretation Note, that may be of valuable guidance and therefore the Interpretation Note can not be dismissed entirely. The first being that the approach SARS appears to endorse in the Interpretation Note, is to determine the place of effective management, regard must be had to where the operational management and commercial decisions and strategy are *executed and implemented*, and not necessarily where such decisions are *taken*,¹³¹ however in the subsequently issued Discussion Paper this approach is modified. Furthermore it advocates a case-by-case approach and thus the specific facts of each matter will be crucially important, in determine an entity's place of effective management.

The Interpretation Note is therefore not an all encompassing source addressing all queries and uncertainties, and secondly it is not without critique, a fact that SARS acknowledged and seeks to improve through interaction and comment. It has therefore in 2011 published a Discussion Paper on the Interpretation Note¹³² as foundation for such discussion. This criticisms, and the Discussion Paper, are discussed next.

6 3 5 Critique on the Interpretation Note & the issuing of the Discussion Paper

The Critique

The Discussion Paper summarizes the criticisms on the Interpretation Note in four main areas.

(a) The first criticism

The first relates to the focus of the general approach outlined in the Note and its potential conflict with the international view. As stated above, the view expressed by SARS in the Note focuses on the place of *execution and implementation* of strategic decisions and policies,¹³³ and looks to the *day-to-day management*, where internationally the emphasis is on the *making of key* decisions and appears to favour a higher level of management.¹³⁴ This alternative approach by SARS has been

¹³¹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 25.

¹³² South African Revenue Services "Discussion Paper on Interpretation Note 6 Place of Effective Management" issued September 2011.

¹³³ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 6.

¹³⁴ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* at 335; Van der Merwe BA "The Phrase 'Place of Effective Management' Effectively Explained" 2006 (18) *SA Merc LJ* at 124.

applauded by some commentators who are of the view that it is far less easy to manipulate.¹³⁵ Historically, entities were hierarchical structured as opposed to managed divisionally and their management would be easy to locate at a specific point of time, due to the limited options for travelling, options that were then time consuming and quite costly.¹³⁶ So too were communication over vast geographic distances not as effective, instantaneous or as inexpensive as today. Now however, as Van der Merwe¹³⁷ explains-

“..as a result of sophisticated telecommunication technology (such as video conferencing, and electronic discussion groups via the Internet) and improved global transportation, it is no longer necessary for a person to be physically located, or for people to meet, in any one particular place...”

Thus with increased mobility and facilitated by technology, a place of effective management based on top-level management and where they make decisions, could be skilfully crafted and manipulated according to the taxpayer’s choice. Thus the lower level approach and different focus of SARS “keeps pace with the discernible change in management structures, reporting lines and responsibilities as a result of the modern multinational and electronical business environment.”¹³⁸

Yet South Africa’s domestic meaning to have regard to the place where strategic policies and decisions are *executed and implemented*, then differs from the international view, which looks to where the most senior decisions are in substance *made/taken*.¹³⁹ This is seen as a cause for concern for taxpayers establishing offshore trusts and entities, as SARS’ view appears to be much wider than the international view.¹⁴⁰ This is regarded as a fundamental divergence, which complicates tax planning for entities with international aspects.¹⁴¹ An approach to focus solely (or almost solely) on the place where the board of directors or a similar body meets, is advocated by some taxpayers and tax practitioners, and is motivated by this tension between the general

¹³⁵ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 124.

¹³⁶ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 124.

¹³⁷ Van der Merwe, BA “Residence of a Company – The Meaning of ‘Effective Management’ (2002) 14 *SA Merc LJ* at 81.

¹³⁸ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 121

¹³⁹ Fichardt, L & Delechat, A “Residence Revisited” September 2010 (1) *Business Tax & Company Law Quarterly* at 12-13

¹⁴⁰ Keirby-Smith, B “ Finally Some Local Guidance on the Place of Effective Management” – available at http://www.saica.co.za/integritax/2011/2012.Placement_of_effective_management.htm - last accessed on 06/05/2013.

¹⁴¹ Anon “ In what country does a company reside for tax purposes?” (February 2009) *Synopsis Tax Today* PriceWaterhouseCooper.

approach of the Note and those in international precedents and guidelines.¹⁴² Particularly in instances where the interpretation of the term is required in double tax agreements based on the OECD's Model Tax Convention, this difference in approach is most severe.¹⁴³

The discrepancy between the approach in the Note and international precedent, raises doubts as to whether a court would accept the approach in a treaty context, or whether the term would effectively be given a different interpretation for treaty and domestic (non-treaty) contexts.¹⁴⁴ As stated earlier, SARS' Interpretation Notes do not constitute legislation. Moreover, local courts are bound to consider international law in their interpretation of the term.¹⁴⁵ Thus whilst domestically the Note may be regarded as informative to the local interpretation, in a treaty context to determine the meaning, to the extent that there are guidelines issued by the OECD and international commentaries, courts would need to take cognisance thereof. It is their constitutional obligation to apply customary international law and they, may on the basis thereof, therefore reach a different conclusion, than they would have solely on application of the Note.¹⁴⁶ This could then lead to different meanings attributed to the same phrase, dependent on whether it is a domestic or international context- such a result would not be desirable.¹⁴⁷ The discussion of the *Oceanic*¹⁴⁸-case below seeks to illustrate this, with the court taking no heed of SARS' view and instead endorsing the international jurisprudence to formulate a meaning for the term.

An interesting point is made by Hattingh, that in the Interpretation Note, SARS did acknowledge that there are various meanings attributed to the term internationally, but instead of elaborating on these views and addressing whether they are acceptable or not to SARS, it opted to develop yet another meaning, a meaning for which it did not give nor cite local or foreign or international authority for its viewpoint.¹⁴⁹

¹⁴² SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 6.

¹⁴³ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 6. See also footnote 49 above.

¹⁴⁴ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 6. In the *Oceanic*-case discussed below the court did not make such a distinction and opted instead to follow the international meaning attributed to the term in a treaty context. See also Gutuza, T "Analysis" (2012) 24 *SA Mercantile Law Journal* at 426.

¹⁴⁵ S 231 of the Constitution of South Africa, Act 108 of 1996.

¹⁴⁶ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 42; section 232 of the Constitution of South Africa, 108 of 1996.

¹⁴⁷ Van der Merwe BA "The Phrase 'Place of Effective Management' Effectively Explained" 2006 (18) *SA Merc LJ* at 137.

¹⁴⁸ (2012) 74 SATC 127.

¹⁴⁹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.2.

The comparison included in the Discussion paper regarding international precedent and recent developments is discussed in the next chapters.¹⁵⁰

(b) The second criticism

The second criticism stems from the inconsistent use of terminology, particularly between the general approach section and the practical application section of the note. For example whilst the introduction section refers to executive directors, in the general approach the “executive” description is omitted, and further in the practical application decisions are referred to as being taken by “senior managers”, whereas earlier on the phrase included both “directors and senior managers”.¹⁵¹ Confusion also arises as to the reference in the introduction to the second level management, to “make and implement day-to-day management and business activities”, which appears to overlap with the third tier.¹⁵² Also of concern to commentators is the statutory basis for the use of the “economic nexus” test.¹⁵³ This has been discussed above.

(c) The third criticism

An inconsistency between some of the facts and circumstances listed as guidelines and those in the general approach section, forms the third area of criticism. Particularly puzzling to commentators is the inclusion of the two items in such list, being the following: “where the controlling shareholders make key management and commercial decisions in relation to the company” and “legal factors such as the place of incorporation, formation or establishment, the location of registered office and public officer.”¹⁵⁴

(d) The fourth criticism

The fourth area of criticism relates to the omission of any guidance in respect of passive and intermediate holding companies.¹⁵⁵ Clegg elaborates hereon in an aptly named article, “One Size

¹⁵⁰ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 7 under “International Benchmarking” – See the next chapters, chapter 7 and 8.

¹⁵¹ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 128.

¹⁵² Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 126.

¹⁵³ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 6

¹⁵⁴ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 6

¹⁵⁵ Goosen, C “International Tax Planning: The concept of Place of Effective Management” at 15.

does not fit all”, contending that in an operating company, the executive management functions would normally be fulfilled by the activities of the managing director, who ensures that the board’s vision is given effect to in the company’s operations, and thus the place of effective management should generally be easy to determine.¹⁵⁶ This may be complicated where various people share the senior management functions, but, he submits, in the event of a disagreement, one person would still “call the shots” and thus lead to the place of effective management.¹⁵⁷ On the other side of the spectrum is an investment holding company, where its board’s functions are limited to quarterly meetings to assess the financial and management reports of its subsidiaries, review the performance of its portfolio, recommend strategy changes and in such a company, the meeting place of the board of directors would be the place of effective management.¹⁵⁸ In conclusion, he submits that in non-corporate entities such as trusts, different structures of control and management may require a different approach, but that the above principles should still be applicable.¹⁵⁹

(e) A last criticism

A further point of critique is raised by Hattingh in that SARS’ view as to the management of the company does not accord with company law and appears to ignore it altogether.¹⁶⁰ SARS’ current view appears to demote effective management to a lower level of management, whereas the “management” in the statutory definition refers to the management of the entire and crucial affairs of the company and not the management of some aspect within the company. He finds it problematic to equate management of the company, to only those that implement decisions and exclude those who take and make those decisions.¹⁶¹ It affronts company law which requires collective action by the board of directors and regards the board to be principally responsible for the management of the company. Instead, based on SARS’ view, regard would not be had to the aforesaid, but to the individual director servant or agent, who would implement the decision, a view that Hattingh finds to be “speculative, pedantic and against a central idea of South African company law.”¹⁶² Furthermore, an abrogation of fiduciary responsibilities to manage the whole of the affairs of the company, would render the directors personally liable. He therefore concludes that “it is most unusual to suggest that one finds the “directing mind”, namely the management of

¹⁵⁶ Clegg, D “One Size does not fit all” *Tax Planning Corporate and Personal* (Vol 26) (2011).

¹⁵⁷ Clegg, D “One Size does not fit all” *Tax Planning Corporate and Personal* (Vol 26) (2011).

¹⁵⁸ Clegg, D “One Size does not fit all” *Tax Planning Corporate and Personal* (Vol 26) (2011).

¹⁵⁹ Clegg, D “One Size does not fit all” *Tax Planning Corporate and Personal* (Vol 26) (2011).

¹⁶⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.3.

¹⁶¹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.3.

¹⁶² Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.3.

the company, at the place where directorate decisions are implemented by some agent or servant or where the employees of the company conduct the day-to-day running of the business.”¹⁶³ Consequently he concludes that there can be no support for SARS’ view, that those responsible for the implementation of strategy and policy decisions are responsible for the management of the company. Management of the company should focus on the decision-making and decision-taking process by the board being principally responsible for its management.¹⁶⁴ To this aspect, we return in the discussion below at paragraph 6.7 which considers the tension between trust law and tax law.

6 3 6 The Discussion Paper

The Discussion Paper follows on the “Gateway to Africa” initiative, which National Treasury announced in 2010. The aim of this initiative is to promote South Africa as an attractive base for foreign and domestic investment into other African countries.¹⁶⁵ As an incentive of this initiative, headquarter companies enjoy favourable tax benefits, but concerns have been raised that foreign subsidiaries of such companies would be regarded as locally resident, based on SARS’ approach to the place of effective management as outlined in the Interpretation Note, and thus undermine the initiative.¹⁶⁶ This then forms a motivating cause for the publishing of the Discussion Paper and explains why its initial scope is expressly limited to domestic and foreign companies with an undertaking that other entities such as trusts will be address in a successive project.¹⁶⁷ The Discussion Paper may therefore not be entirely apt to trusts, but it is important in establishing SARS’ approach as now refined. This approach can be gleaned from the revisions that are tentatively proposed in the Discussion Paper. The goals of these revisions are also recorded and form the background thereto.¹⁶⁸ These goals are described by SARS as being multiple, but also at times to be “competing goals” and thus a fine balance need to be struck.¹⁶⁹

¹⁶³ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.3.

¹⁶⁴ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.3.

¹⁶⁵ SARS “Discussion Paper on Interpretation Note 6” September 2011 at at par 1 and 3.

¹⁶⁶ The consequences for the foreign operating entity is severe: firstly as a deemed resident, it would need to recomputed its income each year and determine its tax liability in terms of our legislation, and thereafter claim a rebate for any foreign income taxes proved to be payable in the country in which it operates. It would also be subject to secondary tax on companies and the dividend withholding tax scheduled for implementation in April 2012 -SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 3.

¹⁶⁷ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 2. It is also said that they present “separate and distinct issues.”

¹⁶⁸ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.

¹⁶⁹ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.

6 3 6 1 The underlying goals

The first of these goals is to ensure that the place of effective management fulfils its purpose as a substantive test that is shielded against “simple formalistic manipulation.”¹⁷⁰ This is after all one of the reasons why the test of place of effective management was imported in the Act, in addition to the more formal test of place of incorporation, which is prone to manipulation.¹⁷¹ It is said that a board centric approach would not in today’s technological world be able to fulfil this function, as both domestic and international authorities have recognized.¹⁷²

A second goal would be to reduce uncertainty and thus the areas in the Interpretation Note causing such uncertainty should be addressed. These include the discrepancy in approach in the Note with the weight of international authority, insofar as SARS’ general approach focuses on the place of implementation of decisions, as opposed to where substantive decision-making takes place; secondly, the resultant blurring of “second” and “third” levels of management; and lastly, by including factors as guidelines, which appear to be in contrast with the general approach outlined earlier in the Interpretation Note.¹⁷³ The revisions, thirdly, must be able to accommodate a range of varied factual situations.¹⁷⁴ Thus the need for all relevant facts to be examined can not be done away with, nor can a clear-cut bright line test be provided. It must however address any apparent conflicts or inconsistencies present in the current guideline.¹⁷⁵ Lastly, it must address the concerns of potential investor in the head quarter regime, and provide sufficient guidance.¹⁷⁶

6 3 6 2 The proposed revisions

SARS tables its proposed revisions in four groups. The first focuses on the refinement of the general approach outlined in the Interpretation Note, as the intention is not to eradicate it.¹⁷⁷ SARS states that it will continue to focus on the “second level of management”, but that the primary emphasis would be clarified, to ensure that it is the top personnel who “call the shots” and exercise “realistic

¹⁷⁰ As was initially advanced as its benefit in the Katz Commission, Fifth Interim Report, para 6.1.2.1.

¹⁷¹ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 4..

¹⁷² SARS gives the example of he OECD which in 2008, deleted any reference to an entity’s board of directors or similar body in its Commentary on Article 4 of the Model Tax Convention.

¹⁷³ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8

¹⁷⁴ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8

¹⁷⁵ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8

¹⁷⁶ Particularly in relation to foreign operating subsidiaries with *bona fide* foreign operations and on the ground top level managers responsible for the high level day to day running of such operations - SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.

¹⁷⁷ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.1.

positive management”, who should form the focal point. These senior executives and officers would generally be responsible for (a) developing or formulating key operation or commercial strategies and policies, for taking decisions on these for the company, regardless of whether these strategies, policies and decisions are subject to formal approval by the board or a similar body and (b) to ensure these strategies and policies are carried out.¹⁷⁸ From the scope of the “second level management,” SARS excludes the following: decision-making regarding extraordinary matters, which are commonly reserved for the board or the shareholders and secondly, the day to day operational decision-making, which is done by junior and middle management and similarly, also the performance of routine administrative or support functions.¹⁷⁹

In furtherance of its goal to bring the approach in line with international authority, and to avoid the blurring of second and tertiary operational levels of management, it is proposed to delete the current references to the *implementation* of strategy and policy.¹⁸⁰ As corporate practices are divergent by nature, SARS retains the view in the Interpretation Note that no definitive rules can be laid down and that all relevant facts and circumstances must be examined in determining the place of effective management.

The second group of revisions will seek to address the inconsistent use of terminology and proposes to include definitions for basis terms such as following: senior management, operational management, executive/inside directors, non-executive/outside directors, head office, base of operations and passive holding company.

The section setting out the relevant facts and circumstances in the Note, forms the third area or revision.¹⁸¹ It is proposed that the legal factors relating to the incorporation, formation and establishment of the entity, be deleted. Further, that the reference to controlling shareholders, which make key management and commercial decisions, be clarified.¹⁸² Essentially, this factor would be applicable in instance where the controlling shareholders in fact “call the shots”, whilst

¹⁷⁸ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.1

¹⁷⁹ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.1

¹⁸⁰ A practical examples is included in the Discussion Paper: should a manufacturing company have its head office in Johannesburg where it senior management (eg managing director, finance directors, sales director, HR director and their immediate subordinates) is based and its main plant in Botswana where the manufacturing takes place under the supervision of local management, its place of effective management would be Johannesburg. This would not change whether its board met in Botswana or whether it routinely approved proposals formulated by senior management , or took decisions on extraordinary matters.

¹⁸¹ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.3.

¹⁸² SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.3

the board of directors or similar body is not the actual decision-maker.¹⁸³ SARS submits that this factor would be particularly relevant in determining the place of effective management of passive holding companies. A third modification to this section would be the addition of the following factors: (a) delegations of authority, by the board of directors or similar body, for example, to an executive committee; (b) consideration of differing board structures, for example, distinctions between commercial and no-commercial or supervisory boards, (c) the identification of various factors that will generally be given little weight e.g. The place where the administrative activities, such as the opening of a bank account, take place; (d) refinement of the distinctions between various levels of management¹⁸⁴; (e) criteria for determining the base of operations for senior management in situations where senior management travels frequently or operates from multiple locations – with meetings held, for example, by video conferencing. Lastly, it is intended to include practical application examples of the factors.¹⁸⁵

The fourth revision relates to the bringing of SARS' approach in line with the international community, in particularly the OECD's 2008 Commentary and the position taken by many of SARS' tax treaty partners.¹⁸⁶ Although it is hoped that all the proposed changes will bring SARS' approach *en par* with the aforesaid parties, to provide a solution for situations where it is not, a further revision will be included to explicitly provide for any dispute between SARS and a tax treaty partner, regarding the application of the place of effective management as a tie-breaker, to be resolved by the competent authorities of the two states through an applicable mutual agreement procedures.¹⁸⁷

In summation of the Discussion Paper, it is clear that there has been a sway in SARS' view. It appears to wish to move away from a focus on the implementation of policy and strategy, to focus on those responsible for developing the entity's key strategies and policies and taking decisions thereon.¹⁸⁸ Underlining this move, is an intention to 'more closely align its approach with

¹⁸³ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 8.3

¹⁸⁴ SARS gives the example of companies which function of a divisional basis and each division is then often run by an executive vice president or operational management who reports to a higher level of management which bears the responsibility of company as a whole. In such an instance, the place of effective management would be the place where the top level management is primarily or predominantly based - SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 8.3.

¹⁸⁵ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 8.3.

¹⁸⁶ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 8.4.

¹⁸⁷ This mutual agreement procedure is already found in 12 of the 70 double tax agreements SARS has concluded with other countries. SARS "Discussion Paper on Interpretation Note 6" September 2011 at footnote 1 and par 8.4.

¹⁸⁸ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 8.1

international norms’ which may be an important pointer to the source and contents of the eventual revised Interpretation Note.¹⁸⁹ Such words also appear to be aligned with international authors such as Vogel, who stressed that “what is decisive is not the place where the management directives take *effect* but rather the place where they are *given*”, as well where “important policies are actually made.”¹⁹⁰

Whilst the ordinary meaning of the term in the Act, and the interpretation attributed to it by SARS, as now discussed, is insightful –it is however not binding or conclusive. Therefore regard must be had to other sources so to interpret, debate and formulate a meaning for this term.¹⁹¹ Such sources include the viewpoints of the various legal and academic authors, and are discussed next.

6 4 Views of Academics and Legal authors on “place of effective management”

6 4 1 Fifth Interim Report of the Katz Commission

As per the introductory paragraph to this chapter, the Katz Commission’s report was published prior to the change-over to the residence-based system of taxation and the inclusion of the term in South Africa’s tax legislation.¹⁹² It did however recommend the utilization of the term and as such it is interesting to reflect on meaning the Commission had in mind at that juncture. It is clear that the Commission did not equate the term to the “managed and controlled” test, often applied to companies.¹⁹³ Instead they recommended the use of the concept of effective management as referred to in Article 4(3) of the OECD Model Tax Convention.¹⁹⁴ This may be an indication that they wished the meaning linked to the interpretation under the OECD Model Tax Convention to be applicable (i.e. the tax treaty meaning). The next chapter discusses same. Lastly, the Katz Commission was of the view that an appropriate definition in our legislation would be instrumental to its successful application.¹⁹⁵

¹⁸⁹ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.1

¹⁹⁰ Vogel, K *Double taxation Convention* (1991) at 262.

¹⁹¹ Goosen, C “International Tax Planning: The concept of Place of Effective Management” research dissertation submitted to the University of Cape Town on 15 February 2006 at 8.

¹⁹² Katz Commission “Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa” (7 March 1997) available at www.polity.org.za/polity/govdocs/commissions/katz-5.html - last accessed on 05/05/2013.

¹⁹³ Para 6.1.2 of the Report.

¹⁹⁴ Para 6.1.2 of the Report.

¹⁹⁵ See also Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 27 who state “no clarity exists on the meaning of the term in a tax treaty context. If anything, the tax treaty

6 4 2 Various authors on trust law

Unfortunately the authors on trust law do not offer much guidance in their publications, which is understandable as the taxation aspects of trusts was not their focus. Pace & van der Westhuizen¹⁹⁶ as well as Olivier¹⁹⁷ merely paraphrase the statutory definition. Geach¹⁹⁸ writes that

“... as far as trusts are concerned, a resident is a trust established or formed in South Africa or a trust that has its place of effective management in South Africa. As far as the latter is concerned, this means that if for example, an Isle of Man trust is *controlled* by South African residents, this apparently foreign trust will be regarded as a resident for South African trust purposes.” (own italics)

As well as

“It should be noted that if an offshore or foreign trust is *managed or controlled* by South African residents, the trust will be regarded as South African resident for South African income tax and capital gains tax purposes.”¹⁹⁹ (own italics)

Geach therefore focuses on the control aspect. This view appears to be in contrast with SARS’ Interpretation Note which encourages a move away from these terms.²⁰⁰

6 4 3 Various authors on tax law

Meyerowitz²⁰¹ expresses his view as follows -

“...the place of effective management is normally the place where the directors meet on the company business, which may differ from the place where a company carries on business or is managed by staff or directors individually and not as a board. Where the company has executive directors, the facts may reveal that the company is effectively managed where such directors, in contrast to the board of directors as a whole, conduct the company business. Similarly in the case of a trust, the place of effective management would normally be the place where the trustees meet to deal with the affairs of the trust or, where the trustees leave the management to a particular trustee, the place where he functions on behalf of the trust.”

Although Meyerowitz appears to emphasise the meeting place where decisions are made (and thus a higher level of management), his view in relation to trust does appear to allow for regard to be

meaning is probably must closer to ‘managed and controlled’ than the Katz Report may have intended. It is therefore regrettable that the recommendation of the Katz Report to define the term in the Act has not been followed.”

¹⁹⁶ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B21.3.3. at 76.

¹⁹⁷ Olivier et al *Trust Law and Practice* (November 2011) at 7-5.

¹⁹⁸ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 234.

¹⁹⁹ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 27.

²⁰⁰ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002) “The reference to “managed or controlled” .. is therefore no longer applicable.” – See discussion below as well.

²⁰¹ Meyerowitz D *Meyerowitz on Income Tax (2007-2008)* at par 5-19.

had to the actual functioning of the trust and that such place could be the place of effective management of the trust. However, he appears to be oblivious to the fact that it is not only the trustees or a trustee who could be implementing the management of the trust and thus, as no mention is made of parties other than the trustees (i.e. assets managers/protector etc), it is an open question as to whether this view accepts that the location of where such other parties fulfil such functions may constitute the place of effective management of the trust.

Silke²⁰² comments on the divergence of views on the interpretation of this term, and concludes that

“Perhaps the closest one could come to a solution in principle, it is submitted, is to say that the place from where factually and effectively the day-to-day affairs of the company are managed by its executive directors and management, will be the place of effective management. This would be the place where strategic decisions for the conduct of the company’s business are in substance formulated and implemented with a degree of regularity. These decisions must pertain to the company’s day-to-day activities in terms of managing the ordinary operations of the business.”

In relation to trusts, Silke acknowledges that fictitious or artificial persons such as trusts are capable of having a residence and being resident.²⁰³ Silke then submits that a trust will be resident in the Republic, if the trustees are resident in the Republic *or* if the trust fund is administered from the Republic.²⁰⁴ The latter can be determined as to whether the trustees meet in the Republic to attend to the affairs of the trust.²⁰⁵ Silke lastly cautions that it remains a factual exercise, and where the assets of the trusts are effectively managed is crucial.²⁰⁶

This view is also endorsed by Emslie *et al*²⁰⁷ who having stated that artificial persons are capable of having a residence based on the case of *Nathan’s Estate v CIR*²⁰⁸, consider that the residence of a trust be determined with reference to the residence of its trustees and the place from which the trust affairs are administered.

Haupt’s concise viewpoint is that the “place of effective management in the case of a trust, is the

²⁰² De Koker, A P & Williams, R C *Silke on South African Income Tax* at 14.45 available electronically on LexisNexis.

²⁰³ De Koker, AP & Williams, R C *Silke on South African Income Tax* at 14.43 available electronically on LexisNexis.

²⁰⁴ De Koker, AP & Williams, R C *Silke on South African Income Tax* at 14.43 available electronically on LexisNexis.

²⁰⁵ De Koker, AP & Williams, R C *Silke on South African Income Tax* at 14.43 available electronically on LexisNexis.

²⁰⁶ De Koker, AP & Williams, R C *Silke on South African Income Tax* at 14.43 available electronically on LexisNexis – Each instance to be interpreted on its own merits.

²⁰⁷ Emslie, TS *et al Income Tax Cases & Materials* (2002) at 105.

²⁰⁸ 1948 (3) SA 866 (N).

place where the trustees fulfil their fiduciary duties as trustees.”²⁰⁹ The fiduciary duties of a trustee were discussed in detail in chapter 3. It is unclear whether duties prescribed by statute or specifically laid down in the trust deed and the place where these are carried out, is then irrelevant according to this view. Such fiduciary duties can in our view be best described as general ethical duties that are underlined by the fundamental consideration to act in the best interest of the beneficiaries. They are however of such wide import and can practically be fulfilled from a variety of places, that this view is extremely difficult to apply in practice.

Davis et al²¹⁰ have a more practical approach -

“Management requires the taking of decisions and the implementation of those decisions, and it is the place where the most vital of those actions take place that will determine the place of effective management. The place of effective management is not necessarily the same as the place where the assets of the enterprise are situated or the place where it is legally domiciled.”

Cohen & Kruger²¹¹ also advocate a practical approach. They submit is that the test to be applied in determining the place of effective management in relation to a trust, is to ask “who exercises the real authority to take the decisions necessary to conduct the ongoing business of the trust?”²¹² In their view SARS would look to the activities of those who actually manage the trust, as opposed to those who exercise overriding control.²¹³ Also important is that the requirement is for the trust to be “effectively” managed, and thus whilst it may be that the trustees who usually effects this, it may equally be done by other parties, such as the settlor, the trust administrators or a trust company.²¹⁴ They illustrate their view with a practical example. Should a South African investment advisor be appointed to invest and manage the sole asset of an offshore trust, its share portfolio, it may be argued by SARS that it is not the offshore trustees who are effectively managing the trust, as they have not participated in the trust’s affairs.²¹⁵ They however caution that such a situation must also be distinguished from one where the investment advisors make recommendations to the trustees, thereafter the trustees not only consider the advice before implementation, but also have

²⁰⁹ Haupt P *Notes on South African Income Tax 2013* at 27.

²¹⁰ Davis, D Olivier, L & Urquhart, G *Juta’s Commentary on Income Tax* (Revision Service 15) available electronically on Juta.

²¹¹ Cohen T & Kruger D “Offshore Trusts: Many Dragons wait in Ambush “ 2010 (1) (3) *Business Tax & Company Law Quarterly* at 24 – 29.

²¹² Cohen T & Kruger D “Offshore Trusts: Many Dragons wait in Ambush “ 2010 (1) (3) *Business Tax & Company Law Quarterly* at 24.

²¹³ Cohen T & Kruger D “Offshore Trusts: Many Dragons wait in Ambush “ 2010 (1) (3) *Business Tax & Company Law Quarterly* at 26.

²¹⁴ Cohen T & Kruger D “Offshore Trusts: Many Dragons wait in Ambush “ 2010 (1) (3) *Business Tax & Company Law Quarterly* at 26.

²¹⁵ Cohen T & Kruger D “Offshore Trusts: Many Dragons wait in Ambush “ 2010 (1) (3) *Business Tax & Company Law Quarterly* at 26.

the necessary skills to do so.²¹⁶ They also warn that effective management of a trust may come under the spotlight on a number of occasions, firstly at the establishment stage of the trust where specific powers may be granted to the South African protector or settler, secondly during the ongoing management of the trust; and also if an offshore corporate trustee is itself not effectively managed outside South Africa.²¹⁷ Their approach seems to be a pragmatic hands-on approach. It also stresses that the facts of each case be ascertained and considered on its merits.

The internal view²¹⁸ of the accounting and tax firm, Ernst & Young is summarized in the following core statement that that effective management contemplates –

‘the periodic, most senior executive management functions, which are required for the management of the affairs of a company, trust or other entity, as a whole’ or, put another way, ‘“calling the shots” in the context of the management as opposed to “control” of the company’.

In their view the crucial question to be asked is “by whom and where are the regular senior executive functions exercised, that are required for the running of the affairs of a company as a whole?”²¹⁹ Yet they also emphasize that there is not a ‘one-size fits all’ approach, but that each situation must be considered upon its factual circumstances.²²⁰

A more in-depth discussion is provided by Honiball & Olivier. They state that a South African trust will be “effectively managed outside South Africa if the trustees manage or conduct all the business of the trust outside South Africa.”²²¹ To determine the place of effective management, they submit that the place where the trustees convene their meetings is an important consideration, but is not conclusive.²²² The role of other parties, such as the protector or the investment manager, the place where such party performs his or her duties, and the place where the trust assets are managed, are further considerations.²²³ Thus an understanding of the operational activities of the trust and the

²¹⁶ Cohen T & Kruger D “Offshore Trusts: Many Dragons wait in Ambush “ 2010 (1) (3) *Business Tax & Company Law Quarterly* at 27.

²¹⁷ Cohen T & Kruger D “Offshore Trusts: Many Dragons wait in Ambush “ 2010 (1) (3) *Business Tax & Company Law Quarterly* at 27

²¹⁸ Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (3 June 2011). The author explains that the firm has its own considered views which by company policy must be adhered to in all written opinions by the firm on the subject concerned.

²¹⁹ Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (June 2011).

²²⁰ Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (3 June 2011).

²²¹ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 68.

²²² Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 69.

²²³ The role of the Protector was extensively discussed in Chapter 3. The authors further submit that where a trust has been formed in a jurisdiction which recognises a protector, it does not follow that whilst South Africa trust law may not be familiar with the term, the role of the protector must be

activities of the trustees in relation thereto, is important.²²⁴ It is here where the distinction between active and passive trusts, as was discussed above, becomes relevant. In an active business operation conducted by the trust, the place of effective management would be more easily determined as one would be able to have regard to the place where these activities are carried on.²²⁵ In a passive investment holding trust, the activities would rarely go beyond trustee meetings during which they manage the investment of the trust, and such meetings need not be regular, especially where they have appointed an investment manager.²²⁶ In such an instance, the place where the decision is taken to appoint the investment manager, or renew his or her mandate and the place where those decisions are carried out will impact on the place for residence.²²⁷ Most probably, the place where decisions are taken and carried out will constitute the place of residence of the trust.²²⁸ However should the investment manager have a wide authority to make investment decisions without reference to the trustees, it may be so that on the facts, the trust itself and the business of the trust is effectively managed by the investment manager and thus establish the place of residence there.²²⁹ Where no or few trustee meetings are held, the authors submit that the South African courts may look to the 'residence of the trustees' themselves.²³⁰

Thus they submit that the place where the trustees meet, is but one of the factors and not conclusive. It still then remains a factual enquiry as to whether the trustees are "in fact the decision-makers and implementers, or whether they are men of straw or persons who rubber-stamp the decision of the real decision-maker."²³¹ For example, trustees who are governed by the beneficiaries, or through a letter of wishes by the founder.²³² These puppet or nominee trustees must be ignored when determining the place of effective management.²³³ Moreover, where it is endeavoured to establish the place of effective management on the basis of the meetings, it is necessary that the trustees should be duly authorised and have sufficient involvement and knowledge of the affairs of the trust to make the decisions, bearing in mind that SARS still looks to where those decisions are implemented.²³⁴

ignored in determining the trust's effective management- Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 70-71.

²²⁴ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 289.

²²⁵ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 289-290.

²²⁶ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 289-290.

²²⁷ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 289-290.

²²⁸ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 154.

²²⁹ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 71.

²³⁰ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 290.

²³¹ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 26.

²³² Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 26.

²³³ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 154.

²³⁴ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 26.

6 4 4 Conclusion on the various views

In conclusion, it is apparent that there is no uniform approach advocated by the authors. Some authors appear to endorse old case law by emphasizing the place of residence of trustees, others place substantial value on where the trustees meet and attend to the decision-making. Others focus more philosophically on where the fiduciary duties are carried out, whilst others focus on only one such duty, namely where the assets of the trust are administered. Whilst some appear to only look to the trustees, others acknowledge that other functionaries may attend to the management of the trust, or that the trustees may act not only of their own accord and upon their own devices.

Some, such as Olivier & Honiball as well as Cohen & Kruger, favour a more practical approach which appears to be more holistic and is in line with SARS' emphases on a factual case-by-case basis, and in the author's view, is the more preferred approach. All of these views, particularly in the absence of a statutory or judicial pronouncement, are valuable in that they identify factors for consideration and stimulate reflection on the meaning of this term in our domestic tax framework.

6 5 Guidance from historical approach & judicial precedent

A concept that is often used in relation to the residence of artificial entities is "management and control." It is used in a number of countries as a test for domestic residency.²³⁵ In some instances it is regarded to be synonymous to the "place of effective management," and described as yielding the same results practically.²³⁶ More often it is regarded as implying a higher level of management ("a board level" or "superior policy making"),²³⁷ than the place of effective management. Practically it is said that "management and control" looks to where the top level decisions are made, where the board of directors meet, thus lower level managerial decisions and day-to-day trading activities are irrelevant.²³⁸ Historically, it has also featured in South African tax

²³⁵ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 155.

²³⁶ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 26 – "in practice the two forms of management will often coincide." Also Hattingh - "The author's view... is that these concepts are almost identical, and that the only real difference is one of emphasis as regards the evidentiary burden..." Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.2.1.

²³⁷ Van der Merwe, BA "Residence of a Company – The Meaning of 'Effective Management'" (2002) 14 *SA Merc LJ* at 85.

²³⁸ Anon "In what country does a company reside for tax purposes?" (February 2009) *Synopsis Tax Today* PriceWaterhouseCoopers

case law.²³⁹ The fact that the South African legislator expressly did not employ this term when it defined the term “residence,” can be seen as an indication that it intended a concept different to it, or at least a move away from it. The Interpretation Note²⁴⁰ reinforces this notion by stating as follows -

“The Revenue Laws Amendment Act, 2000 (Act No. 59 of 2000) introduced a definition of “resident” in section 1 of the Act, which includes the term “place of effective management” as one of the tests to determine the residence of a person other than a natural person. The inconsistent use of the concepts “managed and controlled”, “managed or controlled” and “effectively managed” was addressed simultaneously and a more uniform approach is now followed in the Act. The reference to “managed or controlled” in Practice Note No. 7 dated 6 August 1999, paragraph 1.1.3, is therefore no longer applicable.”

However it is submitted that an investigation into the concept of "management and control" will have value, not only to understand the basis upon which other countries establish residency, but also as it showcases factors that may improve the application and understanding of the concept of “place of effective management.” It is further submitted that the historical approach followed in South Africa as illustrated by case law, is also of value as it provides insight on how South African courts have typically dealt with the concept of residence in relation to artificial entities.²⁴¹

6 5 1 *Nathan’s Estate v CIR 1948 (3) SA 866*

This case appears to be the only occasion in South African historical tax jurisprudence where the courts were tasked with the question whether artificial *persona* such as an estate fund/trust created in a Will can be regarded as resident and where it would then be resident. In terms of the Will of the late Mr Nathan, the corpus of his estate was to be vested for a period of 50 years in his administrators. The administrators invested the funds of the estate upon which income was earned. Income Tax was duly paid thereon but only on national level and not on a provincial level, and the case concerned the assessment of the trust by the Commissioner based on the latter. The administrators were all resident in a particular province, and they acknowledged that the central management, control and administration of the corpus of the estate and its income was carried out

²³⁹ See also Clegg, D “Place of Effective Management” *Tax Planning Corporate and Personal* (Vol 25) (3 June 2011) that the South African income tax framework has at times differentiated between ‘control’, ‘managed and controlled’, ‘managed or controlled’, ‘managed’, and ‘effective management’, used or in use currently for the s 1 definitions of a ‘domestic company’, a ‘connected person’ and a ‘resident’, s 31 and s 10(1)(h); Van der Merwe, BA “Residence of a Company – The Meaning of ‘Effective Management’ (2002) 14 *SA Merc LJ* at 86; Goosen, C “International Tax Planning: The concept of Place of Effective Management” 15 February 2006.

²⁴⁰ SARS *Income Tax Interpretation Note No 6* (issued 26 March 2002).

²⁴¹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.

and conducted from the same province. The crucial question was therefore whether the legislation, which allowed for the taxes to be imposed upon a “person resident” in a province, included artificial persons,²⁴² which the court found that it did²⁴³ and further that an artificial person is capable of having a residence. The court concluded that the trust clearly had a residence in the particular province, as its administrators were resident there and the fund was administered from that province.

Thus, it would appear that the residence of the trustees is an important consideration, as well as the place from where they administer the trust fund. An obvious criticism in today’s mobile world is, that the trustees need not administer the trust from their personal residence, and could equally do it from their office, or a centrally agreed place with their individual residences having little bearing thereon.

6 5 2 *Robinson v COT* 1917 TPD 542

This case did not concern an artificial person but instead a natural person.²⁴⁴ It is however included here as it demonstrates certain fundamental considerations, that the court takes cognizance of in determining residence. The first is that the court will in arriving at its interpretation take due regard of the context and circumstances in which the word is used –

“It is a generally accepted principle that the word ‘residence’ has no fixed legal definition, but must be interpreted according to its ordinary meaning and the context in which it is found.”²⁴⁵ and “ The authorities are clear that residence is a word which varies in meaning according to the circumstances under which it is used.”²⁴⁶

²⁴² In *CIR v JW Jagger & Co (Pty) (Ltd)* 1945 CPD 331 the term “person” in tax legislation at the time was found to held to include both natural and fictitious persons, including persons other than companies. On the facts of the case it was found to include a trust, an association and an university, but not a pension fund that had no persona apart from the company it served. The case however concerned the exemptions a private company was allowed to deduct which does not necessarily equate that it is authority for the imposition of taxes on such persons.

²⁴³ The court referred to various tax cases(*Rhodesia Railways v COT*, *Estate Kootcher v CIR* etc) – although these were concerned with companies the court found that there was no reason why other artificial persons could not be said to have a residence.

²⁴⁴ As the principles of importance can be extrapolated without the background of the matter set out, the facts are here briefly summarized. With the outbreak of war, Sir Robinson came to South Africa, to attend to his considerable business interests here with the intention that once finalized, he would return to England where he lived and had his main residence. At the time of the judgment, he had however remained in South Africa for 2 and ½ years, had occupied houses similar to an ordinary resident would do and there was no indication that a specific time limit had been set for his stay. Sir Robinson was regarded to be tax resident in South Africa. For other cases concerning natural persons see *Cohen v CIR* 1946 AD 174, *CIR v Kuttel* 1992 (3) 242 (A); *H v COT* 1960 (2) SA 695 (SR).

²⁴⁵ Per Mason, J at 544.

²⁴⁶ Per Bristowe, J at 547.

Furthermore there is also an indication that the court takes fiscal policy into consideration²⁴⁷ in that it looks to the justification upon which the tax is levied –

“It is said that in determining the meaning of the word ‘residence’ regard must be had to the object of the Act and the context in which the word appears. These tests are not easy to apply in the present case....But where a person has been living all this time in the country and has had the benefit of its government for himself, his property and business, there seems no *a priori* reason for exempting him from taxation.²⁴⁸”

This consideration of the “benefits” enjoyed by such person, resonates in the “privilege and protection” of residence as stated in *Kergeulen Sealing and Whaling Co Ltd v CIR*,²⁴⁹ for which it is just that the taxpayer can be called upon to contribute to.²⁵⁰ Hattingh concludes that the significance of this case is that the court, when the facts did not present a clear conclusion, resorted to the fiscal policy consideration and the aim and function of the residence criterion.²⁵¹

6 5 3 *Rhodesia Railways v COT* 1925 AD 438

The Rhodesia Railways Company was one of four railway companies around which this case was centred.²⁵² All these companies were formally incorporated in England, but owned and operated railway lines in various colonies of Southern Africa. The lines were managed in such a way, that profit and losses were shared based on the mileage owned by the respective companies. Hattingh²⁵³ explains that at the time -

“...the applicable income tax system ... was territorial and source-based but contained a source-deeming rule that included as taxable income amounts derived by any person who was “ordinarily resident” or who carried on business in one of the colonies. Effectively, this achieved a kind of residence based liability....”

The various companies were assessed for tax on the basis that they were ordinarily resident, alternatively carrying on a business within the territory, and against this they appealed. The court

²⁴⁷ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.2.

²⁴⁸ At par 546. South Africa at the time levied tax on income and thus residence was not used to determine the liability, but the case concerned special exceptions introduced in favour of non-residents who held Government stocks (so as to popularize the type of investment), which the taxpayer sought to utilise on the basis that he was non-resident.

²⁴⁹ 1939 AD 487.

²⁵⁰ 1939 AD 487 at 507.

²⁵¹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.2.

²⁵² The others were the Mashonaland Railway Company, Limited, the Beira Junction Railway Company, Limited, and the Beira Railway Company, Limited. The case was before the Appellate Division of Southern Rhodesia. The arrangement was a combination of agency and partnership. Hattingh terms it an “unincorporated joint venture.”

²⁵³ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.2.

found that the solution in the case would depend on the meaning of the words of “ordinarily resident or carrying on a business within the territory.” Consequently it was primarily a question of language of the Act, interpreted with assistance as may be had from decided cases where it has been previously been considered.²⁵⁴ In the appeal case the finding of “residence” of the companies by the lower court was not contested and thus it only remained to be ascertained whether the companies could be said to “carry on business” within the territory.

However to determine this, the issue as to whether a company could *only* be said to carry on a business where it resided and nowhere else, had to be addressed. The court considered English jurisprudence, particularly the case of *De Beers Consolidated Mines v Howe*,²⁵⁵ where it was stated that “the real business is carried on where the central management and control actually abides.”²⁵⁶ On this basis it was contended that a company could only carry out business where it resided thus. The court did not agree, stating that the “the case emphatically did not decide that the place of a company’s real business or the place of its principal business was the only place where it could carry on business.”²⁵⁷ It also pointed to the analogy to a natural person applied in that case which implicitly rejected such inference.²⁵⁸ Case law further supported this view, such as *Lovell and Another v Commissioner of Taxes*,²⁵⁹ where the court concluded that a company, like an individual, could carry on business in more places than one, and could carry on business as an individual could, in places where it did not reside. On the facts, the court found that the various companies did indeed conduct business within the territory and hence were taxable.

Hattingh refers to the decision in the trail court²⁶⁰ from which two further important considerations can be identified. The first is to have due regard to the circumstances prevailing at the time and in particular the taxation system that is applicable, the court described it as follows:–

“If the Court has to define “residence” for the purpose of its jurisdiction it enquires into the circumstances under which a Company should be justiciable and makes those circumstances equivalent to “residence.” If “residence” for income tax purposes falls to be defined the Court makes an enquiry as to the circumstances appropriate to the payment of Income Tax and thus arrives at its definition. Be it remembered in this connection that residence in England makes income from all sources taxable in England so that a strict definition of residence will naturally

²⁵⁴ At 136.

²⁵⁵ 1906 AC 455.

²⁵⁶ At 137. This rule was described as “the fundamental rule of company residence adopted by the South African Courts - Danzinger E *International Income Tax The South African Perspective* (1991) at 46.

²⁵⁷ At 137.

²⁵⁸ At 137.

²⁵⁹ 1908 AC 46.

²⁶⁰ *Rhodesia Railways, Ltd Appellants v COT* 1925 SR 1

be expected...The only reason why a Company's residence for Income Tax purposes should not be similarly understood is, to my mind, the wide scope of the English Taxation measures based on residence. If residence in England exposed a company to taxation upon Income from English sources only I do not think that residence would be given the limited meaning enshrined in the *de Beers*' case...."²⁶¹

As well as -

"It is only natural that judges in England, a country whose capital goes to develop the raw products of all parts of the earth, should think mainly of the taxation of the revenue derived by the investor who is protected by the armaments of the United Kingdom. In countries, however, where the raw products are produced or where the industries or undertakings promoted by British capital are being carried on, it is only natural that the initial stages in the production of profits should be more closely regarded."²⁶²

The second consideration is that of potential double taxation. It was argued that the provision whereby the colony sought to tax the companies as non-residents solely by reason that they carried on business was *ultra vires* of the legislator, and thus the provision was void. To this court answered-

"Residence, as regards a company, is admittedly an artificial notion. If the central control and management subjects a company to taxation why should the earning of profits in the initial stage not do so also? Both want protection, and this is given by the laws and stable government of the country where the company carries on business. If double taxation is the difficulty, taxing on the basis of residence does not avoid that. This is a matter for arrangement between Legislatures, not for consideration by the Courts. It is the Municipal and not the International aspect that is the main concern of the Court."²⁶³

6 5 4 A Company v COT 1941 SR 79

The concept of "central management and control" was explored in greater depth in this case. In particular in this case the court had the opportunity to consider the effect of the majority shareholders potentially exercising control over the board of the directors, as well as the consequences of the directors acting pursuant to guidance received from its technical advisers.

The facts were as follows: the Appellant Company had been registered in Southern Rhodesia, where it carried on a manufacturing and selling business. This is also where it held its registered office and all board meetings took place. Of the five directors on its board, four (one of whom was the Chairman) were locally resident with the fifth director, the managing director, resident in South

²⁶¹ At 13. See also *Cohen v CIR* 1946 AD 174 at 187-188 per the judgment of Davis AJA where he similarly notes that as the 'fundamental basis of taxation 'differed between South African and England at such time, and the statutory provisions were consequently enacted in pursuance of 'totally different policies', the English cases can be said to be robbed of 'most of their persuasive value.'

²⁶² At 15.

²⁶³ At 19.

Africa. He was also the managing director of the majority shareholder of the company, which was a South African company (referred to as the Union Company in the case).

Under the articles of association the board of directors was vested with the legal management and control of the affairs of the company. The articles further required a director to hold at least one share and consequently the shares were held by the directors as nominees on behalf of the majority shareholder. Potentially then the directors could be removed at any time from office by the majority shareholder. Certain important matters were also under the control of the majority shareholder.²⁶⁴ Moreover the shareholder company was also appointed as technical adviser at an annual fee. The chairman of the company acknowledged in testimony that in almost all matters, the board of the Appellant company acted on the advice and suggestion of the shareholder company. That the board would look to them for guidance was a natural consequence of the fact that the shareholder company had “long and wide experience of the business” and were further the company’s technical advisers. The Chairman further explained that –

“...as a matter of courtesy to the majority shareholders he and his fellow directors would study their wishes on matters of direction and control. While maintaining that the directors of the appellant company were free to act contrary to the suggestion of the Union Company, he frankly admitted that if on any matter that company insisted on its suggestion being given effect to, he would feel himself obliged either to agree or to resign.”

The Commissioner of Taxes was therefore of the view, that the board of directors had no independent function in the central management and control of the company and thus assessed it as a company outside its territory. The court held the opposite view. In arriving at this conclusion the court drew a distinction between effective control as used in the popular sense and legal management and control:

“The general effect of the witness’ evidence.... is to establish beyond any doubt that, using the words in their popular sense, the effective control and management of the appellant company lie in the hands of the Union Company. The control may be exercised by way of suggestion and advice and in some instances the directors may refuse to act on that advice, but it can be accepted that on all matters of substance affecting the business of the appellant company not only does the direction come from the head office of the Union Company but also that that head office would in case of need take steps to ensure its direction being followed by exercising the power it holds in regard to the appointment of directors. But it is equally beyond doubt that however subservient the directors of the appellant company may be to the wishes and instructions of the Union Company they are, under the articles of association, invested with the legal management and control of the affairs of the company.”

²⁶⁴

Such as: the appropriation of profits; the amount of the dividend to be declared in any year; the appointment of directors; the scheme for the payment of pensions to employees; the payment of bonuses and gratuities to employees; the construction of dwelling houses for employees; the payment of donations.

The next question is then to which of these concepts (legal management and control or popular effective control) did the words “central management and control” relate to? The court found that in the absence of any indication to the contrary, these words must be interpreted in their legal sense. Thus by law, the management and control of the company is vested in its directors, who alone are empowered to perform all acts necessary to carry on the business of the company. Such actions taken in exercising the direction and management of the company, must be regarded as their own actions unless it is proved that they are but mere agents. In the present instance the court found that however much the board may be influenced and guided by the shareholder company, they are still responsible for the actions performed in managing the business. As these actions were performed within Southern Rhodesia, the company was held to be resident accordingly.

6 5 5 *Estate Kootcher v CIR 1941 AD 256*

In this case, a different approach was followed - namely to determine the residence of an artificial creation by way of analogy to a human being.²⁶⁵ The court summarizes this approach best –

“A human being has a body and a mind and the mind always accompanies the body; the mind therefore resides (if a mind can be said to reside) where the body resides. A corporation has no body but it has what by analogy can be called a directing mind. In a human being the location of the body with its attendant mind, if such location be periodic or usual or habitual, determines the residence of that human being, and it is therefore to be expected that the residences of a corporation will be determined by the periodic, usual or habitual location of the directing mind.”²⁶⁶

And further

“A useful analogy can again be drawn by considering the case of a human being. He does not acquire a “residence” or a “domicile”, properly so called, in a country which he does not visit in person, merely by trading in that country; and similarly a corporation cannot acquire a residence in a country merely by carrying on trade through agents in that country.”²⁶⁷

Hattingh states that this analogy and artificial controlling mind is not “very informative.”²⁶⁸ The

²⁶⁵ This case concerned the statutory predecessor to estate duty, namely the Death Duties Act, 29 of 1922, and particularly the Standard Bank of SA Ltd, which was regarded as company incorporated in England. It had its registered office in England, and its business was controlled by a board of directors which met in England as well. In South Africa and the former South- West Africa, there were various branches of the bank which were under the supervision of a General Manager in Cape Town who reported to the English board. The court, applying the De Beers-rule, placed emphases on where the board met and thus the bank was not held to be resident in South Africa.

²⁶⁶ At 260-261.

²⁶⁷ At 262.

²⁶⁸ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.3.

court however regards the case of *De Beers Consolidated Mines v Howe*²⁶⁹ as authority for its approach where it was similarly said that,

“In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business... I regard that as the true rule, and the real business is carried on where the central management and control actually abides”

The *De Beers*-case is discussed in the next chapter.

6 5 6 ITC 1054 (1964) 26 SATC 260 (F)

This case offers guidance as to the practical evidence a court will have regard to when determining the residence of a company. In this matter, the only issue in dispute was whether the company was ordinarily resident on the evidence led by it. As starting point, the court commented on the considerable number of cases where this question has also been considered. It was not necessary to discuss these cases and instead the court summarized their authority, namely that firstly it is always a question of fact where an artificial person is resident, and secondly, that a company is resident where its ‘central management and control actually abides.’

The court then proceeded to consider the evidence put before it. The memorandum and articles of association was first and established clearly that in law the management and control of the company was vested in the board of directors. The board consisted of three directors, one who was not-resident, one resident and the last was indeterminate and could therefore not be found to be conclusively resident. The share registry reflected that two of the three directors held one share each with the greater and thus remaining shareholding held by a company registered in the Bahamas. The minute book was also presented in evidence and recorded that all meetings were held in Southern Rhodesia. There was disagreement about the value of this evidence. The Commissioner’s representative submitted that it was not conclusive as it merely showed that the control was “apparently exercised here.” Particularly as none of the directors personally gave evidence, it could well be that they were but nominal figures accepting instructions from parties or entities outside the borders. The court disagreed concluding that even where the directors are “guinea pig directors” they are to be regarded as having the control of the company. They are not able to shelter behind such nominal character and will be responsible for civil or criminal liability. The last consideration was the lack of evidence regarding the meetings of the shareholders. No direct evidence was led on this aspect but the minute book did reveal that such meetings were held

²⁶⁹ 1906 AC 455

in the country. Yet this was irrelevant as the authorities are clear, that “question of where shareholders reside or meet is of little, if any, significance in determining where the central management and control of a company actually abides.”

The case also thus illustrates the issue of formal control versus effective control, although the documentary records reflected formal “apparent” control there was, as the Commissioner argued, no evidence of actual effective control. The court dismissed this argument as indicated above on the basis of the ultimate responsibility that lies with the directors. Yet just as there was no evidence to prove “actual control”, there was also no evidence submitted to court to prove that the company was controlled by other persons than the directors, which may have brought about a different conclusion by the court. Danziger therefore submits that whether formal or effective control is required for residence is therefore an open question.²⁷⁰

Gutuza similarly recognizes that there are two possible approaches which may be derived from these historical cases – a *de facto* approach – to look to the directing mind of the company, and a legal approach – to look at the rules of the company as found in its documentation, common law and legislation.²⁷¹ She submits however that it is where the distinction between a company and a trust is important as the latter's "legal status outside the Income Tax Act does not exist," hence a different analysis and facts and circumstances would be applicable.²⁷² With a legal approach the rules which give a company the status of person would be examined by reviewing its incorporation documents, case law relating to its action and relevant legislation.²⁷³ On application to the *Oceanic*-case she submits that the role and decision-making of the trustees would therefore be considered, but the analogy can not be carried further as a trust does not derive any legal personality from legislation, incorporation documents, etc.²⁷⁴ Whilst it is agreed that a trust is not a legal person and neither legislation, case law or the trust deed can imbue it with such a personality, there is still a legal framework against which it can be measured which arises from the specific provisions of the trust deed, and the common law rules as well as obligations found in the Trust Property Control Act. For example such legal rules require that the trustees act jointly, that they exercise their discretion independently and unfettered by others, that they may delegate the implementation of their decisions, but not the making of them. Similarly then whereas one may find on the basis of the

²⁷⁰ Danziger E *International Income Tax The South African Perspective* (1991) at 50.

²⁷¹ Gutuza, T "Analysis: Has Recent UK Case Law Affected the Interplay Between 'Place of Effective Management' and 'Controlled Foreign Companies?'" (2012) 24 *SA Mercantile Law Journal* 424.

²⁷² Gutuza, T "Analysis" (2012) 24 *SA Mercantile Law Journal* at fn 24 at 427.

²⁷³ Gutuza, T "Analysis" (2012) 24 *SA Mercantile Law Journal* at 429.

²⁷⁴ Gutuza, T "Analysis" (2012) 24 *SA Mercantile Law Journal* at 429.

company's incorporating documents and relevant statutory provisions, that the company's legal place of effective management is located on the level of its board, one could on the basis of the aforesaid framework, find the trust's legal place of effective management to be located on the level of its trustees, and yet factually the management may be done by other parties. It is therefore submitted that the distinction between a legal and factual approach remain relevant, even in a trust setting where the trust does not have legal personality, whilst it is further agreed with Gutuza that the trust context does however require different circumstances and facts to be analysed.

6 5 7 Commissioner, South African Revenue Service v Tradehold Ltd 2013 (4) SA 194 (SCA)

A high-level approach can be seen in the more recent *Tradehold*-case,²⁷⁵ which dealt with the exit charge in relation to capital gains which arises when a resident ceases to be a resident.²⁷⁶ The court was not called upon to consider the particular meaning of place of effective management as criteria for residency, but it is still interesting to note what had been accepted as constituting such effective management.

The company in question is described as an investment holding company which had been incorporated in South African and is listed on the Johannesburg Stock Exchange.²⁷⁷ On 2 July 2002, the the board of directors met in Luxembourg and took a decision that as from that date, the company would hold all further board meetings in Luxembourg. This had the effect that the place of effective management would from such date be in Luxembourg²⁷⁸ and it would be liable for tax there as resident. Although the residence status of the company was not in issue, it is implicit in the aforesaid that the mere holding of board meetings was regarded as sufficient to establish the place of effective management in another country. Indeed it was regarded as "common cause" that with effect from date of the decision, the company had relocated its place of effective management.²⁷⁹

²⁷⁵ *Commissioner, South African Revenue Service v Tradehold Ltd* 2013 (4) SA 194 (SCA).

²⁷⁶ Due to the operation of Par12(1) of Schedule 8 of the Income Tax Act, 58 of 1962 which deems the resident to have disposed of its assets upon ceasing to be a resident.

²⁷⁷ Par 2. Its asset base comprised a 100% shareholding in another company which via its sole shareholding in a subsidiary, owned 65% of the share capital in an UK-based company.

²⁷⁸ Par 3 – the court refers to the relocation of its effective management.

²⁷⁹ See Par 5 and 5 of the tax court case *ITC Case no 1848* 73 SATC 170. For further discussion iro the the case and these exit charge provisions see Dachs, P & Smit, N "Christo Wiese's Tradehold wins Tax Court Case" available at <http://www.moneyweb.co.za/moneyweb-tax/christo-wieses-tradehold-wins-tax-court-case?sn=2009+Detail> – last accessed 05/09/2013; Ed "You may be Right, Minister" *The Taxpayer* (2012) 61 No 7 at 121-122; Mazansky, E "Letter" *The Taxpayer* (2012) 61 No 6 at 102.

6 5 8 Conclusion in respect of the historical approach & judicial precedent

Upon review of these cases, Hattingh finds them to be an endorsement that the effective management of a company lies typically on a very high level of management, and that in a company situation, the default position is that it is the board of directors effectively manages the company, unless there are facts to the contrary.²⁸⁰ Only in certain circumstance did our courts feel compelled that other functionaries not being the board, managed the company and in such few situations it was dominant persons such as a shareholder.²⁸¹ He concludes that none of our historical jurisprudence has found that lower levels of management constitute the effective management of the company.²⁸² SARS' current interpretation of "residence" is therefore not only out of kilter with the international community, but also with historical judicial views as to its meanings.

Various authors contend that SARS most likely intended a different interpretation to be attributed to the "place of effective management", than that of the historical "control and management."²⁸³ The latter is described as formalistic and does not take into account that other persons than the directors may exercise control.²⁸⁴ Also that the test of "control and management" is to some extent artificial, open to manipulation and may result in multiple residence as there may be many places where the board takes "superior, policy and strategic decisions."²⁸⁵

None-the-less the value of these cases lies therein that they provide insight as to how courts may deal with the task of determining residence for an artificial entity and identifies factors that may be relevant to such a task. Important is the fact that often recourse is made to the justification or the legal policy behind the imposition of taxes based on residence. A more recent case is now discussed.

²⁸⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.4.

²⁸¹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.4.

²⁸² Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.4.

²⁸³ Van der Merwe, BA "Residence of a Company – The Meaning of 'Effective Management' (2002) 14 *SA Merc LJ* at 88; Goosen, C "International Tax Planning: The concept of Place of Effective Management" 15 February 2006.

²⁸⁴ Danzinger E *International Income Tax The South African Perspective* (1991) at 49.

²⁸⁵ Van der Merwe, BA "Residence of a Company – The Meaning of 'Effective Management' (2002) 14 *SA Merc LJ* at 89. (As opposed to an effective management test that focuses on the day-to-day management and which would more often be located in one place.)

6 6 Guidance from the recent case of the Oceanic Trust Co Ltd No v Commissioner of SARS²⁸⁶

This case concerned a Mauritian registered offshore trust, Specialised Insurance Solutions (Mauritius) Trust (SISM). The sole trustee of SISM was The Oceanic Trust Co. Ltd, a company registered and incorporated under the laws of Mauritius. In terms of the deed of settlement of SISM, the proper law of the deed would be Mauritius and its laws would govern the trust's construction, effects and administration with its trustees obliged to maintain their principal place of business and conduct their affairs from premises in Mauritius.²⁸⁷

SISM carried out the business of captive reinsurer to mCubed Life Limited, a South African registered company, from its inception till 2006.²⁸⁸ Essentially premiums of the policies of reinsurance were transferred to SISM and constituted assets invested in South Africa. Its main activity was therefore the captive re-insurance business. It had appointed a South African company as its asset manager and investment advisor for its South African investments, which company was a wholly owned subsidiary of the parent company of mCubed Life Limited.²⁸⁹ All these entities therefore formed part of an intergroup structure.

During this period SISM rendered income tax returns in Mauritius and considered its tax obligations to be limited to Mauritius. SARS had a different viewpoint and in 2009 issued an assessment for R1.5 billion and as one of the bases for the assessment contended that SISM was resident in South Africa as it had its "place of effective management" in South Africa.²⁹⁰ SARS then appointed Standard Bank as its agent in terms of Section 99 and as such, instructed it to remit the assessment amount to SARS.²⁹¹ Consequently Standard Bank as agent to the Commissioner paid the R20 655 150

²⁸⁶ Decided on 14 June 2011. (2011) 74 SATC 1; For a summary of the case see Silke, J "The Devil's in the Detail" (2013) 27 *Tax Planning* 68 – 72. The case also concerned the application of Section 99 of the Act which encapsulates the controversial "pay now, argue later" rule and whereby in the present instance SARS, by appointing the bank of SISM as its agent was able to seize R20 million. However this rule falls outside the scope of the study and aspects related thereto are not discussed. See instead Maake, M "Mauritian trust company fails in court bid for R20 million tax refund" – <http://www.bdlive.co.za/articles/2011/10/21/mauritian-trust-company-fails-in-court-bid-for-r20m-tax-refund> accessed on 05/05/2013; Napier, N and Salani, R "Challenging Environment for Taxpayers" published in Cliffe Dekker Hofmeyr's Tax Alert, July 2011 edition – available on <http://www.cliffedekkerhofmeyr.com/en/news/press-releases/2011/challenging-environment-for-taxpayers.html>, last accessed on 05/05/2013.

²⁸⁷ Par 3.

²⁸⁸ Par 4

²⁸⁹ Par 4

²⁹⁰ An alternative basis was that SISM derived income from a SA source, and carried on the business of a permanent establishment as defined in the Act.

²⁹¹ The case also concerned the application of Section 99 of the Act which encapsulates the controversial

in the banking account of SIMS over to SARS. The Commissioner further gave written notice to SIMS that it would proceed with legal action against it, so to, amongst others, recover the outstanding tax. The Oceanic Trust, in its capacity as trustee, then as a matter of urgency launched an application to the Western Cape High Court to restrain SARS from taking these steps, and in particular sought as part of the application for declaratory relief, specifically a declaratory order to the effect that SIMS was not a “resident” of South Africa as defined in the Act.

SIMS argued that the place of effective management of SIMS has always been in Mauritius, it had been established and formed there and its sole trustee was resident in Mauritius, thus no one in South Africa could have “orchestrated” the management of it in South Africa, nor as the trustee had always been in Mauritius, could any decision by the trustee have been made in South Africa.²⁹² The fact that SIMS carried on its business and certain activities in South Africa subsequent to its agreement with mCubed Life, did not affect its place of effective management.²⁹³ It placed reliance on the English decision of *Commissioner for Her Majesty’s Revenue and Customs v Smallwood & Anor.*²⁹⁴ This case is in further detail discussed in the next chapter. Essentially in that case a trust established in the United Kingdom had historically been controlled by trustees resident in the United Kingdom, but for a short period and to facilitate a particular transaction, such trustees had resigned and a Mauritian trustee been appointed.²⁹⁵ The court there concluded that despite such exportation of the trust, it had always been effectively managed from the United Kingdom. A snapshot approach to determine the place of effective management was rejected by the court.²⁹⁶ Thus, SIMS argued, that there had never been any exportation or importation of the trust in the present instance, but that its trustee as the continuing body of the trust had always been in Mauritius and was resident there accordingly.²⁹⁷

SARS disputed this and alleged that SIMS’s entire income originated from business activities

“pay now, argue later” rule and whereby in the present instance SARS, by appointing the bank of SIMS as its agent was able to seize R20 million. However this rule falls outside the scope of the study and aspects related thereto are not discussed. See instead Maake, M “Mauritian trust company fails in court bid for R20 million tax refund” – <http://www.bdlive.co.za/articles/2011/10/21/mauritian-trust-company-fails-in-court-bid-for-r20m-tax-refund> accessed on 05/05/2013; Napier, N and Salani, R “Challengng Environment for Taxpayers” published in Cliffe Dekker Hofmeyr’s Tax Alert, July 2011 edition – available on <http://www.cliffedekkerhofmeyr.com/en/news/press-releases/2011/challenging-environment-for-taxpayers.html>, last accessed on 05/05/2013.

²⁹² Par 53.

²⁹³ Par 53.

²⁹⁴ [2010] EWCA Civ 778.

²⁹⁵ Par 49 -51.

²⁹⁶ Par 52.

²⁹⁷ Par 53.

conducted in South Africa, that its bank statements reflect that no funds were transferred from South Africa to Mauritius, and that instructions on reinsurance premiums, policies and maturities emanated from mCubed Life and sometimes from its parent company in South Africa, decisions as to the handling of the premiums (investment/disinvestment) were made by mCubed Life, all investments were made in South Africa, that it also regularly received instructions from mCubed Life on SISM's investment and that despite claiming its business to be managed in Mauritius, SISM had not provided any documentation or any minutes of trustees meetings of SISM in Mauritius.

The court found SISM's reliance on the *Smallwood*-decision to be misplaced, as that case was based not only on the general test for the 'place of effective management' but also on a specific section of the UK legislation, which provided that the trustees be treated as a single and continuing body of persons who and as resident in the UK, unless the general administration of the trust is ordinarily carried on outside the UK and the trustees or the majority of them for the time being are not resident or not ordinarily resident in the UK.²⁹⁸ Instead the court, per Judge Willem Louw, summarized the key features of the *Smallwood* case relevant to the case as²⁹⁹:

- The place of effective management (POEM) is the place where key management and commercial decisions necessary for the conduct of the entities' business are in substance made.
- The POEM will ordinarily be the place where the most senior group of persons (e.g. board of directors) makes its decisions, where the actions to be taken by the entity as a whole are determined;
- No definite rule can be given and all relevant facts and circumstances must be examined to determine the POEM of an entity;
- There may be more than one place of management but only one POEM at any one time;
- The court undertook a painstaking analysis of the facts and the way the scheme was set up and was implemented in order to come to the conclusion on where the POEM of the trust in that case was.

Furthermore the court concluded that in order to determine whether SISM was a resident or not, it would need to enquire into the facts and to make factual findings. This the High Court has no jurisdiction to do, as it is the tax court that as the statutory appointed specialist court is entrusted with the determination of factual questions.³⁰⁰ The High Court's jurisdiction is limited to hear and

²⁹⁸ See principle number 5 at par 54.

²⁹⁹ Par 54.

³⁰⁰ The tax court is established by section 83 of the Act as a specialist court to hear appeals against

decide only income tax cases turning on questions of law and not to make findings of any facts. Where, however “all the material facts are fully found” or “the facts as stated are sufficiently clear”, then the question becomes one of law as it is the question is then whether on the facts, the case falls within the relief requested.³⁰¹ However the High Court in the present instance were of the view, that all the material facts relating to the management of SISM have not been fully found and traversed, and thus the question whether SISM is a resident of South Africa is not at this stage, only a question of law.³⁰² Such matters would therefore need to crystallise in the appeal before the Tax Court who could make such findings.

Even if it is proposed that the facts are sufficiently clear to make a decision on the place where the key management and commercial decision necessary to SISM’s business were made, the High Court was of the view that it had not been successfully established that the place of effective management was outside South Africa, as it appears that certain key management decisions or at the least, key commercial decisions were in substance made in South Africa.³⁰³ On application of the Smallwood case, then the facts to the extent that they have been proved, did not establish the place of effective management to be in Mauritius, and not in South Africa. The further applications for declaratory orders were similarly dismissed by the High Court.³⁰⁴

Concluding remarks regarding the case

Despite being almost a decade on the statute book, the phrase “place of effective management” had not prior to this case been considered, and thus this case is a welcome addition.³⁰⁵ It is so that it is only a provincial high court case and therefore not binding on other divisions, and was furthermore only an application for declaratory relief. The court also did not make any conclusions as to the place of effective management of the trust, as there were insufficient facts to do so. Yet, the case still brings guidance to the table, and particularly as it relates to a trust (as opposed to other entities), it must particularly be appreciated.

assessments issued by SARS and is the determination of factual issues is entrusted solely to it. The High Court only has jurisdiction in respect of income tax cases turning on legal issues – this is trite law, see *Metcash Trading Limited v Commissioner, SARS* 2002 (1) SA 1109 at 1135, *Whitfield v Phillips and Another* 1957 (3) SA 318.

³⁰¹ Par 45 – 48.

³⁰² Par 57

³⁰³ Par 58.

³⁰⁴ Par 58.

³⁰⁵ Williams, R B “Tax Residence – A court gives some guidance” in *Synopsis Tax Today* (June 2011) issued by PriceWaterhouseCooper, available at <http://www.thesait.org.za/news/68266/> - last accessed on 06/05/2013.

It did for example endorse certain principles of the Smallwood case, in particular that the place of effective management is where “the key management and commercial decisions necessary for the conduct of the entities’ business are in substance made”, as opposed to where they are implemented. The case therefore appears to have pre-empted the contents of the recently published Discussion Paper, which announced a move away from the implementation approach found in the initial interpretation Note, and which also seeks to bring South Africa in line with international developments and precedents. It is also interesting that the court did not consider Interpretation Note 6, which was the only document evincing SARS’ approach at the time of the judgement.³⁰⁶

The value of the judgement therefore lies therein that it provides insight as to stance the court will potentially take in applying the place of effective management concept. As Keirby-Smith concludes, “until recently, there had been no South African case law... this meant that taxpayers have had no clarity on how the courts in this country are likely to interpret this concept... it [the case] provides guidance to taxpayers...”³⁰⁷

The South African approach to the concept of place of effective management is therefore changing and appears it will in future conform to the international approach as outlined in the OECD guidelines.³⁰⁸ This is also in line with the underlying goals to the revisions the Discussion Paper proposes. La Grange stresses this as the importance of this judgment, namely that in relation to persons other than natural persons the place of effective management is where the key management and commercial decisions necessary to the entity’s business is made as opposed to where they are implemented.³⁰⁹ So too does Keirby-Smith see it as an endorsement of the international view that the place of effective management is where the key management and commercial decisions are in substance made and not necessarily where they are implemented.³¹⁰

³⁰⁶ Pearson, B & Gounden, N “Place of Effective Management – Foreign Entities to take heed of a recent court case”, available at http://www.deloitte.com/assets/DcomSouthAfrica/Local%20Assets/Documents/Tax%20News%203%202011_Final.pdf – last accessed 06/05/2013.

³⁰⁷ Keirby-Smith, B “ Finally Some Local Guidance on the Place of Effective Management” – available at http://www.saica.co.za/integritax/2011/2012.Placement_of_effective_management.htm - last accessed on 06/05/2013.

³⁰⁸ Keirby-Smith, B “ Finally Some Local Guidance on the Place of Effective Management” – available at http://www.saica.co.za/integritax/2011/2012.Placement_of_effective_management.htm - last accessed on 06/05/2013.

³⁰⁹ La Grange, A (ENS) “ Determining the Place of Effective Management” – available at <http://www.golegal.co.za/commercial/determining-place-effective-management> – last accessed on 06/05/2013.

³¹⁰ Keirby-Smith, B “ Finally Some Local Guidance on the Place of Effective Management” – available at http://www.saica.co.za/integritax/2011/2012.Placement_of_effective_management.htm - last

However, until such time as the Interpretation Note is therefore revised and not only proposed to be revised per the Discussion Paper, it appears that this case has sets out a different approach to 'place of effective management' than in the Interpretation Note and consequently may lead to a different conclusion being reached as to an entity's place of residence.³¹¹

Also of note, was the fact that the evidence, (or lack thereof) placed before the court was crucial. Williams concludes that "the production of relevant minutes of meetings and discussion records will be a vital part of this trail evidence."³¹² Olivier & Honiball had previously offered a practical recommendation that, for example, the passport of the trustees would be relevant to evidence their visits to a specific country for purposes of making and implementing decisions relating to the trustees.³¹³ Yet the evidence will need to show not only that board meetings were held at a particular location, but that key decisions were made at such meetings.³¹⁴ To comply with trust law principles, and in particular the duty of independence of the trustees, discussed in Chapter 3, apart from being duly constituted, Du Toit further urges that it will be inadequate to only record the outcome of the voting process, instead the minutes should also reflect, at minimum a synopsis, of the deliberation preceding the voting to reflect each trustee's formulated view, and to refute any challenges of collusion or secretiveness.³¹⁵

A further important point is that the court reiterated the principle that attention must be given to *all* the relevant facts and circumstances in determining the POEM of an entity. There is no definite rule that can be lain down. Nor will a formalistic or mechanical approach be tolerated. SARS in their letter of assessment to the Applicant had summarized their approach –

"In the end, the question as to where an entity's place of effective management is located is one of factIt will depend upon a conspectus of all the facts regarding the management and operation of the business."

accessed on 06/05/2013.

³¹¹ Pearson, B & Gounden, N "Place of Effective Management – Foreign Entities to take heed of a recent court case", available at http://www.deloitte.com/assets/Dcom-SouthAfrica/Local%20Assets/Documents/Tax%20News%203%202011_Final.pdf – last accessed 06/05/2013.

³¹² Williams, R B "Tax Residence – A court gives some guidance" in Synopsis Tax Today (June 2011) issued by PriceWaterhouseCooper, available at <http://www.thesait.org.za/news/68266/> - last accessed on 06/05/2013.

³¹³ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 154.

³¹⁴ Williams, R B "Tax Residence – A court gives some guidance" in Synopsis Tax Today (June 2011) issued by PriceWaterhouseCooper, available at <http://www.thesait.org.za/news/68266/> - last accessed on 06/05/2013.

³¹⁵ Du Toit, F "A Trustee's Duty of Independence" (2009) 73 THRHR at 649.

6 7 Tension between tax law and trust law

The initial view of the South African Revenue authorities as evinced in the Interpretation Note sought to determine the place of effective management by having regard to the place where policy and strategic decisions were *implemented* and looked to a lower level of management. In the 2011 published Discussion Paper SARS appears to have modified its view, intending to delete all current references to the “implementation” of strategy and policy, and will clarify that “that the primary emphasis is upon those “top” personnel who “call the shots” and exercise “realistic positive management” albeit still at the second level.³¹⁶ This approach endorses taking into account those who are responsible for developing or formulating key operational or commercial strategies and policies, or taking decisions on key operational or commercial actions, and ensuring that these strategies and policies are carried out.

The question arises as to how these approaches accord with the South African trust law. It may be worthwhile to briefly recap the trust principles enunciated in previous chapters. In chapter 2 whilst discussing the foundations of trust law, the core idea of the trust was articulated to be ‘the administration of trust property by a trustee not for his own benefit but for the benefit of another’ – indeed stated as one of the *essentialia* of the trust, is the obligation resting upon the *trustees* to administer the trust property. Flowing from the rule that the trust obligation burdens the trustee and the trustee must act to fulfil it,³¹⁷ is the requirement that the “fundamental *decisions* relating to a trust need to be *taken* by the trustees, the *implementation* of such decisions may be *delegated* to others, although the ultimate responsibility remains with the trustees.”³¹⁸ The discussion in chapter 3 reaffirmed that the trustees may therefore consult professionals or employ experts, may enlist subordinates to attend to the more routine aspects of the trust administration, or outsource the day-to-day running of the trust to a co-trustee, company, management committee or trustee, but may not abdicate their responsibilities.³¹⁹

Also fundamental to trust law as was discussed in Chapter 3 are the duties resting upon a trustee. Three essential duties govern a trustee: the responsibility to give effect to the trust instrument, to act with ‘care, diligence and skill’ which can reasonably be expected of a person managing the affairs of another in the performance of their duties and exercise of their powers, and to exercise

³¹⁶ SARS “Discussion Paper on Interpretation Note 6” September 2011 at par 8.1.

³¹⁷ Cameron, E et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 327.

³¹⁸ *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) at para 24.

³¹⁹ Cameron et al *Honoré’s South African Law of Trusts* 5th Ed (2002) at 327.

an independent discretion except in relation to questions of law.³²⁰ This second and third responsibility casts upon them a duty of active supervision and inquiry. As stated earlier, a trustee is tasked to take active steps to become knowledgeable about the status of the trust property³²¹ and can not therefore adopt a passive approach of waiting upon such information as "not knowing what one ought to have known" is regarded as negligence.³²² Similarly, should the trustees passively exercise no independent views it can be a ground for removal of the trustees.³²³ Geach therefore warns that trustee must not act under the instructions or undue influence of any parties to the trust, and must at all times exercise an independent and objective judgment.³²⁴ Du Toit states that this duty of independence essentially obliges a trustee to bring independent judgment to bear when participating in the decision-making processes of trust administration, and emphasize that³²⁵ –

“to this end, a trustee must formulate and express his own view when engaging in trustee decision-making, which view must be unfettered and free from influence, pressure or instruction from another, whether it be the trust founder, co-trustees, the trust beneficiaries or any other person, such as for example the financial planner on whose advice the founder created the trust.”

It is further trite law that all trustees must act jointly.³²⁶ This “joint action rule” obliges trustees to act collectively in the exercise of their powers and execution of their duties, and does not only apply to important trustee decisions, but in respect of all trust matters. Specifically then in relation to trustee decision-making it would be unacceptable for a trustee to simple “rubberstamp”, or commit without applying his mind to the matter,³²⁷ nor can a trustee but be a “mere puppet” for

³²⁰ Cameron et al *Honoré's South African Law of Trusts* 5th ed (2002) at 16.

³²¹ Pace RP & Van der Westhuizen WM *Wills and Trust* (October 2012) –B15.1.8 at 54(13).

³²² See the case of *Boyce No v Bloem* 1960 3 SA 855 (T) – “It is no excuse for a person who by virtue of his office is required to make enquiry, to allege ignorance... and he who ought to know is just as much in culpa as he who knows, and he who neglects to know that which he ought to know is not to be excused...”

³²³ *Tijmstra v Blunt-Mackenzie* 2002 1 SA 459 (T) 472A–C; Davis et al *Estate Planning* (May 2013) at 5-8(4) list such ground of removal as being the reliance upon a dominant co-trustee without expressing an independent view.

³²⁴ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 72. He further states (when discussing the potential liability of the trustee at 100 that "there is no defence for a trustee to argue that he/she did not take an active part in the affairs of the trust... a trustee must at least perform a watchdog role, especially when one is a managing trustee. This position should be compared with that of an executive and non-executive director."

³²⁵ Du Toit, F “A Trustee’s Duty of Independence” (2009) 73 THRHR at 641.

³²⁶ In the *Land and Agricultural Bank v Parker* case this rule was regard as a foundation of South African trust law. Further cases such as *Nieuwoudt v Vrystaat Mielies (Edms) Bpk* 2004 3 SA 486 (SCA); *Goolam Ally Faily Trust v Textile, Curtaining & Trimming (Pty) Ltd* 1989 4 SA 985 (C). *Thorpe v Trittenwein* 2007 2 SA 172 (SCA) at 176l.

³²⁷ Du Toit, F “A Trustee’s Duty of Independence” (2009) 73 THRHR at 641.

another, having no independent views and relying on another.³²⁸ Whilst a trustee may delegate administrative duties and compliance with the trust deed duties, it may not delegate that which relate to “areas where the exercise of a discretion is called for by the trustees in carrying out their duties of management and control.”³²⁹

Taking these trust law principles into consideration, it appears that upon application of the initial view of SARS in its Interpretation Note, it is permissible in trust law to look to other parties than just the trustees, be it trust administrators, advisors, agents, a mandated co-trustee or other functionaries when reviewing where a *decision was implemented*, as it is legally permissible for such action to be delegated to them. However, it is not legally appropriate in trust law to look to such parties when determining whether a decision was *made* for the trust, as such power vests solely in the trustees and is they, who as a collective body, must exercise it.

Particularly should the envisaged revisions set out in the Discussion Paper be promulgated, based on trust law principles, one can only conclude that it is the trustees who must “call the shots” and are tasked to exercise the “realistic positive management” of the trust. It is the trustees who must formulate the policy and make strategic decisions in line with the trust’s particular objective as per the trust instrument, whose provisions they are tasked to give effect to. It is they who are bound to exercise an impartial and independent discretion in all matters, an obligation which is one of the three main principles governing trust administration in South African trust law.³³⁰ Should one take into account the onerous duties imposed upon the trustees, the standard of care, diligence and skill, supervision and action as more fully discussed in chapter 3 expected of them, one would assume that a trustee appointed in office, would but arduously strive to fulfil these duties. It has after all been said that a trustee will not be able to escape liability by merely alleging and proving inactivity in the administration of the trust resulting in ignorance of its affairs, or by leaving matters in the hands of a co-trustee without enquiry, there is just simply “no place for a sleeping trustee or puppet trustee in the law of trusts.”³³¹

³²⁸ *Tijmstra v Blunt –MacKenzie* (2002) 1 SA 459 (T).

³²⁹ *Hoosen v Deedat* (1999) 4 SA 425 (SCA) at 86. For example here the validity of a power of attorney granted by a trustee to his daughter-in-law was questioned as it authorized her to act on his behalf and place for the express purpose of voting on his behalf – this the court felt entitled her to form her own view and express an independent judgment from the trustee who she need not consult, and consequently was not a tenable situation.

³³⁰ Du Toit, F “A Trustee’s Duty of Independence” (2009) 73 THRHR at 637.

³³¹ De Waal, M “Liability of co-Trustees for breach of trust” Stell LR(1999) 1 at 32.

Such a singular top-level approach (to only look to the board of trustees) per trust law principles, however seems out of kilter with SARS' declaration that it would continue to focus on a secondary tier level, and would still adhere to a case by case approach. The latter requires that all relevant facts and circumstances must be reviewed, which indicates that SARS would wish to review matters holistically and take into account the role of such other parties, notwithstanding that they are not the trustees. If so, then SARS would need to either retain "implementation", as opposed to only "decision-making" for trusts, which would allow them to have regard to other parties than just the trustees, or SARS would need to develop and define an approach specifically for trusts, which would enable them to take cognisance of such other parties, alternatively they will need to provide a sound justification for so doing. The possible justifications that SARS may rely on, are discussed next.

6 8 The impact of abuse of the trust form

The trust law principles enunciated above may be said to create a *theoretical ideal* of trustees complying with such fiduciary duties, but *factually*, it is entirely possible that in some instances certain other parties, such as the trust's professional advisors, or related parties, such as the founder or a Protector or enforcer, a dominant co-trustee, may actually (usurp and) exert such functions. For example, in relation to founders, the words of Du Toit³³² remain apt

"Trust founders often seek to retain effective control over trust property....A founder's failure to relinquish the requisite control over trust property through such interventions will not necessarily preclude the arrangement between himself and the trust's trustees from outwardly appearing as a trust, but may well prevent the arrangement from constituting a trust in substance by virtue of the fact that effective control over the trust property remains vested in the founder and not the trustees."

Olivier & Honiball also provide a practical example of an investment manager -

"While the place of effective management of a trust would normally be the place where the trustees meet to consider and conduct the business of the trust, regard must also be had to the place where the trust assets are managed in circumstances where they are managed by an investment manager who acts under the overall control of the trustees but has wide authority to make investments decisions without reference to the trustees. In such a case the facts may reveal that the trust itself or the business of the trust is actually effectively managed by the investment manager."³³³

³³² Du Toit, F "A Trustee's Duty of Independence" (2009) 73 THRHR at 637.

³³³ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 70-71.

A more recent and real example can be found in the *Oceanic*³³⁴—case discussed above. In this case the appointed trustee was a trust company, which had been established and formed in Mauritius, had been resident and situate in Mauritius and according to it, had made no decision in South Africa. Thus on application of the principle that only the trustee of the trust must make its decisions, it would appear quite facile to conclude that the place of decision-making and thus residence was outside South Africa. The court, although not deciding the issue of place of effective management, concluded however that it appeared that “at least some key commercial decisions necessary for the conduct of SIMS’s business were made in South Africa.”³³⁵ If one then reviews the facts, it can only imply that the court accepted that these decisions were made by other parties, and not by the appointed trustee who was never in South Africa.³³⁶

This prompts the following questions: on what authority could these parties (being not the trustees) do so and on what legal basis is their actions recognised so that the court is able take cognisance thereof?³³⁷ These are particularly important questions as should SARS affirm its Discussion Paper and offer no further separate approach for trusts, then it would be limited in law to look only at those authorised to “call the shots” and thus only the trustees, yet SARS’ underlying intention appears to opt for a broader approach, which would thus require some legal justification. So too, as per the discussion above, did many of the legal authors advocate a pragmatic approach, calling for a review of all the facts and in particular the roles played by other parties, than just the trustees in determining the place of effective management. Thus their views also necessitate that there be some validation to do so prior to being allowed to regard other parties and attach legal significance to their actions. Perhaps the answer can to be found in SARS’ letter of assessment to the taxpayer,

“In the end, the question as to where an entity’s place of effective management is located is one of fact and of substance over legal form...”

A first possible justification can be found herein, namely that “residence” is essentially a question of a fact. This is underpinned by the express use of the word “effective”, as per the statutory test for residence “place of effective management”, indicating that the test the legislator sought to impose was realistic, actual management of the trust and not mere formal legal management.

³³⁴ Decided on 14 June 2011. (2012) 74 SATC 127.

³³⁵ Par 58.

³³⁶ Presumably by its investment manager company and its parent company.

³³⁷ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at Chapter 19 Paragraph 19.5.7.5.4.

A second possible justification to be found herein, is that of the substance-over-form doctrine (*plus valet quod agitur quam simulate concipitur*), which could be invoked in certain circumstances.³³⁸ Translated, it states that “what is actually done is more important than that which seems to have been done.” As far back as 1910, the court explained this rule in the case of *Zandberg v van Zyl*,

“Now as a general rule, the parties to a contract [or transaction] express themselves in language calculated without subterfuge or concealment to embody the agreement at which they arrived. They intend to be the contract to be exactly what it purports, and the shape which it assumes is what they meant it should have. Not infrequently, however (either to secure some advantage which otherwise the law would not give, or to escape some disability which otherwise the law would impose), the parties to a transaction endeavour to conceal its real character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature. And when a court is asked to decide any rights under such an agreement, it can only do so by giving effect to what the transaction really is, not what in form it purports to be. The maxim then applies *plus valet quod agitur quam quod simulate concipitur*. But the words of the rule indicate its limitations. The court must be satisfied that there is a real intention, definitely ascertainable, which differs from the simulated intention. For if the parties in fact mean that a contract shall have effect in accordance with its tenor, the circumstances that the same object might have been attained in another way will not necessarily make the arrangement other than it purports to be. The enquiry, therefore, is in each case one of fact, for the right solution of which no general rule can be laid down.”³³⁹

Thus the courts may in the application of this rule, consider all the facts in determining whether a transaction is real as opposed to simulated. Thus, where the *form* is such that there is duly appointed trustee, purportedly acting independently and free of influence, but in *substance* it is just a pretence for those who actively seek the powers and attributes of trusteeship, yet intentionally disguises their identity, the court may look to the truth.³⁴⁰ Hattingh remarks that in company law, if a parallel situation were to occur in respect of directors, there is case law that such puppet directors would be regarded as fraud and all the consequences of directorship attached to the actions of the persons behind such simulation.³⁴¹

In a very recent case, *Khabola NO v Ralitabo NO*³⁴² the court found that the trust in question was a simulation and without substance. This was concluded from the facts which revealed that the co-trustees were expected to make contributions, the trust deed did not name any beneficiaries to the trust, the co-trustees had tacitly agreed to the founder to perform the role of general manager,

³³⁸ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at Chapter 19 Paragraph 19.5.7.5.4.

³³⁹ *Zandberg v Van Zyl* 1910 AD 301.

³⁴⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at Chapter 19 Paragraph at 19.3.2.1 and 19.5.7.5.4.

³⁴¹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at Chapter 19 Paragraph 19.5.7.5.4.

³⁴² 2011 ZAFSCH 62 (Case No 5512/2010) Judgement delivered on 24 March 2011.

they held no trustee meetings and had from the onset the creation of a partnership in mind.³⁴³ Thus the court may go beyond the form – the terminology, the trust deed, etc and look towards the real substance. As the court was only tasked to decide the issue of *locus standi* in its judgment, it did not go further than the aforesaid.³⁴⁴

The object of the substance over form-rule however falls upon transactions – either at the inception of the trust such as in the *Khabola*-case or upon specific transactions entered into during its existence. So where trustees are properly appointed, instructions and mandates and agreements are what they purported be, then on what basis can the actions of others be regarded to be the effective management of the trust as opposed to the appointed trustees? This Hattingh warns, creates an enormous uncertainty, as the implication is that “legitimate transactions cannot be expected to bestow their natural consequences.”³⁴⁵ As an alternative to the substance over form doctrine, he proposes that use could also be made of the “abuse of the institution of a trust”-doctrine.³⁴⁶

The *locus classicus* for this doctrine is accepted to be the case of *Land and Agricultural Bank of South Africa v Parker and Others*³⁴⁷, and for this reason a brief exposition is provided. Here the court, although it was not required to decide on the issue, felt that it was necessary to make some observations about the abuse of the trust form, which the case had brought to light.³⁴⁸ Its starting point was to stress that the core idea of the trust is the separation of ownership (or control) from enjoyment. The importance of this separation was said to lie therein that it serves to secure diligence on the part of the trustee, as a failure may lead to action by beneficiaries whose interests conduce to demanding better, and secondly it acts to ensure independence of judgment on the part of the trustee, calling him to carefully scrutinize transactions aimed at binding the trust, and compliance with formalities (whether relating to authority or internal procedures), since an independent trustee "can have no interest in concluding transactions that may prove invalid."³⁴⁹ Historically thus the structural features of a trust ensured ‘propriety and rigour and

³⁴³ Par 5

³⁴⁴ Par 6.

³⁴⁵ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at Chapter 19 Paragraph 19.5.7.5.4.

³⁴⁶ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (Ed John F Avery Jones et al) (2009) at Chapter 19 Paragraph 19.5.7.5.4.

³⁴⁷ 2005 (2) SA 77 (SCA). It is regarded as one of the most influential cases to date. – see Hyland, SA & Smith, BS “Abuse of the trust figure in South Africa : an analysis of a number of recent developments” *Journal for Estate Planning Law* 2006 (1) at 10.

³⁴⁸ Par 19 at 86.

³⁴⁹ Par 22 at 87.

accountability in its administration.³⁵⁰ But the court found that over the two decades preceding the judgment, there had been a marked change with a ‘newer type of trust developing where assets are put in a trust whilst everything else remains as before.’³⁵¹ The court explained that

“The core idea of the trust is debased in such cases because the trust form is employed not to separate beneficial interest from control, but to permit everything to remain ‘as before’, though now on terms that privilege those who enjoy benefit as before while simultaneously continuing to exercise control.”³⁵²

This particular case concerned a family trust³⁵³ and the validity of certain business transactions concluded by a complement of a subminimum of trustees with a bank. Here the relevant family unit constituted both the trust’s management as well as its beneficiaries. The trustees of the trust were a married couple, of which one was also founder of the trust, and both together with their descendants were the beneficiaries of the trust.³⁵⁴ At a later stage a further trustee, being their son, was also appointed. To the court it was clear that in such a trust, there was no real functional separation of ownership and enjoyment.³⁵⁵ Such rupture of the control/enjoyment divide could only attract abuse.³⁵⁶

Yet the court found that the authorities being the Master and the judicial bench are not entirely powerless to prevent such abuse. The court stated as follows –

“The courts will themselves in appropriate cases ensure that the trust form is not abused. The courts have the power and the duty to evolve the law of trusts by adapting the trust idea to the principles of our law. This power may have to be invoked to ensure that trusts function in accordance with principles of business efficacy, sound commercial accountability and the reasonable expectations of outsiders who deal with them. This could be achieved through methods appropriate to each case.”³⁵⁷

As a first method, in appropriate cases, the inference may be drawn that the trustee who entered into the allegedly unauthorised transaction, was in fact authorised expressly or tacitly thereto as the agent of the trustee.³⁵⁸ Thus the law of agency may be applied. If the trustees previously

³⁵⁰ Par 23 at 87.

³⁵¹ Par 24 at 87 and 26 at 88.

³⁵² Par 26 at 88.

³⁵³ The court offers an explanation of same “those designed to secrete the interests and protect the property of a group of family members, usually identified in the trust deed by name or by descent or by degree of kinship to the founder” – par 25 at 88.

³⁵⁴ Par 27 at 88.

³⁵⁵ Par 29 at 88.

³⁵⁶ Par 29 at 88.

³⁵⁷ Par 37 at 90.

³⁵⁸ Par 37.2.

permitted the trustee in effective charge of the trust's affairs, "free rein" to conclude contracts, this would be a factor relevant to drawing such inference.³⁵⁹ Adding to such an assumption, would be a close identity of interest between the trustee and beneficiaries. This was not the first matter where the courts had raised the issue as to whether one trustee may be the agent for another, and the court therefore referred to the *Nieuwoudt*-case.³⁶⁰ In the *Nieuwoudt*-case the court had concluded, that the particular trustee had not addressed the issue as to whether the powers of management over the trust business (farming) had in fact been delegated to him, to enable the day-to-day business of the trust to be carried on.³⁶¹ Specifically, the relevant trustee (being the farmer and husband to the co-trustee) had not explained whether he had conveyed the signature of the contract to his co-trustee (wife) or whether if he did, she had by words or conduct, expressed agreement with it or denied his authority to conclude the agreement..³⁶² Judge Harms further gave the following guidance in that case -

"...the fact that trustees have to act jointly does not mean that the ordinary principles of the law of agency do not apply. The trustees may expressly or impliedly authorise someone to act on their behalf and that person may be one of the trustees. There is no reason why a third party may not act on the ostensible authority of one of the trustees, but whether a particular trustee has the ostensible authority to act on behalf of the other trustees is a matter of fact and not one of law. This case should consequently serve as a warning to everyone who deals with a trust to be careful..."³⁶³

Aside from agency, as a second method,³⁶⁴ the court in *Land and Agricultural Bank of South Africa v Parker and Others* proposed that a corporate law remedy of piercing the veil may be utilized in a trust setting to go behind the trust form –

"It may be necessary to go further and extend well-established principles to trusts by holding in a suitable case that the trustees' conduct invites the inference that the trust form was a mere cover for the conduct of business 'as before', and that the assets allegedly vesting in trustees in fact belong to one or more of the trustees and so may be used in satisfaction of debts to the repayment of which the trustees purported to bind the trust. Where trustees of a family trust, including the founder, act in breach of the duties imposed by the trust deed, and

³⁵⁹ Hyland, SA & Smith, BS "Abuse of the trust figure in South Africa : an analysis of a number of recent developments" *Journal for Estate Planning Law* 2006 (1) at 9.

³⁶⁰ *Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk* 2004 (3) SA 486 (SCA). The case concerned a sale of maize concluded by the trust. Only one of the two trustees had signed the agreement. Subsequently it sought to escape the contractual obligations averring it was a nullity as it was not signed by both trustees and the trust instrument's provision required all decisions to be unanimous.

³⁶¹ Whilst the court was inclined to dismiss the trustee's appeal against the court's a quo finding, the agreement to be valid and enforceable, it did not do so as the issue was referred for further evidence by the respondent Par 6 at 491 of *Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk* 2004 (3) SA 486 (SCA).

³⁶² Par 13 at 492 of *Nieuwoudt and Another NNO v Vrystaat Mielies (Edms) Bpk* 2004 (3) SA 486 (SCA).

³⁶³ Par 23-24.

³⁶⁴ The "methods" it proposed included the appointment of an independent trustee, the possible application of the Turquand rule. See par 34-36 and 37.2.

purport on their sole authority to enter into contracts binding the trust, that may provide evidence that the trust form is a veneer that in justice should be pierced in the interests of creditors.”³⁶⁵

Thus a third justification for the court to have regard to the actions of such other parties as the real controllers and management of the trust, may be the application of the abuse of the trust form which would allow it either to apply the law of agency, or go behind the trust form by analogy to the corporate law remedy of piercing the corporate veil.

Case law on the abuse of trusts

An area where the abuse of the trust form is often under discussion is in divorce proceedings, a few examples are discussed to showcase the extent to which the management of a trust may be affected by the actions of parties thereto.

For example in *Jordaan v Jordaan*,³⁶⁶ the question was whether it would be just and equitable to take into account assets of various trusts³⁶⁷ in determining the redistribution order to be made in terms of the Divorce Act.³⁶⁸ A trust constitutes a separate institution *sui generis* and its assets should therefore not *per se* be regarded as that of the founder, or a trustee. In this particular matter, the court found that the wording of the Divorce Act³⁶⁹ empowered it to take all relevant factors into account in making such a determination, and it may therefore look to the way in which trust was administered in the past.³⁷⁰ In particular, the court found that the husband had used the trust for financial gain in his personal capacity previously.³⁷¹ The court pointed to the fact that the financial statements reflected large sums of moneys flowing between the trusts and the trustee, as

³⁶⁵ Par 37.3 at 91.

³⁶⁶ 2001 (3) SA 288 (C).

³⁶⁷ In total there were five trusts, of which one was formed shortly after the divorce proceedings were instituted, apparently with the aim to place such assets of a reach of the spouse. See par 17.6 & 33.

³⁶⁸ In terms of s 7(3) of Divorce Act 70 of 1979

³⁶⁹ In particular the wording of S7(5) of the Divorce Act 70 of 1979.

³⁷⁰ Par 29 at 300. See also the case of *Brunette v Brunette and Another NO* 2009 (5) S 81 (SE). In this case, the one spouse applied for the assets of two trusts to be deemed as partnership assets, and be included for purposes of the redistribution order to be made in divorce proceedings. This was opposed by the other spouse who argued that such an order would be extraordinary and legally incompetent based on the true nature and accepted separate identity of a trust. The court reiterated that the way the trust was administered in the past would be highly relevant in determining whether such assets should be regarded as partnership assets, and at trail this will need to be proved. The court concluded that the trusts' balance sheet reflected that the profits were distributed to both spouses and that prima facie it therefore appears that the trust assets were regarded as the assets of the partnership.

³⁷¹ Par 29 at 300. (*Jordaan* case cited above).

well as loans being made to him, without any formal decisions by the trustees on record.³⁷² Other examples in the case included that in respect of immovable property owned by one of the trusts, he dictated a letter that it may only be utilized with *his* (personal) written consent, that a loan to a beneficiary would only be repaid if the beneficiary in question showed *him* personally the necessary respect, he further did not consult his co-trustees, *mero motu* removed his wife as trustee, held no records of decisions, and regarded the trust income as his own.³⁷³ The court therefore found that on his own evidence, the trusts were actually his alter ego and that he regarded them as such.³⁷⁴ Consequently it would be just and equitable to take the assets into account when making the redistribution order.

However, the case must not be seen as an easy gateway in all family matters for the trust's assets to be included, see for example the case of *Maritz v Maritz*,³⁷⁵ where the court refused to do so. Much is therefore dependent on the facts and the particular role and actions of the parties. This is best illustrated by the case of *Badenhorst v Badenhorst*³⁷⁶, where again application was made to include the assets of an *inter vivos* trust as forming part of the spouse's estate for purposes of the distribution agreement.

The court confirmed the entrenched legal principles, that a trust is not a separate legal entity, but an institution *sui generis*³⁷⁷ and its assets and liabilities vest in the trustees of the trust.³⁷⁸ However the mere fact that it vested in the trustees and not in the spouse's estate did not *per se* exclude them from being taken into account when a redistribution order is made.³⁷⁹ To however successfully claim such an inclusion it is necessary that there be evidence, that such party controlled the trust

³⁷² Par 29 at 300. (Jordaan case cited above).

³⁷³ Par 24.1 at 298, 24.2 at 299 and, 31 at 300.

³⁷⁴ Par 33 at 301. In so concluding that it would be just and equitable to take such assets into account, the court found that it is therefore not necessary to decide the issue of whether the corporate veil must be pierced.

³⁷⁵ 2005 JDR 0209 (T) – Judgement marked not reportable. Again in divorce proceedings, one spouse argued that the manner in which the other dealt with the assets of the trust were as if they were his own and that in so doing, it could be concluded that the trust was the spouse's alter ego. Here the trust had separate financial records and annual financial statements which were separate from the spouse's, and were prepared by auditors. Although there were averred incidences of where money of the trust was utilized to pay expenses or due to him was deposited to the trust's account, the court found that all such financial transactions have a clear trail and explanation, were not improper, or irregular and the records and financial statement of the trust were not other than what they appear to be. Here too there was no finding that the spouse had utilized the trust for personal gain or regarded its income as his own. There were therefore no facts to justify a finding that the trust was the spouse's *alter ego*.

³⁷⁶ 2006 (2) SA 255 (SCA).

³⁷⁷ *Braun v Blann and Botha* NNO1984 (2) SA 850 (A).

³⁷⁸ *Commissioner for Inland Revenue v G MacNeillie's Estate* 1961 (3) SA 833 (A).

³⁷⁹ Par 9 at 260 of *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA).

and but for the trust would have acquired and owned the assets in his own name.³⁸⁰ The court elaborated on the control element –

“Control must be *de facto* and not necessarily *de iure*...*de iure* control of a trust is in the hands of the trustees but very often the founder in business or family trusts appoints close relatives or friends who are either supine or do the bidding of their appointer. *De facto* the founder controls the trust. To determine whether a party has such control it is necessary to first have regard to the terms of the trust deed, and secondly to consider the evidence of how the affairs of the trust were conducted during the marriage. It may be that in terms of the trust deed some or all the assets are beyond the control of the founder, for instance where a vesting has taken place by a beneficiary, such as a charitable institution accepting the benefit. In such a case, provided the party had not made the bequest with the intention of frustrating the wife's or husband's claim for redistribution, the asset or assets concerned cannot be taken into account.³⁸¹

In the present instance the court found it to be a “classic instance” of one party having full control of the trust assets and using the trust for his business activities.³⁸² Particularly in relation to his actions, the court found that the spouse as trustee had seldom consulted or sought approval from his co-trustee, and did not distinguish between his personal assets and those of the trusts,³⁸³ thus making it clear that “but for the trust, ownership in all the assets would have vested in him.”³⁸⁴

There have been further cases where the courts have found sufficient justification to warrant going behind the trust form. The case of *Van der Merwe NO and Others v Hydraberg Hydraulics CC and others; Van der Merwe NO and Others v Bosman and Others*³⁸⁵ certainly paved the way. This case has been described as “arguably the most explicit judicial expression to date” in respect of piercing the trust veneer, where it was in agreement with the demands of equity.³⁸⁶

The case concerned the validity of an agreement of sale pertaining to immovable property which had been signed by only two of three mandatory trustees and placed their authority to bind the trust under the spotlight. In the endeavour to ultimately hold the respective trustees responsible, an argument was advanced that the circumstances were such that the court should disregard the

³⁸⁰ Par 9 at 260 -261. *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA).

³⁸¹ Par 9 at 261. *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA).

³⁸² Par 10 at 261. *Badenhorst v Badenhorst* 2006 (2) SA 255 (SCA).

³⁸³ The court referred to the following instances: (a) in a credit facility application, he had listed the trust assets as his own (b) so too were liabilities of bonds over fixed property and rental income regarded as his one (c) a trust asset was insured in his personal name (d) the trust financed a property acquired in his name (e) he received income from an entity of which half of the shareholding was held in the trust.

³⁸⁴ Par 11 at 261.

³⁸⁵ 2010 (5) SA 555 (WCC).

³⁸⁶ Du Toit F Juta's Quarterly Review of South African Law, Trusts 2010 (October to December 2010) (4) available online at Jutastat.

veener of a trust under which the two individuals had in fact conducted their 'personal business as usual'³⁸⁷ Here two of the trustees had represented, that they were the only trustees of the trust and had done so not only in the conclusion of the contested agreement, but had also instituted legal proceedings stating on oath that they were duly authorized to do so without involving the third trustee. They made decisions as to the distribution of the trust income, implemented the agreement and accepted the first substantial payment without consulting the third trustee.³⁸⁸ The court found that the trust in question bore the unwholesome hallmarks of the 'newer type' of business trust as was referred to in the Parker decision above.³⁸⁹ Such features not only apparent from its structure,³⁹⁰ but also in the manner in which the trust affairs had been conducted.³⁹¹ On the facts the court found that their persisting conduct of the trust's affairs was as if it were the affairs of the two personally.³⁹² Thus the court stated,

“The abuse of the trust form is something that should not lightly be countenanced by the courts in cases in which the veneer of a trust is used to protect the trustees against fraud and dishonesty and to raise unscrupulous defences against bona fide third parties seeking to enforce the performance of contractual obligations purportedly entered into by such trustees ostensibly in that capacity.”³⁹³

The decision to disregard the veneer would, similar to one piercing the corporate veil, be a decision to grant an equitable remedy.³⁹⁴ Whereas in company law, the instance of piercing of the corporate veil is mitigated by policy considerations, stemming from the need to respect corporate or juristic personality, with these trusts, there is no question of disregarding juristic personality.³⁹⁵ Here the court stressed, the issue is whether or not it would be conscionable for a court to give credence to

³⁸⁷ Par 32 at 567. (*Van der Merwe NO and Others v Hydraberg Hydraulics CC and others*; 2010 (5) SA 555 (WCC).

³⁸⁸ Par 32 at 567. (*Van der Merwe NO and Others v Hydraberg Hydraulics CC and others*; 2010 (5) SA 555 (WCC).

³⁸⁹ Par 35 at 568. (*Van der Merwe NO and Others v Hydraberg Hydraulics CC and others*; 2010 (5) SA 555 (WCC).

³⁹⁰ The trust instrument obliged the appointment of a third independent trustee, but on the whole of its provisions, such appointment is undermined. Such provisions have the effect that such trustee only holds office at the pleasure of the two other trustees, or their successive trustees appointed by their respective family members. At voting, such trustee will be outnumbered by the other two who would constitute the majority.

³⁹¹ As best expressed in the court's words "Instead, as is all too likely to happen with such a trust structure, the beneficiary trustees have sidelined the independent trustee; and, when he ceased to fulfil his essential role in the control of the Trust's affairs, they blithely proceeded without him, indifferent to the trust instrument's requirement that there be a minimum of three B effectively functioning trustees..." – see par 35 at 569.

³⁹² Par 36 at 569. (*Van der Merwe NO and Others v Hydraberg Hydraulics CC and others*).

³⁹³ Par 38 at 570.

³⁹⁴ Par 38 at 570.

³⁹⁵ Par 38 at 570-571.

a natural person's disguise as a trustee of what is in reality treated by such person as his personal property.³⁹⁶

The court found that the present matter would be an appropriate case to have disregarded the veneer of the trust form, had it been legally possible.³⁹⁷ This would have defeated an 'unscrupulous resort by trustees to internal formalities and conveniently assumed lack of capacity to escape the contract.'³⁹⁸ This could have been done by either holding the aberrant trustees personally liable for their performance, or secondly, by directing the trust to perform the obligation as if had been properly incurred by the trustees acting in the capacity that they purported.³⁹⁹ Unfortunately it was not legally possible for the court to do so in the present instance, as the statutory formalities applicable to contracts in respect of the disposal of immovable property, applied to the trust as a formally constituted legal concept. Therefore the statutory formality required that the sale agreement be concluded by all trustees, alternatively by one or some on the written authority of all of the trustees given and acting jointly.⁴⁰⁰ The statement that had it not been for the formality requirements imposed on it, the court would not have hesitated to compel the trust to perform or the errant trustees, it is seen to be a loud warning to those who conduct the trust's affairs in such manner where the trust is nothing but their alter ego.⁴⁰¹

So too in the case of *First Rand Limited v Britz*⁴⁰² the court found that it was authorized to go behind the trust veneer and authorize the execution of assets owned by the trust. Although seemingly not so sensitive to the fact that a trust has no corporate personality, and thus a veil to pierce, the court summarized its understanding of the applicable legal authorities, in particular company law sources, to be that –

“that when the trustees of a trust do not treat the trust as separate entities the corporate veil will also be pierced. The corporate veil will also be pierced where fraud exists. However fraud is not always required in order pierce the veil. ...the applicant only has to show that the trustees do not treat the trusts as any separate entities but as their "alter ego" or instrumentality to promote their private, extra-trust interests in order to show that the trustees misuse or abuse the personality of the trust and consequently to pierce the veil.”⁴⁰³

³⁹⁶ Par 38 at 571.

³⁹⁷ Par 41 at 571.

³⁹⁸ Par 42 at 572.

³⁹⁹ Par 42 at 572.

⁴⁰⁰ Par 42 at 572.

⁴⁰¹ Du Toit F Juta's Quarterly Review of South African Law , Trusts 2010 (October to December 2010) (4) available online at Jutastat; Thompson, D & Deetlefs, D “Warning: trustees should proceed with great care. “ Without Prejudice, Jun 2011 at 8-9.

⁴⁰² 2011 JDR 0866 (GNP).

⁴⁰³ Par 63 at 28.

The court found that it had been shown that the trustees did not treat the trust as separate entity, and cited for example the lack of a lease in respect of their occupancy of the residential property owned by the trust, failure to produce the financial statements, furnish proof of rental, not refuting that no trustees meetings had been held, there was no physical delivery of the movables transferred to the trust etc.⁴⁰⁴ Thus it concluded that the trustees did not regard the trust as separate and that it was therefore allowed to declare that the assets be seen as part of the personal assets of the founder and thus attachable⁴⁰⁵.

Also in an application to attach assets, although to confirm jurisdiction, the court was asked in the case of *Rees and Others v Harris and Others*,⁴⁰⁶ to confirm whether the assets of a trust could be effectively considered to be that of the trustee. Phrased differently the court said that the question is whether it is established on a balance of probabilities, that the trust is the *alter ego* of the debtor, thus whether it was necessary to strip the façade of the separate legal personality, if any, of the trust.⁴⁰⁷ Whilst the court came to the conclusion that the order could not be granted on the facts and evidence before it,⁴⁰⁸ it did stress the following important legal principles. Firstly it referred to important case law in the company law spheres. From the case of *Ebrahim and Another v Airport Cold Storage (Pty) Ltd*,⁴⁰⁹ the following quote is apt.

“...Although juristic persons are recognised by the Bill of Rights — they may be bound by its provisions, and may even receive its benefits — it is an apposite truism that close corporations and companies are imbued with identity only by virtue of statute. In this sense their separate existence remains a figment of law, liable to be curtailed or withdrawn when the objects of their creation are abused or thwarted. The section retracts the fundamental attribute of corporate personality, namely separate legal existence, with its corollary of autonomous and independent liability for debts, when the level of mismanagement of the corporation's affairs exceeds the merely inept or incompetent and becomes heedlessly gross or dishonest. The provision in effect exacts a quid pro quo: for the benefit of immunity from liability for its debts, those running the corporation may not use its formal identity to incur obligations recklessly, grossly negligently or fraudulently. If they do, they risk being made personally liable.”

It also referred to Blackman, which explains that

“In certain instances the separateness of a company from its shareholders is disregarded by the court. This is referred to as the lifting or piercing of the corporate veil... In that it is the acts of the members that give rise to the piercing of the corporate veil, it follows that there will be no piercing unless the members dominate the finances, policies and business practices of the company that gives rise to the transaction attacked to such an extent that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own. Such

⁴⁰⁴ Par 64 -68 at 28 – 31.

⁴⁰⁵ Par 69 at 31.

⁴⁰⁶ 2012 (1) SA 583 (GSJ).

⁴⁰⁷ Par 12 at 587.

⁴⁰⁸ Par 42 at 598.

⁴⁰⁹ 2008 (6) SA 585 (SCA) at paras 15,21 and 22.

dominance, in itself, however, is not sufficient to justify the piercing of the veil; it is, however, a prerequisite."⁴¹⁰

Yet the court warned that the piercing of the veil remains an exceptional occurrence.⁴¹¹ To emphasize this aspect, it quoted authority in the form of the *Hülse-Reutter and Others v Gödde*⁴¹² case where it was stated that a court has no general discretion to simply disregard the existence of a separate identity whenever it considers it just or convenient to do so, and that the circumstances in which the court may disregard is not settled.⁴¹³

In an another case concerning trusts,⁴¹⁴ the court had affirmed this cautious and respectful approach-

"A court will not lightly disregard a corporate entity's separate legal personality and will endeavour to maintain the separate personality. This reluctance is said to exist because of the deeply seated notion of fair play in our law.... Where the use or the establishment of a corporate entity is borne out of deceit, fraud or impropriety, the corporate veil may yet still be lifted....Where a corporate entity was properly established but has been misused in a particular instance to perpetrate fraud, or a dishonest or improper purpose, there is no reason in principle why its separate personality cannot be disregarded in relation to the transaction in question while giving full effect to it in other respects.

In my opinion it matters not whether the corporate entity is a Trust or a company. Provided it can be established on a balance of probabilities, that the particular transactions complained of were the tainted fruits of fraud or other improper conduct, a court would, in appropriate circumstances, disregard the separate legal personality in order to reveal the perpetrator as the "true villain of the piece".⁴¹⁵

In a trust setting the court thus applied the above principles and found that, in appropriate circumstances the veneer of a trust may be pierced in the same way as the corporate veil of a company.⁴¹⁶ Such veneer must be pierced where the trustees clearly do not treat the trust as a separate entity and where special circumstances exist to show that there has been an abuse of the

⁴¹⁰ Blackman et al *Commentary on the Companies Act* vol 1 para 5 at 4-123.

⁴¹¹ Par 13 at 588.

⁴¹² 2001 (4) SA 1336 (SCA) at 1346 A-C.

⁴¹³ Also the well-known case of *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Other* 1995 (4) SA 790 (SCA) at 790 I-J, 802 F-H, 803 D-J, was quoted "Lifting the corporate veil means disregarding the dichotomy between a company and the natural person behind it (or in control of its activities) and attributing liability to that person where he has misused or abused the principle of corporate personality. . . It has, however, come to be accepted that fraud, dishonesty or improper conduct could provide grounds for piercing the corporate veil."

⁴¹⁴ *Knoop NO and Others v Birkenstock Properties (Pty) Ltd and Others* (7095/2008) [2009] ZAFSHC 67 (4 June 2009).

⁴¹⁵ Par 12,13,15-17. This case is however criticized in that whilst the piercing of the corporate veil in relation to juristic persons such as companies and the piercing of the veneer of a trust may bear the same consequences, it is a profound distinction to make and uphold that a trust does not have a corporate personality and is not a legal person. See Du Toit, F Juta's Quarterly Review of South African Law, Trusts, 2009 (April to June 2009) (2). Discussion of the case, *Knoop NO v Birkenstock Properties (Pty) Ltd* (unreported, case no 7095/2008 (FB), 4 June 2009).

⁴¹⁶ Par 17 at 591. *Ebrahim and Another v Airport Cold Storage (Pty) Ltd* 2008 (6) SA 585 (SCA)

trust by the trustee.⁴¹⁷ Thus the natural person behind the trust form will be personally liability in instances where a legitimately established trust is misused in an improper fashion by its trustees to perpetrate deceit, and/or fraud.⁴¹⁸ The assets of a trust will be considered to be that of the trustee personally where it has been shown that the trustee who had *de facto* control of the trust assets acquired and owned it effectively for his own benefit only.⁴¹⁹

Conclusion

These cases are real examples of the ways in which the trust form can be abused and illustrate the ways in which the court may address such abuse, and look behind the form to those committing such abuse. However in all of these cases, the court looked towards parties contractually related to the trust, be it a founder, a dominant trustee or dominant co-trustees, but not to outsiders such as professional advisors.

The above discussion has illustrated the possible justifications for taking into account the role and actions of other parties, than just the trustees in the search to determine the place of effective management of the trust. This was done as there is an apparent inconsistency between trust law theory, which dictates that only the trustees may make the decisions for the trust and conduct its management, whereas in practice it is possible for other parties such as the trust's professional advisors, or related parties, such as the founder or a Protector or enforcer, a dominant co-trustee, to in fact fulfil these actions or usurp this role. This is not only a possibility as court cases abound with real situations where this has occurred. Alternatively should SARS and the courts simply proceed on the basis that it may look to such parties and attach legal significance to their actions, then superficially it could be put down as an anomaly of law, an irregularity between what trust law dictates and what tax practice yields. Deeper than that, is however the fact that such a practice would in the long run undermine the solidity of trust law principles and also detract from legal certainty. It is therefore suggested that SARS either retains the "implementation" of decisions as a basis for consideration, alternatively it will need to develop a specific approach for trusts, or lastly if it introduces its refined approach set out in the Discussion Paper with the focus on decision-making, then it should utilise the above justifications to demonstrate that it does respect trust law principles and to overcome practical inconsistencies with it, will seek sound legal justification to do so.

⁴¹⁷ Par 17 at 591 as above.

⁴¹⁸ Par 17 at 591 as above.

⁴¹⁹ Par 17 at 591 as above.

6 9 Manipulation of the term & the advent of the electronic age

PriceWaterhouseCoopers explains that the historical criterion of “central management and control” with its focus on where top-level decisions were made by the board, was particularly open to manipulation, as it was an effortless matter for the board of directors to arrange and hold their meetings in a low-tax jurisdiction.⁴²⁰ This was made even easier when international air travel became quick and easy in the twentieth century.⁴²¹ For this reason many countries jettisoned this criterion and adopted “the place of effective management” criterion.

Where the term the “place of effective management” is however interpreted to denote a superior level management decision making, then this problem again comes to the fore as often the focus will then be on the place where the directors or trustees meet, which could easily be manipulated. Internationally where such an approach is advocated, and specifically the OECD’s view (as will be discussed in the next chapter) is stated to be under pressure due to these factors.⁴²² SARS’ approach was therefore regarded as one that kept pace with such developments.⁴²³

Yet whilst it has been said that the place of effective management is a less artificial test for example than the place of incorporation, it is still here that the possibility of avoidance is enhanced by the emergence of electronic communications. As was stated previously, electronic mediums are said to present the “information, tools and opportunities to make residence a “more deliberate choice than mere fate.”⁴²⁴ As the concept was developed in the days of ‘brick and mortar’ it is challenged by the advent of the electronic era and technological advancement which facilitate its manipulation.⁴²⁵ Technology can make these concepts less location-specific.⁴²⁶

⁴²⁰ Anon “ In what country does a company reside for tax purposes?” (February 2009) *Synopsis Tax Today* PriceWaterhouseCoopers

⁴²¹ Anon “ In what country does a company reside for tax purposes?” (February 2009) *Synopsis Tax Today* PriceWaterhouseCoopers

⁴²² Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 337. In particular its adequacy is questioned, see Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 20. Oguttu, AW “Resolving double taxation” 2008 (41) *CILSA* at 103.

⁴²³ Oguttu, AW “Resolving double taxation” 2008 (41) *CILSA* at 99.

⁴²⁴ Kohl, U “The Horror Scope for the Taxation Office: The Internet and its Impact on Residence” (1998) 21 *University of New South Wales LJ* at 436.; Also Li, J “E-commerce Tax Policy in Australia, Canada and the USA” (2000) 23 (2) *University of New South Wales Law Journal* 313.

⁴²⁵ Oguttu, AW “Resolving double taxation” 2008 (41) *CILSA* at 89.

⁴²⁶ Pinto, D “Taxation Issues in a World of Electronic Commerce” (1999)2 (4) *Journal of Australian Taxation* 227 at par1.3.10.

The possible impacts were already recognised in the 5th Interim Katz Commission report, which foretold of “the possible irrelevance of a physical presence to trade, the ease with which current residence notions can be manipulated through hyper-mobility of an entire office and trading and management capacity.”⁴²⁷ Due to such technological advances, it is said that the migration or moving of places of a taxpayer’s is easier, and thus they may often opt for low tax jurisdictions. As one commentator put in relation to companies, they “used to be like cows in a field, waiting to be milked, now the cows have wings.”⁴²⁸ Technology further facilitates the management personnel to be more involved in the entity without necessarily being resident in such country and lastly enables them to communicate in ways which are undetectable, or unverifiable, thereby exacerbating obtaining evidence of their activities should it be wished to disguise them.⁴²⁹

Such an increased technological and highly mobile world can predominantly be said to have a two-fold impact on the place of effective management. The first being the increased potential of manipulation as explained above, and the other being the added complexity it brings to the test of determining a single place of effective management. As Du Plessis⁴³⁰ explains the dilemma–

“the advent of the Internet and the advance in communication means using electronic resources have significantly affected the application of the term ‘place of effective management.’ It is no longer a given that a group of people will meet in one place to take a decision, because technology enables them to ‘meet’ electronically and take decisions, irrespective of where they are physically located. It has also enabled senior management and boards to increase their mobility, making it difficult to tie effective management down to one place.”

In the context of trusts, this occurrence also comes to the fore. Here its traditional management, the trustees would be able to meet whilst each located in different places. Alternatively they may choose to meet at a different place for such meetings on a rotational basis or meet with each others whilst en route.⁴³¹ Often a trust deed will allow the trustees to determine the manner in which it will conduct its administration and should they for example, decide to utilize electronic communications as the key medium for the resolution of the trust affairs (for example by email facilities debate and pass resolutions) and all such trustees are located in different countries, then determining the place of effective management for the trust is complicated.⁴³² Furthermore, the

⁴²⁷ Available at www.polity.org/za/olity/govdocs/commissions/katz-5.html - last accessed on 05/05/2013.

⁴²⁸ Rees-Mogg, W “A world of city states” National Post, 5 March 1999 p A18.

⁴²⁹ Buys, R (Ed) Cyberlaw The law of the Internet in South Africa Ch 8 par 3.3 at 238. (Edition?)

⁴³⁰ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 337.

⁴³¹ Oguttu, AW “Resolving double taxation” 2008 (41) *CILSA* at 90.

⁴³² Oguttu, AW “Resolving double taxation” 2008 (41) *CILSA* at 89

operational activities in relation to its assets can be done from any point in the world. For example in the context of investment management, capital can be located and relocated between the world markets with ease. This increased mobility of capital was already discussed and is not reiterated here for the sake of brevity.⁴³³ Thus locating a place of effective management for the trust becomes very difficult to pinpoint.

Judging by the rapid growth in internet users⁴³⁴ it can be anticipated that electronic mediums and communications conducted thereby will only increase. Solely in South Africa, an increase of 25% year on year was reported, with the amount of internet users in 2010 at 6,8 million and for 2011, at 8,5 million.⁴³⁵ It is equated to be a revolution, which “when it has run its course, may have a greater impact on this planet than anything that has preceded.”⁴³⁶ This advent and growth is said to have signalled the beginning of new era in taxation.⁴³⁷

The South African Revenue Service sought to address the impact of such technology through its deemed place of effective management rule, whereby it states where management functions are not executed at a singled location due to the utilization of distance communication, then the place of effective management would best be reflected where the day-to-day operational management and commercial decisions are actually implemented. This seemingly denotes a lower level again, as it points to the place where decisions are implemented day-to-day and almost appears to coincide with the tier of the entity’s business activity. In a trust, such day-to-day activity may be limited. Even its regular activities and where they are implemented, may be strongly impacted by electronic mediums. For example the trust’s asset manager may implement a portfolio change for the trust, whilst he is based in London, in respect of shares held on the Johannesburg Stock Exchange. In such a scenario, SARS’s third rule is triggered, namely that of the strongest economic nexus. This latter

⁴³³ See discussion at Chapter 1 paragraph 1.2.2.

⁴³⁴ See Goldstein, A & O’Connor D “E-Commerce of development: Prospects and Policy Issues” Working Paper No. 164 at 8 where they state” In historical perspective the Internet has diffused at a far faster rate than earlier generation of communications technology: from 1990 to early 2000, the estimated number of Internet users grew more than tenfold to roughly 300 million, affecting the way in which people communicate with each other, acquire information, learn, do business and interact culturally.

⁴³⁵ Bottomley, E-J “SA internetgebruikers groei fluks” Published 11 May 2012 on <http://m.news24.com/sake24/Maatskappye/IKT/SA-internetgebruikers-groei-fluks-20120510>. Last accessed 11/05/2013.

⁴³⁶ Davis, DM “Residence based taxation: Is it up to the e-commerce challenge” quoting D J Johnston Preface to Electronic Commerce –Opportunities and Challenges for Government (OECD). See also Michael Lewis – “One day some social historian will look back with wonder on the havoc wreaked by the internet.” July 2001.

⁴³⁷ Buys, R (Ed) Cyberlaw The law of the Internet in South Africa Ch 8 par 3.3 at 231. It is said that it calls for tax authorities to adapt their application of existing tax principles, practices and procedures.

test Davis too regards as the only other viable test, explaining that the

“economic connections to the state may be characterized by the extent to which land, labour, capital and enterprise (being the factors of production) are employed by the entity in pursuit of profit. Accordingly, the determination of residence could turn on the discovery of with which state the entity has the strongest ties.”⁴³⁸

Earlier on, the criticism against the utilization of such a test in a residence based taxation was outlined as it is *source* based taxation, which aims to identify the state with which the income has its closest economic connection, rather than residence. The possible justification for it in such a context was also advanced, the latter being that if residence is perceived as the state providing certain facilities and infrastructure to its residents, then those who benefit the most from such facilities and infrastructure ought to contribute to the state’s coffers via residence based taxes.⁴³⁹ It is however argued that basing residence on economic nexus, ensures that the entity will not be resident in a jurisdiction where no activities are occasioned by its presence.⁴⁴⁰

This test would bring one back to a factual enquiry, which could be quite complex and may be of some magnitude to complete: if one takes into account that first such ties would need to be identified, if necessary also defined,⁴⁴¹ then quantified and lastly compared so as to ascertain the “*strongest* economic connections.” Whereas earlier it had been stated, that the appeal of a residence based taxation lies therein that the authorities need not investigate each transaction for an instance of source within its jurisdiction, and need only look to whether such person is resident, it now appears that “residence” too may involve highly complex factual investigations. Yet this appears to be the only viable method to provide an answer to a globalised world, where due to technology and electronic communications an entity may not have a singular “place of effective management.”⁴⁴²

In chapter 5, it was noted that one of the motivations for South Africa moving from a source based system of taxation to a residence based taxation, was to provide for the more globalised and

⁴³⁸ Davis, DM “Residence based taxation: Is it up to the e-commerce challenge” 2002 *Acta Juridica* at 164.

⁴³⁹ Adapted from the OECD’s Discussion Paper.

⁴⁴⁰ Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 231.

⁴⁴¹ Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 31.

⁴⁴² Wesson N “Die Effek van die Internet op die Inwonerbeginsel, soos gedefinieer in Inkomstebelastingwet Nr. 58 van 1962.” 2002 (10) *Meditari Accountancy Research* at 254; Verwey, PM “The Principles of Source and Residence Taxation of Electronic Commerce Transactions in South Africa” (2007) Mini-dissertation submitted to the North-West University at 35.

electronic world it was to be integrated with.⁴⁴³ In particular prior to the change-over in a Discussion paper, SARS concluded that in the world of cyberspace it is often very difficult, if not impossible to apply traditional concepts of source by linking an item of income with a specific source or geographical location, thus this taxation base would lose its rational and become obsolete.⁴⁴⁴ Also with increased information and communication technologies, it is easier to shift the income to a source country with low tax rates, and thus, as it therefore cannot ensure feasibility and manipulation, it is considered to be no longer useful.⁴⁴⁵ In contrast, it was argued that all taxpayers need to be resident somewhere.⁴⁴⁶ After all, “residence can be determined more easily than the source of income, as the source of income is more mobile and more obscure.”⁴⁴⁷ Yet this too seems to buckle under the electronic impact especially as the latter facilitates the dissipation of management of an entity throughout the world, connecting them only by way of video conferencing, email, and other electronic communications and thereby undermining the accuracy of determining the place of effective management.⁴⁴⁸ As there are others who argue that a focus on income generating activity would have been more appropriate in an electronic age,⁴⁴⁹ it is therefore a valid question as to whether such a change over was prudent and not too hasty.⁴⁵⁰

6 10 Multiple places of effective management/Dual residence

The possibility of multiple places of effective management resulting was discussed above. Particularly this may result where use is made of electronic communications by the trustees situate in different countries, and thus consequently determining a single place of effective management

⁴⁴³ See chapter 5 at par 5 Also note the Briefing Note where it the greater involvement of South African entities offshore was acknowledged, as well as the need to cater for electronic transactions (e-commerce).

⁴⁴⁴ SARS “Electronic Commerce in South African Taxation: Discussion document published by SARS (1999) at 17. South Africa was not alone in such an opinion as both the United States Treasury and Australian Taxation office held a similar view.

⁴⁴⁵ Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 20.

⁴⁴⁶ Wesson N “Die Effek van die Internet op die Inwonerbeginsel, soos gedefinieer in Inkomstebelastingwet Nr. 58 van 1962.” 2002 (10) *Meditari Accountancy Research* at 255.

⁴⁴⁷ Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 23. They further argue that residence cannot despite such problems be relocated that easily and relocation of the residence is not effected often.

⁴⁴⁸ Davis, DM “Residence based taxation: Is it up to the e-commerce challenge” 2002 *Acta Juridica* at 169. See also the Business and Industry Advisory Committee and International Chamber of Commerce to the OECD in their Policy Statement issued 15 December 1999, cautioning against a premature shift.

⁴⁴⁹ Davis views it as “powerful support” - Davis, DM “Residence based taxation: Is it up to the e-commerce challenge” 2002 *Acta Juridica* at 168.

⁴⁵⁰ Davis, DM “Residence based taxation: Is it up to the e-commerce challenge” 2002 *Acta Juridica* at 172.

becomes difficult.⁴⁵¹ Some authors suggest that in such an instance weights could be allocated to the importance of functions performed within each country, or by looking towards where the majority reside⁴⁵², alternatively by looking towards those who ultimately call the shots.⁴⁵³ A further alternative also discussed above, is the economic nexus which will be expanded upon in the ensuing chapters.

Yet whilst it is possible that a dual residence may practically arise, it would then need to be addressed through the relevant treaty between such countries. Thus Honiball & Olivier submit that the question whether a trust can have dual residence is academic, as the proviso to the definition in the Act states that a person loses his South African residency when he is regarded as exclusively resident in another contracting state for treaty purposes.⁴⁵⁴ More firmly Van der Merwe states that, “Dual residence is not an option under treaty law, as it is specifically designed to provide clarity in cases of dual attachment.”⁴⁵⁵

6 11 New developments: The Taxation Laws Amendment Act, 22 of 2012

A draft Taxation Laws Amendment Bill was published for comment in July 2012 and following a process of public hearings, workshops, discussions with stakeholders and comments from interested parties,⁴⁵⁶ was revised and in October 2012, formally tabled in Parliament. In January 2013, it was assented to and the Taxation Laws Amendment Act was promulgated on 30 January

⁴⁵¹ Technology makes it difficult to pin one constant location and double, multiple or even non-residence may result - Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 125; Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 21-22.

⁴⁵² This is premised on the notion that the residence of the individuals would display greater stability and thus could be used to the advantage of the fiscus in determining residence. Kohl, U “The Horror Scope for the Taxation Office: The Internet and its Impact on Residence” (1998) 21 *University of New South Wales LJ* at 443.

⁴⁵³ Davis, DM “Residence based taxation: Is it up to the e-commerce challenge” 2002 *Acta Juridica* at 164. For further solutions see Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 20.

⁴⁵⁴ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 157.

⁴⁵⁵ Van der Merwe BA “Residence of a Company – the Meaning of Effective Management 2002 (14) *SA Merc LJ* at 89.

⁴⁵⁶ National Treasury *Media Statement: Taxation Laws Amendment Bills, 2012: General Overview* issued on 5 July 2012 at p1. The process is stated to be in accordance with the Money Bills Procedure and Related Matters, 9 of 2009. The Media Statement issued by the National Treasury on 5 July 2012 at www.treasury.gov.za/comm_media/press/2012/2012070501.pdf (last accessed on 01/05/2013) and the Act is available at <http://www.sars.gov.za/AllDocs/LegalDoclib/AmendActs/LAPD-LPrim-AA-2012-03%20-%20Taxation%20Laws%20Amendment%20Act%202012.pdf> (last accessed on 03/05/2013).

2013, effective for all years of assessment ending on or after 1 January 2013.⁴⁵⁷

For purposes of the study here, the most important of the amendments it contains, are the further provisions it inserted to the definition of “resident” in section 1 of the Act.⁴⁵⁸ These amendments form part of the government’s “Financial Centre of Africa Initiatives”,⁴⁵⁹ which are aimed at enhancing South Africa’s position as financial centre and gateway to Africa.⁴⁶⁰ In particular it seeks to provide relief from the effective management test and the potential of double taxation by the addition of particularly two further provisions. The first provision is aimed at excluding as “residents” foreign companies which have been incorporated, established or formed in a country other than South Africa, and is highly taxed in such country.⁴⁶¹ This is done by now expressly excluding from the ambit of “resident” such qualifying companies. The section now reads that

“a resident “does not include any company if—
 (AA) that company is incorporated, established or formed in a country other than the Republic;
 (BB) that company has its place of effective management in the Republic;
 (CC) that company would, but for the company having its place of effective management in the Republic, be a controlled foreign company with a foreign business establishment as defined in section 9D(1); and
 (DD) the aggregate amount of tax payable to all spheres of government of any country other than the Republic by that company in respect of any foreign tax year of that company is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that company had that company, but for this subitem (B), been a resident for that foreign tax year;”

It is however the second provision that is of greater significance to trusts. The second provision is aimed at creating a carve out from the effective management test for foreign investment funds which have a South African local fund manager.⁴⁶² Often such funds are housed in trusts and for

⁴⁵⁷ Taxation Laws Amendment Act, 22 of 2012 – S181(2).

⁴⁵⁸ In particular S 2(1) (w),(x) and (y) of the Amendment Act affects the definition of “resident.”

⁴⁵⁹ National Treasury *Media Statement: Taxation Laws Amendment Bills, 2012: General Overview* issued on 5 July 2012 at page 4

⁴⁶⁰ Anon “Changes to the Definition of Resident” January 2013 – Issue 160 available at http://www.saica.co.za/integritax/2013/2152.Changes_to_definition_of_resident_.htm, last accessed on 06/05/2013.

⁴⁶¹ S 2 (1)(w) of the Act effecting an amendment to definition of “resident” in S1. Essentially a company incorporated in another country could encounter a situation of dual residency should it be effectively managed from South Africa, and thus be exposed to double taxation. In most of these instances the corporate tax payable in the foreign jurisdiction is higher than in SA and thus our local fiscus does not receive any/little additional revenue when the tax credits are applied. Consequently to obliterate the potential of such dual residency, this exclusion is now inserted whereby it is clear that despite their place of effective management in SA, residency will not be attributed. Anon “Changes to the Definition of Resident” January 2013 – Issue 160 available at http://www.saica.co.za/integritax/2013/2152.Changes_to_definition_of_resident_.htm, last accessed on 06/05/2013.

⁴⁶² S 2 (1)(y) of the Act effecting an amendment to definition of “resident” in S1 and the insertion

this reason, this amendment is further elaborated upon below.

The Explanatory Memorandum to the Bill provides the background to the amendment. It describes the current trend of foreign investors (in particular pension funds and other institutional investors), to utilise a variety of international funds as vehicles for specified international investment mandates and to route these investments through low tax jurisdictions,⁴⁶³ for obvious reasons of tax efficacy and avoidance of multiple levels of cross-border taxation.⁴⁶⁴ Increasingly the focus of these investment funds is the African region, including Southern Africa.⁴⁶⁵ Krige endorses the sentiment that Africa is currently attracting heightened interest and attributes the popularity of Africa as destination for foreign investment, due to the scarcity of high return investments in emerging markets in the East and South America.⁴⁶⁶ This has the ripple effect that the demand for and use of local South African expertise is increased. In particular it is noted that certain of these funds seek to utilise local managers for direction upon investing in South Africa, or African assets. As South African investment managers have a proven track record for the skilled management of investments in Africa, such managers are sought after by investors wishing to extend their portfolio into the rest of Africa.⁴⁶⁷ The investment manager is mostly given an investment mandate and receives a fee for such management, whilst administration and other incidental financial services, such as accounting and legal compliance services may also be required.⁴⁶⁸ As summarized in the Memorandum, “South Africa’s economy, its reputation for financial services and regional expertise, make South Africa an ideal destination for international capital, dedicated to African regional investment.”⁴⁶⁹ Implicit to this statement then is the opportunity this presents to such fund managers, the potential it holds for the industry and economy as a whole, whilst enhancing South Africa’s strategic position.

463 of a definition for the term “ foreign investment entity” per S2(1)(h) of the Bill.
Such as the Cayman Island and Netherlands Antilles.

464 Par 5.12. National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill* (Draft) published 29 June 2012 and available at <http://www.treasury.gov.za/public%20comments/TLAB/DRAFT%20Explanatory%20Memorandum.pdf>. (last accessed on 05/05/2013)

465 Par 5.12 of the *Explanatory Memorandum* .

466 Krige S “Tax Treatment of Foreign Funds hampers SA Investment Industry” available at <http://www.werksmans.co.za/keep-informed/in-the-news/media-releases/tax-treatment-of-foreign-funds-hampers-sa-investme.html?Revision=en/19&Start=0>. (Last accessed on 06/05/2013).

467 Anon “Is South Africa a hospitable habitat for foreign funds?” - available at <http://www.golegal.co.za/commercial/south-africa-hospitable-habitat-foreign-funds> (Last accessed on 06/05/2013).

468 Par 5.12 of the *Explanatory Memorandum*.

469 It is particularly South Africa’s infrastructure and location for emerging markets in Africa that serve as attraction. Mattern, S “Making SA a Destination of Choice” 11 August 2010. Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page260?oid=51332&sn=Detail&pid=260>; Last accessed on 06/05/2013). Par 5.12 of the *Explanatory Memorandum*.

Prior to the amendment there were however disadvantages, in utilising such a structure and in particular a South Africa investment manager as it may have the inadvertent consequence of exposing the fund to significant tax liability.⁴⁷⁰ This adverse “side-effect”, follows from the test for residence and in particular the second criteria, that of “effective management”, which if met, would allow the South African authorities to tax the entity on a worldwide basis. Thus, should the use of a local South African manager trigger the test, it may result in the whole of the fund being regarded as tax resident and thus to be subject to worldwide tax levied by the South African authorities. This has an immediate and profound deterring effect on utilising South African local managers, especially as all of the funds originate from an offshore location and such funds have various alternatives worldwide to invest, without such risks.⁴⁷¹ To eliminate the risk of tax residence and thus circumvent the application of the test, one option would be to limit the local South African manager’s freedom to make decisions, but this would negate the very purpose of utilising such a manager.⁴⁷² Krige explains the predicament –

“Given the dominance of the South African economy the country is the most likely destination for African capital. Also with South Africans having proven adept at managing investments elsewhere in Africa, local skills are sought after by investors targeting the rest of Africa... unfortunately this potential is currently difficult to tap because hiring a South African investment manager is an extremely bad idea for a foreign fund...as a fund that has its place of effective management in South Africa will be deemed to be a South African tax resident. Internationally this is the place where fund’s high-level strategic decisions are taken. SARS interpretation differs such that a fund will be effectively managed where the investment decisions are implemented rather than the place where the investment objectives, policy and restrictions are set. ... If South Africa does not react soon, this business will establish itself elsewhere...”⁴⁷³

It is interesting to note that, through the recognition of this problem by government and these new provisions, it has implicitly been accepted, without any reasons given, that cognisance may be taken of parties other than the trustees, such as the fund manager and financial service providers to the entity, in the practical application of the test of effective management.

Against the backdrop of the discussed criticisms on the difference in approach followed by SARS and the international community, a second interesting aspect may be noted. It would be recalled that it had been said by various commentators that the approach followed by SARS is regarded as vague, varies from case to case and focuses on where such decisions are implemented, as opposed

⁴⁷⁰ Par 5.12 of the *Explanatory Memorandum*.

⁴⁷¹ Par 5.12 of the *Explanatory Memorandum*.

⁴⁷² Par 5.12 of the *Explanatory Memorandum*.

⁴⁷³ Krige, S “Is South Africa a hospitable habitat for foreign funds?” <http://www.golegal.co.za/commercial/south-africa-hospitable-habitat-foreign-funds> – last accessed on 06/05/2013.

to where the investment objectives, policies and restrictions are set and strategic decisions made - which is the approach followed in these foreign countries.⁴⁷⁴ In so doing it creates a risky environment, which from the vantage of the investment management industry, would certainly appear preferable to avoid. In the Explanatory Memorandum to the Draft Bill, it was noted that the application of the place of effective management test in these situations is questionable, as the “effective management” test albeit an important and older doctrine, is not a test that was designed for these investment fund situations. Instead it was aimed at situations of traditional direct corporate investment, such as manufacturing and mining.⁴⁷⁵ In a typical foreign owned investment fund, management would essentially consist of balancing or choosing passive portfolio investment, with little value added to the underlying investment, and thus no active business operations would be present.⁴⁷⁶

Prior to the amendments, there were some attempts to accommodate industry. Since 2010, government has targeted this as a key focus area to attract potential foreign investors.⁴⁷⁷ A very limited exemption in relation to investment managers in a limited partnership structure, where the general partner is South African based, as well as an exemption in relation to trading gains and thus for source liability, were introduced.⁴⁷⁸ However it was still felt that the steps taken by government to attract such investment and promote the industry was inadequate. Krige bemoaned the fact, that government’s strategy was to focus on creating attractive fund structures, rather than setting up an attractive environment for the investment management industry. In his view the focus

⁴⁷⁴ Krige S “Tax Treatment of Foreign Funds hampers SA Investment Industry” available at <http://www.werksmans.co.za/keep-informed/in-the-news/media-releases/tax-treatment-of-foreign-funds-hampers-sa-investme.html?Revision=en/19&Start=0>. (Last accessed on 06/05/2013).

⁴⁷⁵ Par 5.12 of the *Explanatory Memorandum*.

⁴⁷⁶ Par 5.12 of the *Explanatory Memorandum*.

⁴⁷⁷ Mattern, S “Making SA a Destination of Choice” 11 August 2010. Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page260?oid=51332&sn=Detail&pid=260> and Lippstreu, D “Treasury should broaden investment funds regime” 13 August 2010 – available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page260?oid=51470&sn=Detail&pid=1>. (Last accessed 06/05/2013).

⁴⁷⁸ The partnership exemption was not regarded as that helpful as few international funds are structured in such manner and where they are structured in such manner often law in such low tax jurisdictions will require that the general partner must be a local entity thus the SA entity could not act as the general partner of such funds. The source exemption relates to the introduced exemption whereby any amounts received by a non-resident from the disposal of an asset are regarded as foreign sourced and thus any trading gains from the sale of an asset (the term includes investment) would be exempted. Worsdale, R “South African Budget Commits to a broad Investment Manger exemption” 24 February 2012. Available at <http://www.moneyweb.co.za/moneyweb-2012-budget/south-african-budget-commits-to-a-broad-investment?sn=2009%20Detail> as well as Bonnette, C “The South African Broad Based Fund Manager Exemption” 4 July 2012. Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page260?oid=69450&sn=Detail&pid=260>. (Last accessed on 06/05/2013.)

should not be on the fund regime where other countries already have the lead⁴⁷⁹, but rather on South Africa's competitive advantage, which lies in the skills of its investment managers, infrastructure and quality of life. He describes the ideal situation⁴⁸⁰ -

“What South Africa needs is a regime that allows investment managers to conduct discretionary activities, whether under a contractual mandate or through a particular structured participation, without creating any tax risk for a foreign fund. This would help grow and expand the local investment management industry, create jobs at all skill levels and attract highly paid individuals who would then pay taxes on the money they earn and the cash they spend locally...It is important that the law is unequivocal in relation to South Africa's taxing rights so that investors are left in no doubt regarding the consequences of using a local manager before they commit to employing local skills.”

This failure to create an enticing environment and eradicate such risks, has been noted by government as the Minister of Finance in the 2012 Budget Speech, acknowledged that it “has deprived local fund managers of foreign investment fund business and has even forced certain local fund managers to relocate abroad.”⁴⁸¹ To accommodate these concerns and facilitate the use of local South African investment managers, it was proposed in the 2012 Budget Speech and has now been incorporated into the Act, that a specific carve-out from the effective management test be created, explicitly for foreign investment funds. Whilst it is aimed at removing the potential for worldwide taxation, due to the use of a local investment manager, the management and performance fees of the local investment manager will remain taxable.⁴⁸² Thus the activities of the South African based investment manager would not render the fund resident *per se* and thus taxable, but the fees generated from these activities by the manager would be taxable. Thus the tax imposed is limited to the local South African value addition.⁴⁸³

⁴⁷⁹ Such as low tax, low regulation environments of which the Cayman and British Virgin Islands are the most popular locations. He further notes that whilst Mauritius has keenly attempted to draw business to its shores, the Caribbean remains the preferred entry point to Africa. Krige S “Tax Treatment of Foreign Funds hampers SA Investment Industry” available at <http://www.werksmans.co.za/keep-informed/in-the-news/media-releases/tax-treatment-of-foreign-funds-hampers-sa-investme.html?Revision=en/19&Start=0>. (Last accessed on 29/10/2012).

⁴⁸⁰ Krige S “Tax Treatment of Foreign Funds hampers SA Investment Industry” available at <http://www.werksmans.co.za/keep-informed/in-the-news/media-releases/tax-treatment-of-foreign-funds-hampers-sa-investme.html?Revision=en/19&Start=0>. (Last accessed on 29/10/2012).

⁴⁸¹ Minister Pravin Gordhan in the 2012 Budget Speech – Annexure C available at <http://www.treasury.gov.za/documents/national%20budget/2012/review/Annexure%20c.pdf> Last accessed on 06/05/2013).

⁴⁸² Par 5.12 of the *Explanatory Memorandum*. The management fee is mostly a percentage based on the value of the assets of the fund whilst the performance fee is apportioned according to the net asset value increase during the year.

⁴⁸³ Par 5.12 of the *Explanatory Memorandum*.

To qualify for the carve-out, the fund must meet the definition of a “foreign investment entity”⁴⁸⁴ and must therefore comply with the following:

- (a) Must be a person other than a natural person
- (b) Which is not incorporated, established or formed in the Republic⁴⁸⁵;
- (c) Of which the assets of which consist solely of a portfolio of one or more of the following: (i) amounts in cash or that constitute cash equivalents;(ii) financial instruments that— (aa) are issued by a listed company or by the government of the Republic in the national, provincial or local sphere; or (bb) if not issued by a listed company or by the government of the Republic in the national, provincial or local sphere, are traded by members of the general public and a market for that trade exists; or(iii) financial instruments, the values of which are determined with reference to financial instruments contemplated in subparagraph (ii); or(iv) rights to receive any asset contemplated in subparagraph (i),(ii) or (iii),which amounts, financial instruments and rights are held by that person for investment purposes;
- (d) South African residents do not hold more than 10 per cent of the shares, units or other form of participatory interest in that person directly or indirectly,⁴⁸⁶ and
- (e) that person has no employees and has no directors or trustees that are engaged in the management of that person on a full-time basis.

Two remarks be made in respect of the definition. Firstly that the test whether an entity has been “established formed or incorporated” as was discussed in Chapter 5 is therefore again important, as the exemptions will only be available should the entity be regarded as formed outside South Africa. Secondly, the last requirement appears to be a contradiction in terms, causing some authors to remark on its oddness, as it essentially necessitates that the fund must have no substance. This is a requirement which none of the major international emerging market funds will meet, as they usually have full time directors and employees, responsible for the global strategy of the fund and coordinate the investment managers in different regions.⁴⁸⁷

In the first drafts it had also been required that the fund must operate comparable to a local collective investment scheme. The public comment had been that this was overly restrictive, as such funds come in a variety of forms (including a trust, company or similar entity recognised under

⁴⁸⁴ See the definition of “foreign investment entity” in S1 of the Act as was inserted by s2(h) of the Taxation Laws Amendment Act, 22 of 2012.

⁴⁸⁵ In the Memorandum this is phrased as “incorporated, formed or otherwise established in a foreign country.

⁴⁸⁶ This requirement too has been criticized as it imposes an additional burden on the fund to identify and monitor the interest of South African residents, and appears superfluous as current exchange control rules would prevent same at the investor level. Lessing, D & Krige S “Further steps towards a South African investment management exemption” Legalbrief October 2012 – available at http://www.werksmans.co.za/live/mobile-innerpage.php?Item_ID=2868&Brief_ID=148. Last accessed on 06/05/2013.

⁴⁸⁷ Per Lessing, D & Krige S “Further steps towards a South African investment management exemption” Legalbrief October 2012 – available at http://www.werksmans.co.za/live/mobileinnerpage.php?Item_ID=2868&Brief_ID=148. Last accessed on 06/05/2013.

foreign law) and not necessarily in a collective investment scheme format.⁴⁸⁸ In the Response Document, National Treasury and SARS had accepted this comment and proposed that an adjustment be made so that the entity need only “carry on activities of an investment scheme” and hold a portfolio of financial instruments.⁴⁸⁹ In the Bill introduced to Parliament, such requirement has fallen by the wayside and only the requirement as to its asset base remain.

If it meets this definition of a foreign investment entity, then in determining whether such entity’s place of effective management is in South Africa, certain activities must be disregarded. These activities are those which constitute firstly a financial service,⁴⁹⁰ or secondly is incidental to such financial service and is rendered in respect of a financial product,⁴⁹¹ and is carried on by a financial service provider,⁴⁹² in terms of a licence issued to that financial service provider.⁴⁹³ The appeal to remove the requirement, that the local investment manager be a licensed financial service provider, had not been accepted by National Treasury and SARS. As justification for its refusal, it stated that it wished the amendment to only be available to managers within a regulated environment and thus have a very specific scope of application.⁴⁹⁴ This ties in with its objective to assist local service providers, so they need not relocate abroad to perform their job functions.⁴⁹⁵

Further calls for the relief to be extended to private equity funds within South Africa or Southern African (as opposed to only listed and listed-type instruments), as well for widening the investment limitation to include widely traded over the counter investments, had not been accepted at this

⁴⁸⁸ Lessing, D & Krige S “Further steps towards a South African investment management exemption” Legalbrief October 2012 – available at http://www.werksmans.co.za/live/mobile-innerpage.php?Item_ID=2868&Brief_ID=148. Last accessed on 06/05/2013. The authors note that the South African collective investment scheme which succeeds from the unit trust regime, is markedly different from their counterparts in popular international fund jurisdictions such as the Cayman Islands, Luxembourg, the British Virgin Islands.

⁴⁸⁹ National Treasury and SARS *Response Document from National Treasury and SARS, as presented to SCOF (Standing Committee on Finance)* 2 October 2012. Available at <http://www.treasury.gov.za/public%20comments/TLAB/Consolidated%20Response%20Document.pdf>. (last accessed on 06/05/2013).

⁴⁹⁰ As defined in section 1 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002);

⁴⁹¹ As exempted in terms of the Financial Advisory and Intermediary Services Act

⁴⁹² As defined in section 1 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002), in terms of a licence issued to that financial service provider under section 8 of that Act.

⁴⁹³ Disregarded activities therefore include financial product advice, intermediary services and activities incidental thereto -Par 5.12 of the *Explanatory Memorandum*

⁴⁹⁴ National Treasury and SARS *Response Document from National Treasury and SARS, as presented to SCOF (Standing Committee on Finance)* 2 October 2012.

⁴⁹⁵ National Treasury and SARS *Response Document from National Treasury and SARS, as presented to SCOF (Standing Committee on Finance)* 2 October 2012.

juncture.⁴⁹⁶ Certain authors have noted with alarm, that the substantial bulk of funds entering Arica at this point are not focused on listed equities, as outside South Africa there are very few listed African companies and the returns investors require, are predominantly only available from private equity instruments rather than listed instruments.⁴⁹⁷ It was however indicated in the Response Document, that such aspects would be studied and investigated further and in respect of the latter, considered in the next legislative cycle.

Compared to other jurisdictions such as the UK, which also has an investment manager exemption, this exemption is regarded as being more extensive. One author is of the view that this is justifiable, as the place of effective management is a concept, which is more difficult to deal in the context of a fund, than the concept of management and control, as applied in the UK.⁴⁹⁸ The exemption in the UK is itself regarded as being framed in generous terms and is regarded as conducive to the attraction and retention of the industry. Particular as its capital city, London, is regarded as the hub of European fund management, with more than 80% of all funds managed there.⁴⁹⁹ The UK's exemption allows the investment manager to conduct its activities, without it creating a local source of profits, nor rendering the fund as tax resident.⁵⁰⁰ In South Africa however, it is felt that whilst the residence problem has been addressed, it has not adequately addressed the source aspect as was done in the UK, as income sourced by the non-resident entity in South Africa may still attract tax.⁵⁰¹

⁴⁹⁶ National Treasury and SARS *Response Document from National Treasury and SARS, as presented to SCOF (Standing Committee on Finance)* 2 October 2012.

⁴⁹⁷ Lessing, D & Krige S "Further steps towards a South African investment management exemption" Legalbrief October 2012 – available at http://www.werksmans.co.za/live/mobile-innerpage.php?Item_ID=2868&Brief_ID=148 (Last accessed 06/05/2013).

⁴⁹⁸ Worsdale, R "South African Budget Commits to a broad Investment Manger exemption" 24February 2012. Available at <http://www.moneyweb.co.za/moneyweb-2012-budget/south-african-budget-commits-to-a-broad-investment?sn=2009%20Detail>. Bonnette, C "The South African Broad Based Fund Manager Exemption" 4 July 2012. Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page260?oid=69450&sn=Detail&pid=260>.(Last cessed on 06/05/2013.) Others agree that it does create opportunities but for local managers to set up offshore funds to utilise the exemption as existing offshore funds will not restructure due to the risks still inherit to the formulation of the exemption. Lessing, D & Krige S "Further steps towards a South African investment management exemption" Legalbrief October 2012 – available at http://www.werksmans.co.za/live/mobile-innerpage.php?Item_ID=2868&Brief_ID=148. Last accessed 06/05/2013.

⁴⁹⁹ Lippstreu, D "Treasury should broaden investment funds regime" 13 August 2010 – available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page260?oid=51470&sn=Detail&pid=1>. (Last accessed 06/05/2013).

⁵⁰⁰ Anon "Is South Africa a hospitable habitat for foreign funds?" - available at <http://www.golegal.co.za/commercial/south-africa-hospitable-habitat-foreign-funds>(Last accessed on 06/05/2013).

⁵⁰¹ Daya explains that non-residents are only subjected to tax on income sourced or deemed to be

It is hoped by National Treasury that the consequence of this exclusion, will “allow local investment managers the freedom to compete for international investment fund business.”⁵⁰² Indeed tax authors regard this investment manager exemption, as a “welcome inclusion” and one which should “persuade fund managers not only not to leave South Africa, but also to relocate to South Africa.”⁵⁰³ It will however only be time that will confirm whether South Africa will be able to capitalize on its position as the gateway to Africa and become the financial nucleus of the continent.

6 12 Conclusion

The “place of effective management” is described by Davis as the “most elastic of concepts.”⁵⁰⁴ Its further virtues are lauded as being a less artificial measure, one that is pragmatic and looks to substance and not only form, and which is more resilient to manipulation. However, the concept does present its own unique and difficult issues of interpretation as well as practical application.

In respect of its interpretation, the chapter started with the ordinary grammatical meaning as premised from dictionary definitions and revealed that it is “actual rather than theoretical” positive management that is required. This SARS, in its Interpretation Note, was of the view would be where a lower level of management would execute and implement the policy and strategic decisions of the entity. The further views of SARS were transposed in a trust setting to mean that the concept is not necessarily equivalent to place of overriding control by the trustees of the trust, nor by such parties as may enjoy default control powers. Thus the place where the trustees meet, would not necessarily be conclusive to determine residence. Nor could the residence of the individual trustees, or of the respective beneficiaries be equated to the place of effective management of the trust. Instead that management is focused on the trust’s purpose and business and therefore necessitates a factual review of its trust deed and objectives as a whole. The place of

sourced in SA – consequently any income which the non-resident entity derives may be subjected to tax if the source of income is within SA, thus causing the entity to fall within our tax net if the source of the income is attributed to be in SA by reason of the activities of the investment manager located in SA. See Daya, L “Are foreign funds managed in SA taxable?” published 2 October 2012 and available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page260?oid=72024&sn=Detail> – last accessed on 06/05/2013.

⁵⁰² Par 5.12 of the *Explanatory Memorandum*

⁵⁰³ Worsdale, R “South African Budget Commits to a broad Investment Manger exemption” 24February 2012. Available at <http://www.moneyweb.co.za/moneyweb-2012-budget/south-african-budget-commits-to-a-broad-investment?sn=2009%20Detail>. Also Anon “Changes to the Definition of Resident” January 2013 – Issue 160 available at http://www.saica.co.za/integritax/2013/2152.Changes_to_definition_of_resident.htm, last accessed on 06/05/2013.

⁵⁰⁴ Davis, DM “The Place of Effective Management” 2007 *The Taxpayer* at 82

effective management is where the policy and strategic decisions made by the trustees are executed upon and implemented by either the trustees, a trustee to whom this function is delegated or by other functionaries.

Locally this view was subjected to criticism⁵⁰⁵, and the interpretations of local academic and legal authors were discussed. But even amongst such commentators there was not an uniform approach: some appeared to endorse old case law by emphasizing the place of residence of trustees, others endorsed a higher level approach, placing value on where the trustees meet and attend to the decision-making. Others focus more philosophically on where the fiduciary duties are carried out, whilst others focus on only one such duty, namely where the assets of the trust are administered. Whilst some appear to only look at the trustees, others acknowledge that other functionaries may attend to the administration of the trust, or that the trustees may act not only of their own accord and upon their own devices. Some therefore advocated a more holistic and hands-on approach, emphasizing the importance of all the facts and that it was necessary to look beyond the trust form and the traditional role of its trustees.

It was deplored however that SARS' approach was not *en par* with the international community, which in their interpretation focused on high level strategic decision making, and that this results in uncertainty, complicates tax planning and detracts from the efficiency of our tax system.⁵⁰⁶ Per the recently published Discussion Paper, SARS now wishes to refine its initial view so that the primary emphasis is on those who "call the shots", thus still on the same management level but shifting the focus to those who actually develop or formulate the strategies, take key decisions and ensure that the strategies and policies are carried out. Such a refinement would seek to align the approach in South Africa with international norms.

The recent local case of the *Oceanic Trust Co Ltd No v Commissioner of SARS*,⁵⁰⁷ which focused on this issue was a historical occasion, as it was the first to provide insight as to how our local courts may interpret the term. It appears to favour an endorsement of the international view, that the

⁵⁰⁵ It is considered to provide limited effect as an interpretation aid and creates unwelcome confusion between the domestic and international interpretation - Verwey, PM "The Principles of Source and Residence Taxation of Electronic Commerce Transactions in South Africa" (2007) Mini-dissertation submitted to the North-West University at 30; Van der Merwe, BA; Van der Merwe BA "The Phrase 'Place of Effective Management' Effectively Explained" 2006 (18) *SA Merc LJ* at 137. Goosen, C "International Tax Planning: The concept of Place of Effective Management" research dissertation submitted to the University of Cape Town on 15 February 2006 at 15.

⁵⁰⁶ Goosen, C "International Tax Planning: The concept of Place of Effective Management" research dissertation submitted to the University of Cape Town on 15 February 2006 at 15.

⁵⁰⁷ (2011) 74 SATC 127.

place of effective management is where the key management and commercial decisions are in substance made as opposed to their implementation.⁵⁰⁸

Locating the place of effective management based on where the management and key decisions are *made*, would in a trust setting be simplistic to apply as it is trite that such function may only be exercised by the trustees. One need therefore only look to them and where they exercise such function. However this could be easily manipulated by constructing the setting so, that the trustees and their decision-making processes are located completely outside the country's borders. Factually it is also possible that the trustees could be but peons of others, and that the real decision making is made by related parties, such as the founder, a dominant co-trustee, beneficiary, professional advisors or investment managers. It was therefore submitted that in a trust setting, SARS should either retain the implementation element, which allows for such parties then to be taken into account, or develop a separate approach in a trust context to address such a situation. It was also investigated, as to what may possibly serve as legal justification for taking the actions of other parties than the trustees into account and attributing effective management based thereon, such as the law of agency, as well as the substance over form and abuse of the trust form-doctrines.

A major challenge to the concept of place of effective management appears to be the utilization of electronic communications, as well as technological advances. This was stated to aggravate the possibility of manipulation as well as complicating the efficiency of the test. Some authors are of the view, that it is particular the technological era that necessitates the reinterpretation or adaptation of the term,⁵⁰⁹ and a resolution of the problems experienced.⁵¹⁰ There is support that the only viable test in such an era is that of the "strongest economic nexus"- test.⁵¹¹ In a trust setting this test would be able to assist in determining residence, where due to the different locations of the parties, and the employment of electronic communications between the parties, the trust's residence is entirely obscure. It would also be able to look beyond the façade where a trust is abused by the parties and functionaries to it.

⁵⁰⁸ Keirby-Smith, B "Finally Some Local Guidance on the Place of Effective Management" – available at http://www.saica.co.za/integritax/2011/2012.Placement_of_effective_management.htm - last accessed on 06/05/2013. La Grange, A (ENS) "Determining the Place of Effective Management" – available at www.golegal.co.za – last accessed on 10/01/2012.

⁵⁰⁹ Wesson N "Die Effek van die Internet op die Inwonerbeginsel, soos gedefinieer in Inkomstebelastingwet Nr. 58 van 1962." 2002 (10) *Meditari Accountancy Research* at 256.

⁵¹⁰ Spengel, C & Schäfer "ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation" Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 21-22.

⁵¹¹ Davis, DM "Residence based taxation: Is it up to the e-commerce challenge" 2002 *Acta Juridica* at 164.

Lastly amendments to the definition of the term “resident” was discussed, as per the recently promulgated Taxation Laws Amendment Act, 22 of 2012. In particular the focus was on the carve-out from the effective management test for foreign investment funds, so as to attract such business and optimise South Africa’s location as gateway to Africa, with the eventual aim of establishing South Africa as financial hub of the continent. The amendments seek to ensure that utilising a local investment manager, will not inadvertently render the entity resident and thus subject to worldwide taxation by the South African authorities. This is achieved by statutorily providing that when the effective management of such entities are determined, activities which constitute a financial service or is incidental thereto and is provided by a licensed financial service provider would be disregarded.

In relation to the above problem, it was noted that implicit to the identification of this problem and the need to address same, is the acceptance by our government authorities, that in the practical application of place of effective management-test, cognisance may be taken of other role-players such as the fund manager or service providers, parties who are not necessarily the directors or trustees. A further aspect that deserves mentioning is the admission by SARS, that the “place of effective management” is not an appropriate test in situations where there is not direct investment, and that the test originated and is therefore better suited, to areas such as manufacturing and mining.⁵¹²

In the lead-up to the proposals, it was also interesting to note that as one of the factors identified as deterring such investment and creating an inhospitable environment, was the discord between South Africa’s local approach to the term of “place of effective management” and the approach followed worldwide, as well as the risks inherent to the South African approach; its vagueness and *ad hoc* nature, thus undermining the certainty such investors seek. This is therefore a practical and real example of the effect the attribution of a particular interpretation and approach to the term “place of effective management” by SARS may have and emphasizes the importance of finding and assigning a meaning to it, that is both certain and consistent with the global community.

In conclusion, the interpretation of the term of “place of effective management” as the second criteria set for “residence” in South Africa has been thoroughly traversed in this chapter. This has been done by reviewing the South African Revenue Service’s approach as set out in published papers, considering the views of local authors, and evaluating judicial precedent, both historical as

⁵¹² Par 5.12 of the *Explanatory Memorandum*.

well as the more recent *Oceanic*-judgement. However in the interpretation of the term, cognisance must also be taken of the international meaning ascribed to it and for this reason the next chapter aims to provide guidance on this aspect.⁵¹³

⁵¹³ This is a legislative mandate imposed by the Constitution of South Africa which in S233 requires courts to in their interpretation of legislation give preference to “any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.”

CHAPTER SEVEN:**THE “RESIDENCE” OF TRUSTS UNDER TAX TREATIES & MODEL TAX CONVENTIONS****7 1 Introduction**

“National tax systems are truly national and are one of the ultimate expressions of national sovereignty; they are usually drawn up in the interests of the nation and not of the nation’s neighbours; which indifference is returned by the neighbours. National tax systems resemble the continental plates of the plate tectonic systems – they are massive, they collide and the impact usually causes one to go under and the other to rise up.”¹

The above quote by Tiley depicts in vivid terms the interaction between the taxation systems of states and stresses the fact, that whilst such systems may appear to only have application within their countries’ borders, it is possible for their consequences to cross such borders, colliding with other countries’ tax systems. The casualties of such collisions are however not the states nor their tax systems, but rather the taxpayers who may now be impacted by two tax systems and thus be exposed to a double tax liability. To address the consequences of these collisions and relieve the impact on taxpayers, states mostly enter into double tax agreements, also called, tax treaties, which provide for such situations.

South Africa has concluded several double tax agreements to regulate the incidence of double taxation. According to the South African Revenue Service, South Africa currently has 70 current double tax agreements in force, of which 55 use the “place of effective management” as tie-breaker.² As is evident from the above paragraph, a tie may arise in the context of double tax agreement, when a person is regarded as resident in both of the two contracting parties to the agreement and thus liable to taxation. Consequently to resolve the tie and determine which country will have taxing rights, such agreements will mostly contain a “tie-breaker”, which acts to resolve the “tied position” of dual residency.³ Thus, when faced with a dual residence entity, the

¹ Tiley, *J Revenue Law* (2005) 5th Ed.

² SARS “Discussion Paper on Interpretation Note 6” September 2011. It would appear that SARS is in the process of negotiating its treaties and the number of treaties where 'place of effective management' is used may have since reduced as it increasingly opts for a "mutual agreement" process. See the discussion of the re-negotiated treaty with Mauritius as an example, at par 7 3 4 1 below.

³ For the treaty or double tax agreement’s provision to be applicable, article 1 of the Model Convention requires fiscal residence in one or both countries. The term residence is then defined in article 4(1), which requires that domestic law be applied to determine whether a person is resident – it provides that “resident of a Contracting State” means any person, who by reason of his domicile, residence, place of management or any other criterion of similar nature.” Situations may therefore arise where a person is regarded as dual resident. However both the distributive rules and the methods to address double taxation require that only state be regarded as the state of residence

concept of “place of effective management” will be invoked to determine which country will be awarded taxing rights or the extent thereof. This augments the importance of the term “place of effective management” and its particular meaning.

In the initial Interpretation Note SARS had issued, it was noted that whilst the term “place of effective management,” is not defined in the Income Tax Act itself, in interpreting this term, international precedent and interpretation will be of assistance.⁴ Reference was expressly made to the fact that the term is used by the Organisation for the Economic Co-operation and Development (the OECD) in its publications and documentation.⁵ The most prolific of the OECD’s tax publications is the OECD Model Tax Convention on Income and on Capital, which acts as the precedent treaty for members of the OECD, to use when conducting negotiations. Although South Africa is not a member of the OECD (it was awarded observer status in 2004), most of its treaties are based on the model tax treaty.⁶ As stated above, the majority of our tax treaties contain a tie-breaker identical to the OECD’s article 4(3), which resolves dual residence on the basis of “place of effective management.”⁷

Aside from the OECD’s Model Tax Convention, the United Nation’s Model Double Tax Convention between Developed and Developing Countries, is regarded as a second widely influential and utilised model treaty.⁸ The USA, a country of significant economic power, has also developed its own model, and utilises it as the basis for its negotiations.⁹ The differences between these models are summarized by Panayi-

“From these three models, the OECD Model is the most widely used one as it a blueprint for tax treaties. The US, however, insists on using its own model when entering into tax treaties. ..It

whilst the other will then be perceived to be the state of source. To determine this one country of residence necessitates the application of a tie-breaker to determine which country will be awarded this status. Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 376. Some term it a conflict of law rule. Sasseville, J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 287.

⁴ SARS “Interpretation Note No. 6: Resident: Place of effective management (persons other than natural persons)” issued 26 March 2002.

⁵ SARS “Interpretation Note No. 6: Resident: Place of effective management (persons other than natural persons)” issued 26 March 2002.

⁶ Hattingh notes that most of our treaties are mainly based on the OECD Model, some incorporating elements of the UN Model Tax Convention and other non-model based clauses. Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.5 at 721. There are no reservations as made by South Africa to the relevant article 4, on record as per the latest commentary (2010).

⁷ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.5 at 721.

⁸ Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 106.

⁹ Panayi, CHJI *Double Taxation, Tax Treaties, Treaty-shopping and the European Community* (2007) at 27. The Netherlands has also developed its model termed the Dutch model.

would seem that these models serve similar objectives. It is their distinct *foci* that might differ. For example, under the US model curbing tax evasion and avoidance is a concern. Under the UN model, benefiting developing nations is a concern.”¹⁰

The provisions of these model conventions are neither binding nor enforceable. Instead their function is to “primarily point the way” for contracting countries to resolve issues.¹¹ This is done by facilitating such negotiations through the provision of a framework, thus obviating the need for elaborate discussions on every point *ab initio* and, which framework can be adapted to the particular circumstances of the respective contracting states.¹² The use of such conventions also advances uniformity of practice amongst the various countries worldwide.¹³

It must be noted however, that the model tax conventions do not address the issue of trusts expressly, and are not geared in their application to trusts. As one author remarked this is “subject that is virtually ignored...”¹⁴ Thus analogy and deduction will be important, but more so, case law where trusts have formed the focus point on more than one occasion.

The discussion here does not set out for consideration and assessment a further test for the tax residence of a trust. Instead this chapter’s value lies in the insight it provides for the interpretation of the place of effective management, which is the second criteria of the South African fiscal test for residence. It will also provide practical guidance as to how the residence of a trust is approached by the international community with this particular residence basis in mind. The United Nation’s Model Tax Convention is regarded firstly in brief, followed by a discussion of the OECD’s Model Convention in greater detail.

7 2 The UN Model Double Taxation Convention

This Model Tax Convention was first published in 1980 by the United Nations, after being prepared

¹⁰ Panayi, CHJ *Double Taxation, Tax Treaties, Treaty-shopping and the European Community* (2007) at 27.

¹¹ United Nations “United Nations Model Double Taxation Convention between Developed and Developing Countries” (2001) at xx. It must be noted that tax treaties do not create jurisdiction to tax for the contracting states – instead they allocate the taxing rights so that double taxation is prevented.

¹² League of Nations *Fiscal Committee: Report to the Council on the Fifth Session of the Committee held in Geneva from June 12th to 17th, 1935* as cited in the United Nations “United Nations Model Double Taxation Convention between Developed and Developing Countries” (2001) at xx.

¹³ Owens, J & Bennett “OECD Model Tax Convention: Why it works” – published 26/10/2008, available at http://www.oecdobserver.org/news/fullstory.php/aid/2756/OECD_Model_Tax_Convention.html, last accessed 10/05/2013.

¹⁴ Avery Jones, JF “The Treatment of Trusts under the OECD Model Convention (Part1)” 1989 BTR(2) at 41 notes that this is subject that is virtually ignored in the OECD Model and its Commentaries.

by the Secretariat and reviewed by a Group of Experts, comprising members from ten developed countries and fifteen developing countries.¹⁵ Similar to the OECD's Model Tax Convention, it is also accompanied by a detailed Commentary. The most recent revised Model Convention of the United Nations was issued in 2011.¹⁶

Already in the 1960's, it had been acknowledged that only a small number of double tax agreements have been entered into between developed and developing countries.¹⁷ This was attributed to the fact that in most cases, the effect of such tax conventions was that the country of source would relinquish the revenue. It was therefore noted that "such a pattern may not be equally appropriate between developing and industrialized countries because income flows are largely from developing to industrialized countries, and the revenue sacrifice would therefore be one-sided."¹⁸

Yet it was also an acknowledged objective of the United Nations, to promote the inflow of investments to such countries on grounds that are economically and socially beneficial to these countries.¹⁹ Consequently in 1967 the Economic and Social Council of the United Nations passed a resolution for a working group to be established, consisting out of tax administrators and experts nominated by the respective governments from developed and developing countries, to investigate and consult as to manner in which the conclusion of tax treaties between such countries could be facilitated.²⁰ They were also tasked to formulate guidelines and techniques for use by such countries, which would be acceptable to both groups of countries and would safeguard their

¹⁵ Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 109. The Group of Experts is now known as the Ad Hoc Group of Experts on International Cooperation in Tax Matters, and in 2005 was converted to a committee structure retaining its 25 member form.

¹⁶ United Nations (Department of Economic & Social Affairs) "Model Double Taxation Convention between Developed and Developing Countries" (2011). The original model was further revised in 1999 and published in 2001, in 2003 a new version of the manual was published electronically and the most recent revision to the model was published in 2011.

¹⁷ United Nations "United Nations Model Double Taxation Convention between Developed and Developing Countries" (2001) at vii as based on the findings of the 1965 Fiscal Committee of the OECD.

¹⁸ United Nations "United Nations Model Double Taxation Convention between Developed and Developing Countries" (2001) at vii.

¹⁹ United Nations "United Nations Model Double Taxation Convention between Developed and Developing Countries" (2001) at vi referring to resolutions of the General Assembly and the Economic and Social Council of the United Nations and the United Nations Conference on Trade and Development. Such inflows enhance the economic development process in such countries but are dependent to a large extent on the particular investment climate in which taxation plays a crucial role. In this regard then double taxation agreements play a central role in protection against double taxation and preventing the discouragement by taxation of the flow of international trade and investment.

²⁰ United Nations "United Nations Model Double Taxation Convention between Developed and Developing Countries" (2001) at viii.

respective revenue interests. Their deliberations culminated in the Model Double Taxation Convention in 1980, preceded in 1979 with a Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries.²¹

To a large extent the UN Model Tax Convention follows the framework of the OECD Model Convention and there are many similarities, if not identical reproductions of certain of the latter's provisions, including its commentaries.²² This the UN Model in its introduction recognises by stating that there are "significant common provisions" between its Model and the OECD Model, with the 'similarities reflecting the importance of achieving consistency, and the areas of divergences, allowing for their main differences in approach.²³ As the name and historical development of the convention indicates, the UN's Model Convention is intended for negotiations between developed and developing countries and its contents therefore exhibits a propensity to award wider taxing rights to the source state than the OECD's Model Convention, which is instead aimed at negotiations between developed countries.²⁴ Arnold & McIntyre therefore conclude that a sensible view is not to regard the UN Model Treaty as an entirely separate model treaty, but instead as "making limited, but important, modifications to the OECD Model Treaty."²⁵ Examples of such similarities are firstly the clauses in the convention relating to the application of the convention, and, secondly those provisions relating to residence and the tiebreaker clause. We turn to these to reflect on the guidance it may be hold for trusts.

Firstly, to determine whether the Convention would be applicable, regard is to be had to Article 1 of the Convention, which states that the Convention shall apply to "persons who are residents of one or both of the Contracting States."²⁶ The term "person" is defined in Article 3 as including an "individual, company or other body of person", whilst article 4(1) states that the term "resident of a contracting state," means any person who under the laws of that state is liable to tax by reason of his domicile, residence, place of incorporation, place of management or any other criterion of

²¹ United Nations (Department of Economic & Social Affairs) "Model Double Taxation Convention between Developed and Developing Countries" (2011) in the Introduction at viii.

²² Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 109. The United Nations acknowledge that the convention is a compromise between the source and residence principle and that it gives the former more weight.

²³ United Nations (Department of Economic & Social Affairs) "Model Double Taxation Convention between Developed and Developing Countries" (2011) in the Introduction at vi. The key difference relate to the relinquishment of taxing rights by contracting states of the rights that would be available to it under domestic law.

²⁴ Russo R (ed) *Fundamentals of International Tax Planning* (2007) at 12.

²⁵ Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 109.

²⁶ United Nations "Model Double Taxation Convention between Developed and Developing Countries" (2011).

similar nature, but does not include any person who is liable to tax in that State in respect only of income from sources in that state or capital situated therein.”²⁷ Trusts are not mentioned anywhere in these articles expressly. They are not specifically included in the definition of “persons” who would qualify to be so resident and trigger the application of the Convention. The only place where trusts are explicitly mentioned in the entire Convention, is in article 13 relating to capital gains, where the disposal of an interest in a trust may be taxed, and which is therefore not helpful to the study at hand.²⁸

In the Commentaries, trusts feature under the Commentary to Article 1, where it is stated in relation to treaty shopping, that often arrangements are made by which persons, who are not entitled to the benefits of the tax treaty, use other persons who are so entitled, to indirectly obtain the benefits. For example an entity resident of a treaty country would act as conduit, to channel income to a non-resident person so as to improperly access the benefits of the tax treaty.²⁹ It is then stated that the conduit entity is “usually a company, but may also be partnership, trust or similar entity that is entitled to treaty benefits.”³⁰ Implicit to this statement, is that a trust may qualify for purposes of the application of the treaty.

The second similarity was in relation to the tie-breaker provision and regard may be had to the approach followed for the application of the term of “place of effective management.” In the event that the application of article 4(1) yields a person to be deemed as resident of both contracting states, then article 4(3) resolves such a situation by stating that the person shall be deemed to be resident only of the state in which its place of effective management is situated. The commentary similarly refers to the OECD’s Commentary and essentially duplicates same. Additionally however the following is stated in relation to the interpretation of place of effective management –

“It is understood that when establishing the ‘place of effective management,’ circumstances which may, *inter alia*, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view and the place where the most important accounting books are kept.”³¹

²⁷ United Nations (Department of Economic & Social Affairs) “Model Double Taxation Convention between Developed and Developing Countries” (2011).

²⁸ Article 13 (4).

²⁹ Par 47 of Article 1 Commentary (2011 Model Convention).

³⁰ Par 47 of Article 1 Commentary (2011 Model Convention). Trusts are further mentioned in the commentary re article 13(4) and article 26 dealing with the exchange of information.

³¹ Par 10 of Article 4 of the Commentary to the Convention - United Nations “United Nations Model Double Taxation Convention between Developed and Developing Countries” (2001) at 67. The

Trusts are not explicitly mentioned in the commentary to this article, nor in the above quoted paragraph. One is able to extrapolate the principle that for the term “place of effective management,” the UN Model Convention’s approach is generally to focus on a very high level of management. In conclusion then, the Convention and its Commentary therefore give but limited guidance and no assistance that is on point as regards trusts. Thus regard is had to the OECD Model Tax Convention.

7 3 The Approach of the OECD

7 3 1 Background

The OECD issued its first model tax convention in 1963, which was revised in 1977. A further fifteen years would pass until a revised model was published in 1992. Since then however, the frequency by which the model is updated over time, has increased exponentially³² (1995, 1997, 2000, 2003, 2005, 2008), with the most recent model issued in 2010. This is regarded as a reflection of the rapid changes in the economy and the concomitant need for tax conventions to keep pace with such developments.³³ The success of the OECD Model Convention is regarded as ‘incredible’, as nearly all existing bilateral tax treaties are based thereon,³⁴ or as another author summarizes it – the convention holds the “consensus position as the benchmark against which essentially all tax treaty negotiations take place.”³⁵

The OECD originates from the Organisation for European Economic Co-operation (OEEC), which in the 1950’s had taken on the task to produce a model treaty for its members and so advance economic integration in Europe.³⁶ This task had initially been started by the League of Nations just after the First World War, and whilst the League did produce a model before the Second World War as well as two during the war, such models did not receive much support.³⁷ It is however here that our discussion starts. Particularly the focus will be on the term “place of effective management” and its development.

authority for that last consideration is not cited anywhere in the text.

³² Russo, R (Ed) *Fundamentals of International Tax Planning* (2007) at 12.

³³ Russo R (ed) *Fundamentals of International Tax Planning* (2007) at 12

³⁴ Arnold BJ & McIntyre MJ *International Tax Primer* (2002) at 109.

³⁵ Barnes, PA “A Model to Celebrate” - published 26 October 2008 and available at http://www.oecdobserver.org/news/fullstory.php/aid/2742/A_model_to_celebrate.html, last accessed 10/10/2013.

³⁶ Harris, P & Oliver, D *International Commercial Tax* (2010) at 16.

³⁷ Harris, P & Oliver, D *International Commercial Tax* (2010) at 17.

7 3 2 The League of Nations: The Reports of the Four Economists and the Technical Experts

Avery Jones records that the expression “place of effective management,” first came to the fore in a Swiss Federal Court decision of 1919.³⁸ Whilst the term was therefore already in existence, it did not appear in the Initial Report of the four economists commissioned to develop solutions to the problem of double taxation, as submitted to the League of Nations in 1923.³⁹ Sarig regards this Report to be the “most comprehensive and influential report” and the “true foundation of modern international taxation and the basis of uniform treaty rules.”⁴⁰ The four economists had been requested by the Financial Committee of the League to address certain pre-formulated reference questions. They were tasked to determine the economic consequences of double taxation, and whether any general principles can be formulated as the basis for an international convention to remove the “evil consequences of double taxation.” Alternatively whether a convention should only be made between particular countries, and if so, whether it could be framed so as to be capable of serving as a generic convention.⁴¹

In the Report the economists reviewed the underlying basis for taxation being that of economic allegiance, identifying four fundamental elements which would assist in identifying the appropriate state of taxation.⁴² These factors were (a) where does the production of wealth take place (b) where is the possession of wealth (c) where are the rights to the wealth enforceable (d) where is it disposed of consumed.⁴³ Whilst the economists did not provide a definition for domicile in their Report, a clear indication is given that already at such early stages, the possibility of remote management was considered –

“It is true that the manager of the factory can generally do most effective work on the spot, but

³⁸ AG Columbus – case dated 27 June 1919; Avery Jones, JF “The Origins of Concepts and Expressions used in the OECD Model and their adoption by States” *Bulletin for International Taxation* (2006) 6 at 232.

³⁹ League of Nations “Report on Double Taxation submitted to the Financial Committee, Economic and Financial Commission” Report by the Experts on Double Taxation: Document E.F.S.73. F.19, April 5, 1923. The four economists were Prof Bruins (Rotterdam), Einaudi (Turin), Seligman (New York) and Stamp (London).

⁴⁰ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule.” *Intertax* 32 10 (2004) 460.

⁴¹ League of Nations “Report on Double Taxation submitted to the Financial Committee, Economic and Financial Commission” Report by the Experts on Double Taxation: Document E.F.S.73. F.19, April 5, 1923.

⁴² League of Nations “Report on Double Taxation submitted to the Financial Committee, Economic and Financial Commission” Report by the Experts on Double Taxation: Document E.F.S.73. F.19, April 5, 1923 at 18 -22.

⁴³ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule.” *Intertax* 32 10 (2004) 460.

this is not necessarily so. In not a few instances the real brains of the management may be found at a distance.”⁴⁴

Also implicit to the aforesaid and the focus on “real,” is that a factual approach was preferred above a formal approach.⁴⁵

The four economists’ Report was followed by a Report of Technical Experts in 1925.⁴⁶ These experts had been nominated by a number of European countries, to form a committee with the aim of studying further questions of double taxation and tax evasion, and with the specific task to discuss the possibility of an agreement on certain points which could form a foundation for the drafting of bilateral agreements or other arrangements concerning double taxation.⁴⁷ Their work culminated in a number of resolutions put forward to the Financial Committee.⁴⁸ In relation to companies and corporate bodies, the resolutions contained a brief exposition on the meaning of “fiscal domicile.”⁴⁹ In their commentary preceding the resolutions, the technical experts described that the various expressions used to refer this term, presented them with “one of the most difficult parts of their work”: namely, the determination of the exact meaning of these expressions.⁵⁰

The various terms were found to overlap and recur, and thus they saw as their first task, the elimination of such confusion by defining the term fiscal domicile, albeit solely for the application of the resolutions. In the case of legal entities, they proposed that this should be the place where the concern has its “effective centre, i.e. the place where the “brain,” “the real centre management and control of the business is situated.”⁵¹ By so doing, it was felt that this would deter businesses from nominally transferring their headquarters to lower tax jurisdictions. A definition was accordingly set out in the Resolutions for fiscal domicile in relation to companies or corporate bodies. Based on these resolutions, in the first model drafts, the term fiscal domicile was defined as the following:

“Fiscal Domicile of Companies or Corporate Bodies

The State which has the right to levy tax is the State in which the head office is situated, or if that office is not the real centre of management and control of the undertaking, the State in

⁴⁴ At 30.

⁴⁵ Russo, R et al *A Decade of Case Law* (2008) at 7.2.3.1.

⁴⁶ League of Nations “Double Taxation and Tax Evasion Report and Resolutions” submitted by the Technical Experts to the Economic and Financial Committee F.212. Geneva, February 1925.

⁴⁷ Preliminary Note to the Report. Seven European countries were requested to nominate representatives as the objective was to proceed with a smaller contingent to determine such a complex question.

⁴⁸ Part IV. General Conclusion at 29.

⁴⁹ At 20.

⁵⁰ At 20.

⁵¹ At 21; Resolutions IV.2 *Fiscal Domicile of Companies or Corporate Bodies* at 34.

which this centre is situated.”

A further model treaty was published by the League after the Second World War, which retained the “real centre of management” test for fiscal domicile.⁵²

7 3 3 The OEEC and The OECD Model Tax Convention

Following the war, the League of Nations underwent a transformation and its successor, the United Nations did not initially continue the work of the League with regard to development of the model tax treaty.⁵³ Instead the Organisation for European Economic Co-operation (the OEEC), stepped in and during the years 1956-1961 published four reports.⁵⁴ In 1961 the OEEC became the OECD and released under this flag, the 1963 Model Tax Convention.⁵⁵

In a commentary on the 1958 report, a very insightful discussion is reported, advocating the use of the expression “place of effective management” and its function:⁵⁶

“The concept of fiscal domicile is another essential concept in double taxation Conventions because it serves to determine the individuals and legal persons contemplated in the Conventions and, in addition, when there is a conflict of domicile, to determine the State which should have the right to tax. In view of the considerable differences between the concepts applied by Member countries in their internal law, unanimous agreement on the concept of domicile in double taxation Conventions is indispensable. .. As regards legal persons, partnerships and associations not possessing legal personality, the Article indicates that in cases of conflict of domicile the State of residence is the State in which the place of effective management is situated.”

It is to be agreed with Hattingh, that this report creates the indubitable impression that with the publication of the 1963 Model Tax convention, the OECD endeavoured to uncouple the concept of place of effective management as tax treaty tie-breaker clause, from the various criteria its members was applying in their domestic law.⁵⁷ Sarig comes to a similar conclusion based on this statement by finding that it indicates that it is a notion distinct and independent of domestic law, acting as a rule to assign residence solely to one state.⁵⁸

⁵² Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 379.

⁵³ Harris, P & Oliver, D *International Commercial Tax* (2010) at 17.

⁵⁴ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.1 at 726.

⁵⁵ The first draft was prepared in 1958 and in 2008, the 50th anniversary thereof was celebrated. See <http://www.oecd.org/mcm/48064973.pdf> -last accessed on 07/05/2013.

⁵⁶ OEEE “Report by the Fiscal Committee on its Activities (Note by the Secretariat) C(58) 118 part 1 dated 28 May 1958. Available at www.taxtreatieshistory.org – last accessed on 07/05/2013.

⁵⁷ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.1 at 727.

⁵⁸ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie

Hattingh further states, that the historical documentation also reflect that the OECD wished to established a factual test, based on the situs of the management. Burgstaller & Haslinger endorses this, stating that the historical development of the term comprised concepts such as place of management and real centre of management and control, which indicate that this was intended to be a factual question, and not an enquiry as to formal criterions.⁵⁹ This level of management was focused on the most effective level: the level where the most important decisions were taken and policies formulated.⁶⁰

Avery Jones sheds light on the substitution of the “real centre of management” used in the initial League of Nations models, with the concept of “place of effective management” in the 1963 OECD Model. He concludes that it was a result of the alignment of the Model, with existing treaties on international shipping and transport business.⁶¹ It appears that a number of these treaties awarded the taxing power to the state in which the place of effective management was situated, others to the “place of management” and others to the “fiscal domicile of the operator.”⁶² One member country, the UK, however consistently applied the criterion of where the business is “managed and controlled”, and had expressly submitted that it bears the same meaning as that of “effective management”.⁶³ Consequently the proposal was made to adopt the expression of “place of effective management” as the preferent criterion.⁶⁴

In the earlier versions, a mutual agreement procedure was also found but at the time of this change, it was removed on the justification that “it will hardly ever be required.”⁶⁵ Avery Jones

breaker rule.” *Intertax* 32 10 (2004) 460.

⁵⁹ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 380.

⁶⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.1 at 728.

⁶¹ Avery Jones, JF “The Origins of Concepts and Expressions used in the OECD Model and their adoption by States” *Bulletin for International Taxation* (2006) 6 at para 2.8.2.

⁶² Par 23 of the Commentary.

⁶³ See also History on Par 23 of the Commentary. This reference to the UK and equitation of management and control to place of effective management was deleted on 23 July 1992 from the Commentary.

⁶⁴ Par 24 of the Commentary. Sasseville has a similar explanation, referring to the Working Party’s discussion, he notes that it was recorded that the tie-breaker rule should be based on the “real seat” approach, but that in the various agreements entered into between countries at the time, there was little uniformity with only the UK consistently using the term “managed and control.” Thus as the “real centre of management” had not attracted a following and only the UK was applying one concept consistently, it opted for the latter. In the final draft this phrase was substituted with the “place of effective management” as it was already used in treaties pertaining to shipping and air transport, and the UK had indicated that it would attribute the same meaning to “place of effective management” as to “managed and controlled.” Sasseville, J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 290-291.

⁶⁵ Avery Jones, JF “Understanding the OECD Model Tax Convention: The Lesson of History” 10 *Florida*

states that, retrospectively, it appears strange that anyone thought that the new expression would be that clear in meaning.⁶⁶ This mutual agreement would however resurface in time.⁶⁷

Thus the 1963 OECD Model Convention⁶⁸ was published, its scope of application being persons who are residents of one or both of the contracting states. The term resident was not defined, whilst person was defined as comprising an individual, company and any other body of persons.⁶⁹ Article 4, entitled “Fiscal domicile” did however contain a definition for the term “resident of a contracting state,” stating that it means any person who under the law of that state is liable to taxation by reason of his domicile, residence, place of management or other criterion of a similar nature.⁷⁰ Where the application of this paragraph led, a person other than an individual, to be resident of both contracting states, it was deemed to be a resident of the contracting state in which its place of effective management is situated.⁷¹

The 1977 Model Convention⁷² contained no significant changes thereto.⁷³ In the Commentary on this particular article, it was expressly stated that it concerns companies and other bodies of persons, irrespective of whether they are or not legal persons.⁷⁴ The Commentary goes on to state that it may be rare in practice for a company to be subject to tax as resident in more than one state.⁷⁵ It however remains a possibility and accordingly special rules should be applicable as to the preferential criterion to be utilised to resolve such a situation.⁷⁶ To attach importance to a purely

Tax Review (2009) 1 at 22.

⁶⁶ Avery Jones, JF “Understanding the OECD Model Tax Convention: The Lesson of History” 10 Florida Tax Review (2009) 1 at 22.

⁶⁷ See the latest OECD Model Tax Convention (2010) and the discussion below at 7 3 4 1.

⁶⁸ OECD “Draft Convention for the Avoidance of Double Taxation with respect to Taxes on Income and Capital Convention between (State A) and (State B) for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital” (1963). Date of Conclusion 30 July 1963. Available at <http://statlinks.oecdcode.org/DMC-1963.PDF> - last accessed on 07/05/2013.

⁶⁹ Art 3(1)(b).

⁷⁰ Art 4(1). In the subsequently published commentary it is expressly stated that treaties are not normally concerned with the domestic laws of the contracting states which will prescribed the conditions for a person to be treated as fiscally resident and thus fully liable to tax, thus they do not lay down the standards which domestic legislation on residence must meet. Instead it is respected that states will take a stand entirely based on their domestic laws.

⁷¹ Art 4(3). In the Preliminary Commentary on the article it is explained that it is here where the special point arises in that the conflict can not be solved by regard to the domestic concepts of residence and in these cases special provisions must be established to determine which of the two concepts is to be given preference (Par 5) (1977 OECD Model Tax Convention).

⁷² OECD “Income and Capital Model Convention” (1977). Date of conclusion 11 April 1977. <http://statlinks.oecdcode.org/MTC-1977.PDF> - last accessed on 07/05/2013.

⁷³ The title of article 4 did however change from “Fiscal Domicile” to “Resident.”

⁷⁴ Par 21 (1977 OECD Model Tax Convention).

⁷⁵ Par 22 (1977 OECD Model Tax Convention).

⁷⁶ In the commentary, albeit in relation to individuals, it is stated that this preference criterion

formal criterion such as registration would be inadequate, and thus importance is attached to the place where the entity is “actually managed.”⁷⁷ Reference is then made to the historical formulation of the preference criterion, specifically that in relation to persons other than individuals, consideration was given to the taxation of income from shipping, air and waterways transport, as was discussed above.⁷⁸ It was as a result of these considerations, that the place of effective management was adopted as the preference criterion.⁷⁹ These comments prevail to this day.

By 1998, the word “only” had been added to tie-breaker provision, thereby making it further clear that for purposes of the tax treaty, the entity will be deemed to *only* be resident in the country in which its place of effective management is situated.⁸⁰

In 2000, a more substantial inclusion was effected⁸¹ and the following insertion was made to paragraph 24 of the Commentary⁸²:

“The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.”

It is clear from the amendment that the focus is on a higher level of management. This is evident from the emphasis on where “key management and commercial decisions” are in substance made and the reference to the “the most senior person or group of persons (for example a board of directors). Emphasis was also placed on the fact that whilst more than one place of management

must be of such a nature that there can be no question that the person concerned will be satisfied in one state only and at the same time it must reflect such an attachment that is felt to be natural that the right to tax devolves upon that particular state. (Par 10)(1977 OECD Model Tax Convention).

⁷⁷ Par 22 (1977 OECD Model Tax Convention).

⁷⁸ Par 23 (1977 OECD Model Tax Convention).

⁷⁹ Par 24 (1977 OECD Model Tax Convention).

⁸⁰ OECD “Model Tax Convention on Income and Capital” (1998). Dated 1 June 1998. <http://www.oecd-ilibrary.org.ez.sun.ac.za/docserver/download/fulltext/2398511e.pdf> - last accessed on 07/05/2013.

⁸¹ OECD “Model Tax Convention on Income and on Capital (2000) . Dated 29 April 2000. <http://www.oecd-ilibrary.org.ez.sun.ac.za/docserver/download/fulltext/2398511e.pdf> - last accessed on 07/05/2013.

⁸² Commentary on Article 4(3), the tie-breaker provision.

may be found for an entity, there can only be one place of effective management. In this, the essential function of the tie-breaker to resolve situations of conflicting tax residency is reaffirmed.⁸³

As there is no definition for the term in the Convention itself, and the Commentary prior to the amendment, was but brief, this further guidance now provided was to be appreciated. It also reinforced the point that place of effective management is a question of fact.⁸⁴ This Commentary was verbatim retained in the 2003 Model Convention,⁸⁵ as well as the 2005 Model Convention.⁸⁶ However in 2008, it was significantly amended.⁸⁷

These amendments can be ascribed to two discussions papers that the OECD published in 2001 and 2003, against a backdrop of a fast modernizing world assailed by new technologies, which enhanced and facilitated communications and mobility. Sarig agrees that it was the advent of cyberspace and the so-called ‘communications revolution’, which was the “most significant reason behind the international tax -community’s call for a general review of some basic rules and principles of trans-frontier taxation, particularly the residence principle for tax treaty purposes.”⁸⁸

The first discussion paper was issued at the turn of this century. Its purpose was twofold. Firstly, to identify possible limitations arising from the application of the “place of effective management”, as a tie breaker rule in the current and future environment, which is characterized by constantly advancing technology and increased electronic commerce. Secondly, to identify possible solutions for such limitations.⁸⁹ To understand the changeover from a traditional paper-based, slower paced and more immobile world, to this highly mobile and interactive era, the following extract provides an apt description:

⁸³ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.3 at 732.

⁸⁴ Technical Advisory Group “The impact of the Communications Revolution on the Application of ‘Place of Effective Management’ as a Tie Breaker Rule” Discussion Draft February 2001 at para 13.

⁸⁵ OECD “Model Tax Convention on Income and on Capital” (2003) Dated 28 January 2003. Available at <http://www.oecd-ilibrary.org.ez.sun.ac.za/docserver/download/fulltext/2302081e.pdf> - last accessed on 07/05/2013.

⁸⁶ OECD “Model Tax Convention on Income and on Capital” (2005) Dated 15 July 2003. Available at <http://www.oecd-ilibrary.org.ez.sun.ac.za/docserver/download/fulltext/2305051e.pdf> - last accessed on 07/05/2013.

⁸⁷ OECD “Model Tax Convention on Income and on Capital” (2008) Dated 17 July 2008. Available at <http://www.oecd-ilibrary.org.ez.sun.ac.za/docserver/download/fulltext/2305051e.pdf> - last accessed on 07/05/2013.

⁸⁸ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule.” *Intertax* 32 10 (2004) 460.

⁸⁹ TAG “The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie-Breaker Rule” OECD February 2001 at para 1.

“... the communications and technological revolution is fundamentally changing the way people run their business. Due to sophisticated telecommunication technology and fast, efficient and relatively cheap transportation, it is no longer necessary for a person or a group of persons to be physically located or meet in any one particular place to run a business. This increased mobility and functional decentralization may have a significant impact on the incidence of dual resident companies, and the application of the place of effective management tie-breaker rules.... In a modern environment, the application of the above factors may not result in a clear determination of which State should be given preference as the State of residence, or may result in an outcome which does not appear to accord with the policy intentions of the provision.”⁹⁰

In order to overcome such problems and put in place a tie-breaker rule that would result in a single territory being identified in all cases, four possible solutions were identified. As a first option, the place of effective management concept could be replaced, or secondly, it could be refined, thirdly a hierarchy of test could be introduced that would function similar to the current tie-breaker provisions for individuals, so that if one test does not provide a conclusive outcome, the next test would apply, and as fourth and last option, a combination of any of the aforesaid tests were proposed.⁹¹

In respect of the first option, three possibilities were advanced as substitutes for the place of effective management as tie-breaker. Firstly, a test of place of incorporation or, in the case of an unincorporated association, place where corporate law applies to the establishment of the enterprise.⁹² The benefit of such a test lay in its simplicity; it is easily understood and has minimal administration and compliance costs.⁹³ Yet the fact that it could easily be manipulated and is in essence but a formal tie without any substantive economic connections, made it an inadequate solution and one that may defeat the underlying policy intent.⁹⁴ The second option was to replace it with the place where the directors/shareholders reside. Such a substitution was criticized for being uncertain and would further not necessarily result in an uncontested answer, especially where the office holders were not natural persons but companies.⁹⁵

The place where the economic nexus to the entity is the strongest, was proposed as the third alternative.⁹⁶ This test would require that the economic connections to a state to be reviewed, in particular to which extent land, labour, capital and enterprise, being the factors of productions are

⁹⁰ Para 34 &35.

⁹¹ Para 48.

⁹² Para 50.

⁹³ Para 51.

⁹⁴ Para 52 – 57.

⁹⁵ Para 58.

⁹⁶ Para 59.

used by the entity in attaining its profits.⁹⁷ The tie-breaker would serve to determine to which country the strongest ties are shown and deem the entity to be resident accordingly. There were some skepticism as to whether the test is appropriate to found residence- based taxation as opposed to source.⁹⁸ The fact that it may also involve subjective comparisons was said to detract from its efficiency and would result in the test being too difficult to apply.⁹⁹ Sarig finds the test to be the most vague of all of the proposals, particularly as no formula is given. It also appears to conflate the economic nexus test, with the principal of economic allegiance underlying the test for place of effective management ¹⁰⁰ He explains that the test is primarily one of fact and circumstances, which correlates to the approach of the four economists who advocated that taxing rights be determined, on the basis of ties between the location where the property and activities are situated and the people who own, control and manage the enterprise. It is also very similar to that which the committee of technical experts had referred to as the place where the “the effective center of the business is situated.” ¹⁰¹

As opposed to replacing the test for place of effective management, an alternative option would be to refine it. In this respect, two proposals were made. Firstly certain factors would be regarded as being the predominant factors, such as where the key management and commercial decisions are made in substance, where the senior group of persons made its decisions and where the actions to be taken by the entity as a whole are determined.¹⁰² A determination should accordingly be made on these factors and where it does not yield a single place of effective management, other factors would be considered and several example factors were listed in the discussion draft.¹⁰³ The *caveat* that ‘no definitive rule can be given and that all relevant facts and circumstances must be examined’, would endorse such an approach.¹⁰⁴ The second alternative would be to give weights to certain factors, but no further detail was given on this suggestion.¹⁰⁵

⁹⁷ Para 59.

⁹⁸ Para 60.

⁹⁹ Para 61.

¹⁰⁰ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule.” *Intertax* 32 10 (2004) 460.

¹⁰¹ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule.” *Intertax* 32 10 (2004) 460.

¹⁰² Para 63.

¹⁰³ Para 64 – such as the location of and functions performed at the headquarters, place of incorporation or registration information on where the central management and control of the company is to be located within company formation documents, relative importance of the functions performed within the two states, where the majority of the directors reside.

¹⁰⁴ Para 64.

¹⁰⁵ Para 65.

The third alternative proposed was replacing the current tie-breaker with a hierarchy of tests, similar to the structure in place for the residency tie-breaker for individuals.¹⁰⁶ A possible framework for such a hierarchy would be: place of effective management, place of incorporation, economic nexus and mutual agreement.¹⁰⁷ The last option suggested was to combine certain of these aforesaid alternatives.¹⁰⁸

In conclusion to the Paper it was noted that in the majority of cases, the place of effective management as tie-breaker would yield the right result, yet, the concern was that it must be capable of effective application, not only in the majority of cases, but in *all* cases of dual residence.¹⁰⁹ After receipt and consideration of comments by various parties to the 2001 Discussion Draft, a further discussion draft was issued in 2003.¹¹⁰ An analysis of the comments had revealed that there was support for two proposals – (a) refining the place of effective management as tie-breaker and (b) developing a hierarchy of test.¹¹¹

In respect of the refinement of the test, the proposal made in this Discussion Draft was essentially an expansion of the Commentary (and not an amendment to the text of the Convention).¹¹² In particular it was suggested, that the place of effective management be stated to normally correspond with the place where there the most senior person or group of persons meets. However cognizance would be taken of cases, where such decisions are made by person or group of persons in one place and formally finalized elsewhere, and this would necessitate that other factors be considered. These factors would include that a distinction is made between where the formal finalization of decisions take place, as to where they are *in substance made*, with the place of effective management following the latter.¹¹³ Thus the place of effective management would be attributed to the place where a controlling interest holder, who effectively makes the key management and commercial decisions, makes those decisions.¹¹⁴ Thirdly, that where the board of

¹⁰⁶ Para 68.

¹⁰⁷ Para 70- 72.

¹⁰⁸ Para 73.

¹⁰⁹ Para 78.

¹¹⁰ TAG “Place of Effective Management –Concept: Suggestions for changes to the OECD Model Tax Convention: Discussion Draft OECD 27 May 2003.

¹¹¹ Para 2.

¹¹² Para 6.

¹¹³ This appears to be a restatement of the general principle that the place of effective management should be where the “key management and commercial decisions ...are in substance made. Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 383.

¹¹⁴ It was required that such decisions must go beyond decisions related to normal management and policy formulation.

directors routinely approve the commercial and strategic decisions by executive officers, the place where these executive officers perform their functions, be a substantive factor in determining the place of effective management.¹¹⁵ Burgstaller & Haslinger concluded that these proposed amendments are good at clarifying the existing provisions, but they are not qualified to solve problems currently encountered and thus a further measure remains necessary, thus explaining the need for the second proposal.¹¹⁶ So too does Russo regard them as only being “a clarification” and is still premised on the underlying basis, that residence lies where the key decisions are taken.¹¹⁷

In respect of the second proposal, the hierarchy of tests, an alternative version of the current tie-breaker rule for non-individuals was proposed, together with a commentary thereon.¹¹⁸ As first tie-breaker, the place of effective management would remain, but where this could not be determined or was found to be in neither contracting state, the next test would be triggered. It was however stated that the second test would only be triggered in “rare cases”, which implicitly conveys the viewpoint of the drafters, namely that this test was to be applied, because the place of effective management was too difficult, or impossible to apply. The test to be applied on this second level was however still uncertain, with the following alternatives put forward: the state with which its economic relations are closer, in which its business activities are primarily carried on, in which its senior executive decisions are primarily taken. Where this test also yields no definitive answer, a deeming provision would be triggered on the next level, requiring that the entity be regarded as resident in the state, from the laws of which it derives its legal status. Yet should the entity derive its legal status from neither state nor both states, then as last test, a mutual agreement procedure between the competent authorities was proposed.¹¹⁹

Burgstaller & Haslinger finds the hierarchy approach to be preferable to the refinement approach. However they reserve their criticisms for the proposed contents of the approach, finding it to be “highly vague” and that it would not contribute to an “operable and existing tie-breaker system.”¹²⁰ In respect of the second test and in particular the third option set out there, 'where the senior

¹¹⁵ Para 7. Guidance as to the distinction between where a decision is made as opposed to where it is approved, was also given in that consideration should be given to the place where advice on recommendations or options relating to the decisions were considered and where the decisions were ultimately developed – per the Discussion draft of the OECD TAG Proposals.

¹¹⁶ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 384.

¹¹⁷ Russo, R et al *A Decade of Case Law* (2008) at 7.2.3.3.

¹¹⁸ Para 2.

¹¹⁹ Para 8 – 9.

¹²⁰ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 387.

executives primarily take their decisions,' they find it to be unhelpful test. They argue that in determining this the same difficulties will arise as when determining the place of effective management, as the latter also focus on key management decisions.¹²¹ In respect of the first two options, the state with which its economic relations are closer, or in which its business activities are primarily situated, they note that this ties in with an 'economic nexus' approach, as well as with the political question as to which country should have the primary taxing rights. The country which provide the infrastructure, or the country where the revenues are derived¹²² To determine the country with which the closer economic relationship prevail, the proposals state that it is the contracting state in which it makes–

“... greater use of economic resources as well as the legal, financial, physical and social infrastructures. The application of that test will involve examining various factors, such as in which State the entity has most of its employees and assets, carries on most of its activities, derives most of its revenues, has its headquarters, carries on most of its senior management functions or from, which State the entity derives legal status.”¹²³

Consequently, these two options overlap as the former necessitates that the *activities* be considered, with the latter option also necessitating that criteria of the first option be considered.¹²⁴ Apart from this inconsistency, there is also the question of how these factors are to be measured, as terms such as “most” and “greater” are used, but without guidance for measurement. It also does not address the situation where two distinct factors are present at their highest level in two countries, for example a greater use of legal and financial infrastructure in country A, whilst in country B, there is a greater use of social and physical infrastructure.¹²⁵ The introduction of the last test as based on a formal criterion of “legal status,” is lastly then also regarded a breach of the principle of “substance over form”, required by “place of effective management” doctrine.

In relation to the last level test, the mutual agreement procedure, Sasseville note that it was not a new creation by the OECD, but rather a reflection of the practice by countries to include this in their

¹²¹ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 385.

¹²² Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 385.

¹²³ TAG “Place of Effective Management –Concept: Suggestions for changes to the OECD Model Tax Convention: Discussion Draft OECD 27 May 2003

¹²⁴ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 385.

¹²⁵ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 386.

tax treaties.¹²⁶ Burgstaller & Haslinger is of the opinion, that this is unnecessary as contracting states may already utilise such process through the application of Article 25 of the Model. It is also unclear on what legal basis the contracting states will be able to settle the issue, if none of the aforementioned rules could yield a result.¹²⁷ Furthermore, they note three further weaknesses. Firstly, that in such a procedure the tax authorities are not expected to settle the question but only to endeavour to achieve result. Secondly, that such a process may be lengthy and time-consuming, and lastly is not considered to be legally binding by the courts.¹²⁸ Russo et al however welcome such a case-by-case approach and mutual agreement procedure, stating that the open character of place of effective management with the uncertainties of which facts and circumstances to take into account, as well as the unclear border between it and the concept of central management, make the mutual agreement procedure “probably the most appropriate way to resolve the issue.”¹²⁹ We return to the mutual agreement procedure later.¹³⁰

It is also to be agreed with Sarig, that it is disappointing that the discussion drafts focused solely on the corporate sphere, by utilizing concepts typical to it, such as its traditional hierarchy and structures, as opposed to following a more flexible approach encompassing all types of entities, whether incorporated or not. As he puts it “attributing a physical nexus merely to titles, figures or other corporate organs is not likely to bring about clearer parameters of a modern-day tie-breaker rule... [it] results in a narrow definition of the POEM concept.”¹³¹ However, the amendments that were eventually introduced in 2008, did not entirely correspond with the last set of proposals. A refinement of the commentary was effected, but the hierarchy of tests was not carried forward. Subsequent to further discussions, the Working Party had concluded that the proposed amendments were not aligned with the viewpoint of the majority of the OECD members.¹³²

7 3 4 The current OECD Model Tax Convention

The text to paragraph 24 now reads as follows:

¹²⁶ Sasseville, J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 296.

¹²⁷ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 387.

¹²⁸ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 386.

¹²⁹ Russo, R et al *A Decade of Case Law* (2008) at 7.3.

¹³⁰ See par 7 3 4 1.

¹³¹ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule.” *Intertax* 32 10 (2004) 460

¹³² Russo, R et al *A Decade of Case Law* (2008) at 7.2.3.4.

“The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business *as a whole* are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.”

Whilst the phrase “as a whole” was added in respect of the decisions to be taken into account, a more profound change occurred. This change was the deletion to the reference to the senior persons or group of persons, such as a board which was included per the previous commentaries. Russo *et al* sums it up – it thus “breaks the link with the place where the most senior persons ... makes its decisions but it calls attention to the *substance* of where the strategic decision has “actually” been made.”¹³³ Du Plessis submits that whilst the deletion suggests that a lower level of management, such as senior executives as opposed to the highest level of management, may now be regarded as making the key management and commercial decisions, it may still be that the most senior level of management makes those decisions.¹³⁴ Thus the focus of the OECD is no longer on which level, but rather on where are the key decisions in substance made.

Also of significance, a further subparagraph was inserted, whereby an alternative was suggested for the tie-breaker as was contained in the proposals. In this new subparagraph 24.1, it was noted that some countries consider that incidences of dual residency of persons other than individuals are “relatively rare” and a case-by-case approach should therefore be followed. It was elaborated that there is support from certain countries, who regard such a case-by-case approach to be the most suited to address difficulties in determining the place of effective management, arising from the utilisation of new communications technologies. Consequently these countries may instead leave the question of residence of such persons, to be settled by the competent authorities. To facilitate this alternative, the following provision may be used in the place of the current article 4(3):

- "3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States."

¹³³ Russo, R et al *A Decade of Case Law* (2008) at 7.3.

¹³⁴ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 329.

The Commentary further stated that the competent authorities would be expected to take into account the following factors in application of this provision:

- where the meetings of its board of directors or equivalent body are usually held,
- where the chief executive officer and other senior executives usually carry on their activities,
- where the senior day-to-day management of the person is carried on,
- where the person's headquarters are located,
- which country's laws govern the legal status of the person,
- where its accounting records are kept,
- whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc.

However, countries who are of the view that the competent authorities should not be given the discretion to resolve such instances of dual residence, without an indication of the factors to be considered, may either supplement the provision to refer expressly to the factors named above, or other factors as they may consider the relevant.¹³⁵ Lastly it is required that the competent authority should clarify which period of time is covered by the decision, as the facts on which a decision will be based may change over time.¹³⁶ No further amendments were made to the updated 2010 Model Tax Convention issued on 22 July 2010.¹³⁷

7 3 4 1 Criticisms against the amendment

The amendment was not received without criticism. Hattingh questions the removal of the reference to the senior persons, finding the basis as “unclear,” and as it was an entrenched principle, its deletion should have been motivated by the OECD.¹³⁸ It is interesting to note that the board’s role has now been shifted from featuring in the explanation of the term, to being but one of the factors in the alternative approach proposed by the OECD. In Hattingh’s view, the removal was a result of the OECD’s confusion, as to the impact of the communications revolution. The latter did not alter the management organs of the company, but only affected the way in which they fulfilled their duties in that they were now more “fluid” and iterant.¹³⁹ He argues that it should have been recognised, that it is the application of a factual management- based test in the modern

¹³⁵ Para 24.1

¹³⁶ Para 24.1

¹³⁷ OECD “Model Tax Convention on Income and on Capital” (2010) as at 22 July 2010. Available at <http://www.oecd-ilibrary.org.ez.sun.ac.za/docserver/download/fulltext/2310111e.pdf> - last accessed on 07/05/2013.

¹³⁸ This would advance transparency. Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.4 at 734.

¹³⁹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.4 at 735.

world, which poses the problem, not the theoretical framework of the entity.¹⁴⁰ This then leads to a second issue, as by moving away from such typical high level to a seemingly lower level of management, it does not take cognisance of passive companies, which due to the nature of its business, usually only functions through a board and does not need other functionaries.¹⁴¹ By way of analogy, certain trusts also fall within this category. Whereas with such structures, the influences of outsiders or dominant parties are sometimes a crucial aspect, this was not addressed in the amendments.¹⁴²

Sasseville is of the opinion that whilst the 2000 Commentary clearly endorsed the Anglo- Saxon board-centric approach, the amended commentary is now more general and can accommodate both the “management of the top-level executives” (European/Continental approach) as well as the board-centric approach.¹⁴³ He argues that an impression may be gleaned that in the 51 years since its promulgation, the OECD has now done a full circle by having a concept that could mean different things and allow for a mutual agreement procedure.¹⁴⁴ Conversely, Sarig found it to be substantially incompatible with the historical development of the notion.¹⁴⁵

Whilst the expression “place of effective management” has been retained from inception to the date, the attributed meaning can be said to have changed over the years, or more neutrally, developed. Hattingh states that “the aim is to develop a unified and consistent meaning separate and distinct from member countries’ internal laws.”¹⁴⁶ It is necessary that there be a common international meaning of the concept, so that it is able to fulfil the purpose it was designed for of resolving incidences of dual residency.¹⁴⁷ In furtherance of the aforesaid, it would therefore not be acceptable in international law for each state to a tax treaty, to have its own particular domestic or tax treaty law meaning on the concept, when it applies the tie-breaker, so that the meaning of the term for tax treaty purposes would eventually depend on which state the party to the treaty is.¹⁴⁸ A

¹⁴⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.4 at 735.

¹⁴¹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.4 at 735.

¹⁴² Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.4 at 735.

¹⁴³ Sasseville, J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 293 and 295.

¹⁴⁴ He elaborates by asking whether it denotes the supervisory management of the board directors of a typical UK company, or the active management of an European managing board, or the management activities of senior executives - Sasseville, J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 297 and 299.

¹⁴⁵ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule.” *Intertax* 32 10 (2004) 460

¹⁴⁶ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.2 at 730.

¹⁴⁷ Olivier, D B “Effective Management” B.T.R. 2001 (5) at 290; Also Vogel, K *Double taxation Conventions* (1991) at 229 requires an “autonomous” meaning to be ascribed hereto.

¹⁴⁸ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.2 at 731.

departure from the accepted domestic meaning, may therefore be necessary in a tax treaty context, so as to advance and recognise the international meaning.¹⁴⁹ Whether the amendment has achieved this 'one consistent' meaning capable of being applied internationally, is doubtful.

7 3 4 2 The future of the 'place of effective management'

In light of the alternative tie-breaker proposed by the OECD, it may be inferred that the future of this concept as primary tie-breaker, is under siege.

The alternative tie-breaker, the mutual agreement procedure, has also locally been proposed by SARS to be included as an additional tie-breaker rule. Specifically, it would be utilized to address those occasions where disagreement may arise between SARS and a treaty partner regarding the application of the place of effective management.¹⁵⁰ Others hold a contrary view in respect of its usefulness, describing its inclusion as “unfortunate.”¹⁵¹ A review of the test does not install a sense of firmness or certainty as it would appear that government authorities will now have the opportunity to determine residence by their own standards and on arbitrary factors identified by them or the OECD. Olivier & Honiball note that whilst it may provide a practical solution, until such time as the issue is resolved, the dual resident will not have access to the treaty benefits.¹⁵² The effect hereof is most aptly summarized by Hattingh,¹⁵³

“The whole point of attaining certainty for the tax treatment of cross-border investment is bedevilled if there is no clear and obligatory mechanism for a solution to the problem of a dual tax resident...Giving carte blanche to a tax authority to come to a solution is not the solution.”

See also Burgstaller & Haslinger who agree that many countries seek to apply similar concepts found in their domestic laws to interpret the term ‘place of effective management’ but that when same occurs, qualification conflicts arise and double taxation could be the result. Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 377.

¹⁴⁹ Hattingh concludes that our courts have accepted such an approach in *LJ Downing v SIR Case Number 6737, 1972, Natal Income Tax Specialist Court (Unreported)*. Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.2 at 731. Burgstaller & Haslinger also call for a “common international understanding of treaty terms” -Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 377.

¹⁵⁰ SARS “Discussion Paper on Interpretation Note 6” September 2011 at 8.4.

¹⁵¹ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.4 at 736.

¹⁵² Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 40.

¹⁵³ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.4 at 736.

SARS however, appears to now be executing their intention, and has for example, substituted the 'place of effective management' tie-breaker with the 'mutual agreement procedure' in its revised double taxation agreement with Mauritius.¹⁵⁴ However as, Bennett notes, this is not so unique an occurrence as this alternative tie-breaker is already found in thirteen of South African treaties, including for example in our treaties with Botswana, Nigeria and Uganda.¹⁵⁵

It is regarded that SARS' main reason for renegotiating the treaty was to counter the perceived abuse under the current (1996) treaty and to prevent erosion of the South African tax base.¹⁵⁶ Thus, as one of the ways to achieve this, Article 4(3) of the Agreement now provides that in instances of dual residency, the "competent authorities of the contracting States shall by mutual agreement endeavour to settle the question and determine the mode of application of the Agreement to such person." It will therefore be up to the South African and Mauritian government authorities to decide whether an entity will be taxed only in South Africa or only in Mauritius. In so doing it is stated that the "effective management criterion [has been] substituted with an administrative discretion"¹⁵⁷ and that the "certainty of a legislated provision is being substituted for the uncertainty of a negotiation between Revenue Authorities."¹⁵⁸ This is regarded as a "significant departure" from the current regime¹⁵⁹ and a "dramatic turn of events."¹⁶⁰

¹⁵⁴ This agreement was signed on 17 May 2013 and is anticipated to come into effect from 1 January 2015, pursuant to the necessary ratifications procedures being done by these countries respective governments. National Treasury "Formal Ratification: Tax Treaty with Mauritius and Oman Tax Treaty Protocol." Available at http://www.pmg.org.za/report/20130619-double-taxation-agreement-cameroon-qatar-mauritius-chile-african-tax-administration-forumtaxinfoexchange?utm_source=Drupal&utm_medium=email&utm_campaign=Free%20Alerts – last accessed 05/09/2013.

¹⁵⁵ Bennett, A "Revised Double Taxation Agreement between SA, Mauritius." Available at <http://www.polity.org.za/article/revised-double-taxation-agreement-between-sa-mauritius-2013-05-31> – last accessed 05/09/2013.

¹⁵⁶ Hattingh, J "Mauritius Tax Treaty: What it means for SA business" Printed 27 May 2013 and available at <http://finweek.com/2013/05/27/mauritius-tax-treaty-what-it-means-for-sa-business/> - last accessed 05/09/2013. The authors report that the total outward investment by SA taxpayers (approx. R53.5 billion) had by 2009, exceeded the total inward investment (R5.9 billion) by foreigners through Mauritius into SA by ten times.

¹⁵⁷ Hattingh, J "Mauritius Tax Treaty: What it means for SA business" Printed 27 May 2013 and available at <http://finweek.com/2013/05/27/mauritius-tax-treaty-what-it-means-for-sa-business/> - last accessed 05/09/2013.

¹⁵⁸ Lessing, D & Mazasny E "South Africa renegotiates Double Tax Agreement with Mauritius." Available at <http://www.polity.org.za/article/south-africa-renegotiates-double-tax-agreement-with-mauritius-2013-05-30> – last accessed 05/09/2013.

¹⁵⁹ Bennett states that it has received a lot of media interest and generally negative reaction. Bennett, A "Revised Double Taxation Agreement between SA, Mauritius." Available at <http://www.polity.org.za/article/revised-double-taxation-agreement-between-sa-mauritius-2013-05-31> – last accessed 05/09/2013.

¹⁶⁰ Hattingh, J "Mauritius Tax Treaty: What it means for SA business" Printed 27 May 2013 and available

It has been pointed out by commentators that it is the taxpayer who is prejudiced by these changes. Firstly the taxpayer is not able to directly take part in the negotiations as he has no right of automatic representation during the process.¹⁶¹ Nor does he have any legal remedy against the decision of the authorities, or their failure to reach an agreement, as there is no objective rule that allows the taxpayer to resort to the court for relief, which differs from the current state.¹⁶² Lessing and Mazansky state that "this is hardly acceptable. At the very least, the treaty should have bound the Revenue Authorities to submit themselves to a binding arbitration process (something which is provided for in the OECD rules.)"¹⁶³ Whilst the treaty has been based on the OECD Model Tax Convention, the factors identified by the OECD in its model, were not included. Consequently the specific principles and the administrative processes which the authorities will apply to reach their agreement is not known.¹⁶⁴ Nor are there any indications as to how long such a process will take and as one author warns, taxpayers will therefore need to rely that the authorities will do so in an "expeditious manner so as to avoid leaving the taxpayer dangling in mid-air."¹⁶⁵

The Article further provides that 'in the absence of such agreement such person shall be considered to be outside the scope of the Agreement except for the provisions of Article 25.'¹⁶⁶ Essentially then, the treaty will "simply not apply,"¹⁶⁷ causing the person to fall outside its scope with no access to its relieving provisions.¹⁶⁸ SARS has also confirmed that should

at <http://finweek.com/2013/05/27/mauritus-tax-treaty-what-it-means-for-sa-business/> - last accessed 05/09/2013.

¹⁶¹ Hattingh, J "Mauritius Tax Treaty: What it means for SA business" Printed 27 May 2013 and available at <http://finweek.com/2013/05/27/mauritus-tax-treaty-what-it-means-for-sa-business/> - last accessed 05/09/2013.

¹⁶² Lessing, D & Mazasny E "South Africa renegotiates Double Tax Agreement with Mauritius." Available at <http://www.polity.org.za/article/south-africa-renegotiates-double-tax-agreement-with-mauritius-2013-05-30-> last accessed 05/09/2013.

¹⁶³ Lessing, D & Mazasny E "South Africa renegotiates Double Tax Agreement with Mauritius." Available at <http://www.polity.org.za/article/south-africa-renegotiates-double-tax-agreement-with-mauritius-2013-05-30-> last accessed 05/09/2013.

¹⁶⁴ Louw, H "New Mauritian Tax Treaty" Published 31 May 2013. Available at <http://www.cliffe.dekkerhofmeyr.com/export/sites/cdh/en/news/publications/2013/tax/downloads/Tax-Alert-31-May-2013.pdf> - last accessed 05/09/2013.

¹⁶⁵ Bower, A "How the Mauritian Tax Treaty will affect business." Published 29 May 2013. Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page271?oid=78008&sn=Detail&pid=271> - last accessed 05/09/2013.

¹⁶⁶ Section 25 deals with the exchange of information between the countries.

¹⁶⁷ Louw, H "New Mauritian Tax Treaty" Published 31 May 2013. Available at <http://www.cliffe.dekkerhofmeyr.com/export/sites/cdh/en/news/publications/2013/tax/downloads/Tax-Alert-31-May-2013.pdf> - last accessed 05/09/2013.

¹⁶⁸ Bennett, A "Revised Double Taxation Agreement between SA, Mauritius." Available at <http://www.polity.org.za/article/revised-double-taxation-agreement-between-sa-mauritius-2013-05-31> - last accessed 05/09/2013. Lamprecht, I "Tax Treaty could see Investors exit Mauritius."

there be no consensus, the entity will not be entitled to any benefits, furthering their earlier reasoning that if an entity caused confusion as to their place of residence, they "should not expect to benefit from these treaties."¹⁶⁹ The entity will then be regarded as resident in both countries and thus subject to tax in both. It is therefore regarded that this change will lead not only to uncertainty but also double taxation for taxpayers.¹⁷⁰

Whilst it is not clear whether SARS will rely on any or all of the factors identified by the OECD to come to a decision as to the entity's residence, if they do, then at least one of these factors, may also hold implications for trusts which are often seen as useful tools for tax avoidance schemes. This factor states that in determining whether a person is a resident of one of the states, but not of the other, consideration must be given as to whether it would -

"would carry the risk of an improper use of the provisions of the Convention"

This "improper use" factor is considered to be a new and drastic departure, as well as an alarming development to include anti-avoidance measures in central tax concepts, instead of addressing such provisions separately.¹⁷¹

In light of this discussion and particular this concrete example where our authorities have elected to move away from the 'place of effective management'-criteria as tie-breaker, it may be asked what the future holds for this concept. It is certainly a worrying trend. Van Weeghel is of the opinion that the concept has "reached the end of its life as a useful criterion to break the residence tie."¹⁷² Specifically in relation to the amendments, he notes that it failed to address certain problems areas, of which one is that of holding, finance and royalty conduit companies. These companies often have limited staff and whilst a management board may be present, it often does not exercise sufficient power to establish 'effective management' in the country of purported residence.¹⁷³ Such companies have similar characteristics to trust and by analogy the same then

Published 28 May 2013. Available at <http://www.moneywebtax.co.za/moneywebtax/view/moneywebtax/en/page271?oid=77973&sn=Detail&pid=271> – last accessed 05/09/2013.

¹⁶⁹ Hattingh, J "Mauritius Tax Treaty: What it means for SA business" Printed 27 May 2013 and available at <http://finweek.com/2013/05/27/mauritius-tax-treaty-what-it-means-for-sa-business/> - last accessed 05/09/2013.

¹⁷⁰ Deloitte "New Mauritius/South Africa DTA." Published 28 May 2013. Available at <https://www.deloitte.com> - last accessed 05/09/2013.

¹⁷² Van Weeghel, S in *Residence of Companies under Tax Treaties and EC Law* (2009 at 3.5 in a chapter entitled "Article 4(3): An inconvenient truth"

¹⁷² Van Weeghel, S in *Residence of Companies under Tax Treaties and EC Law* (2009 at 3.5 in a chapter entitled "Article 4(3): An inconvenient truth."

¹⁷³ Van Weeghel, S in *Residence of Companies under Tax Treaties and EC Law* (2009 at 3.5 in a chapter

holds true. Consequently we now investigate the relationship between the Model Convention and Trusts.

7 4 The OECD Model Tax Convention and Trusts

To qualify for the application of the treaty, it is, insofar as the relevant treaty follows the wording of the model convention, necessary to be a “resident in one of the contracting states.” Article 4(1) defines the term, to mean “any person who under the law of that state is liable to taxation by reason of his domicile, residence, place of management or other criterion of a similar nature.”¹⁷⁴

Three key issues arise in this respect. Firstly whether a trust qualifies as a “person,” secondly, whether it can be regarded to be “liable to taxation” and lastly whether the trust can be regarded as beneficially entitled to the income.¹⁷⁵ A fourth issue may also arise and is somewhat of a conundrum particular to South Africa.

7 4 1 The first issue - a trust as a “person”

The first issue arises in the context of how countries regard the trust for taxation purposes. In South Africa, the trust is statutorily regarded as a person capable of taxation, whereas in other countries trusts are often not regarded separate persons.¹⁷⁶ To recap briefly, in our common law a trust is regarded as a relationship between several parties and although not a legal person *per se*, yet for tax purposes the trust has been statutorily included in the definition of “person.”¹⁷⁷ Thus domestically, a trust is regarded as a person for the imposition of income and capital gains tax. Yet this does not automatically render it a “person” for purposes of double tax agreements.

In the Model Tax Convention, the term “person” is defined. A ‘person’ includes “an individual, a company and any other body of persons.”¹⁷⁸ Thus there is no express indication that it includes a trust. Countries are allowed to specifically make provision for trusts in their agreements, by

entitled “Article 4(3): An inconvenient truth.”

¹⁷⁴ Art 4(1).

¹⁷⁵ There are further issues iro the application of the model tax convention to trusts but only those relevant to the topic at hand is discussed here. Certain of these further issues, such as business profits in relation to articles 5 & 7, capital gains iro article 13, payments made from the trust etc are discussed in Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non-Corporate Entities” 2002 GITC Review Vol II No 1 at 14 – 19.

¹⁷⁶ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 68.

¹⁷⁷ Chapter 2 and 4 has reference.

¹⁷⁸ Art 3(1)(a). The term “company” is defined in art 3(1) (b) as meaning any body corporate or any entity that is treated as a body corporate for tax purposes.

amongst others inserting a definition. The USA is an example of a country following this approach. Honiball & Olivier note that none of South Africa's treaties contain such a definition.¹⁷⁹

Others opt instead to rely on general treaty interpretation and application rules.¹⁸⁰ Where a term is not defined, the Model Tax Convention provides that it should bear the meaning that it has at the time under the domestic law of the state applying the treaty, with a meaning applicable under tax laws taking preference over any other domestic law meaning.¹⁸¹ In South Africa's domestic law, the term "trust" has been defined. Yet this interpretational article, requires that the term be undefined in the treaty itself, and thus Honiball & Olivier note that it presupposes that the term is indeed used in the treaty's content. However as the term "trust" is rarely used in the text of the treaties, the interpretational article is therefore inapplicable.¹⁸²

Guidance may be however be sought from the Commentary on article 3(1), which states that the definition "is not exhaustive and should be read as indicating that the term "person" is used in a very wide sense."¹⁸³ Whilst trusts are therefore not specifically mentioned in the commentary, following such a broad approach, the term "person" can be regarded as also encompassing a trust.¹⁸⁴ This is particular the situation where under domestic law the trust is regarded as a person, that such a consequence would follow.

Alternatively it could be argued, that if the trust is not a "person," then the trustee or trustees, both individual and/or corporate trustees, are still "persons." Should the trust be denied the benefits of the treaty, the trustees who are in receipt of the income or gain, should be able to claim application themselves.¹⁸⁵ Baker however points out that the drawback to this approach of viewing the trustees separately, will arise in the context when the trustees are resident in different countries and could potentially take advantage of different treaties.¹⁸⁶ Avery Jones also notes that

¹⁷⁹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 284.

¹⁸⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 283. The mention that the USA is one of the countries who specifically address trusts in their agreements whilst South Africa follows the latter approach.

¹⁸¹ Art 3 (2).

¹⁸² Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 284.

¹⁸³ OECD's Commentary - Commentary on Article 3 concerning General Definitions.

¹⁸⁴ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 285. They specifically note that the definition by using the word "includes" indicates that is not restricted to only the limited category it mentions.

¹⁸⁵ Baker, P "The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities" 2002 GITC Review Vol II No 1 at 15.

¹⁸⁶ Baker, P "The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities" 2002 GITC Review Vol II No 1 at 15.

whilst the trustee may clearly be treated as a person and thus be the resident for treaty purposes, when the tie-breaker rules are invoked, an awkward situation may result.¹⁸⁷ This is due to the fact that as a “person”, the tie-breaker for individuals would be applied to the trustee, that is regard would be had to their permanent home, centre of vital interest, habitual abode and nationality, yet such rules are not tailored to fit a person acting in a capacity such as the office of trustee.¹⁸⁸ As a trustee in his capacity as trustee would not have a permanent home/habitual abode, etc, it would render the tie-breaker for individuals inapplicable and presumably then the tie-breaker for persons other than individuals, ie the place of effective management would apply.¹⁸⁹ A further alternative view is to regard the trust as a “body of persons,”¹⁹⁰ as it is a relationship involving various parties, and would thereby fall within one of the categories regarded as a “person.”¹⁹¹ The objections to this latter view¹⁹² and the uncertainty as to whether the abovementioned conclusion is indeed correct, prompts Honiball & Olivier to suggest that South Africa should preferably in the negotiation of its tax treaties, include trusts within the definition of “person.”¹⁹³ As stated above, the United States Model Tax Convention has done so and the term “person” expressly includes a trust.

More recently however in the 2010 update to the Model Convention some support for the conclusion reached, is given.¹⁹⁴ In the context of collective investment vehicles (CIV), it is noted that in many countries, such vehicles take the legal form of a trust and would in the domestic tax law of the country where it is established, be treated as a “person,” whether it be the trust itself, or the trustees acting collectively, which is regarded to be “person” or taxpayer.¹⁹⁵ The commentary then goes on to state that “in view of the wide meaning to be given to the term “person”, the fact

¹⁸⁷ Avery Jones, JF “The treatment of trusts under the OECD Model Convention: Part 1” B.T.R. 1989, 2, 41-60 at 65.

¹⁸⁸ Prebble, J “Trust and Double Taxation Agreements” 2005 eJTR 10 with reference to the article by Avery Jones.

¹⁸⁹ Avery Jones, JF “The treatment of trusts under the OECD Model Convention: Part 1” B.T.R. 1989, 2, 41-60 at 65.

¹⁹⁰ It will be recalled that this term has been encountered previously in the study, namely when dealing with the UK and setting out their previous dispensation iro capital gains tax. There the trust was regarded as a “single and continuing body of persons.”

¹⁹¹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 285.

¹⁹² Honiball & Olivier note that at least one local author, Wunch does not regard it to be such and confirms it to not be the viewpoint of South African Revenue Services. Overseas, Baker is also of the view that whilst trust may be associations of persons they are not necessarily bodies of persons in the sense that there is not necessarily a distinct body. Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 285.

¹⁹³ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 285

¹⁹⁴ These comments pertaining to CIV’s were added on 22 July 2010 by the Report entitled the “2010 Update to the Model Tax Convention” adopted by the OECD Council on 22 July 2010, as based on another report entitled “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles” (adopted by the OECD Committee on Fiscal Affairs on 23 April 2010).

¹⁹⁵ Par 6.10 of the Commentary on Article 1 concerning the Persons covered by the Convention (2010 Model Tax Convention).

that the tax law of the country where such a CIV is established would treat it as a taxpayer, would be indicative that the CIV is a “person” for treaty purposes.”¹⁹⁶

Yet even though a trust may be regarded as a “person” it may not be regarded as being a “resident” as a second aspect is also important, namely, whether the trust can be said to be ‘liable to taxation.’ Residency is therefore not only dependent on whether the trust is a “person,” but also as to the tax treatment of the country in which residence is averred.

7 4 2 The second issue - liable to taxation

A second issue to the applicability of the model tax convention to trusts, is therefore whether a trust can be said to be ‘liable to taxation’ as section 4(1) requires the person to be. This term is not taken to require actual payment by the entity of tax, and would be satisfied should the state be able to assert its jurisdiction to tax over the entity in respect of its worldwide income and gains.¹⁹⁷ Furthermore, Prebble notes that the term does not focus on particular income streams and thus a taxpayer is not regarded as resident in respect of one income stream, for example taxable interest and not in respect of the other, say non-taxable dividends, as the crux of the test is directed at the taxpayer and not the tax.¹⁹⁸ The term “liable to taxation” does however require the most comprehensive tax liability over the person.¹⁹⁹

Whilst in South Africa, the Income Tax Act, imposes a statutory liability for the tax on *all* persons, the extent of that liability is impacted by factors such as the status of the person, whether the person is resident or not, whether it earns income of a particular sort or conducts activities of a particular kind.²⁰⁰ In South Africa the most comprehensive tax liability over a person will follow by reason of a person's tax residence in South Africa.²⁰¹ Non-residents who are taxed only on their

¹⁹⁶ Par 6.10 of the Commentary on Article 1 concerning the Persons covered by the Convention (2010 Model Tax Convention).

¹⁹⁷ This the state may be do on any one of he internationally accepted bases for taxation such as place of establishment or location of management - Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities” 2002 GITC Review Vol II No 1 at 3. Also Vogel, K *Double taxation Convention* (1991) at 229 where he states that it not conditional upon the person being taxed actually but rather on whether a personal attachment to the contracting state is present.

¹⁹⁸ Prebble, J “Trust and Double Taxation Agreements” 2005 eJTR 10.

¹⁹⁹ Sarig, S “The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule.” *Intertax* 32 10 (2004) 460.

²⁰⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.1 at 714 and 19.5.9 at 752. S231-234 of the Constitution of South Africa, 108 of 1996.

²⁰¹ Definition of “Gross Income” in Sec 1 of the Income Tax Act , 58 of 1962. Hattingh J in *Residence of*

income sourced from South Africa, or from a deemed South African source, can not be said to be subject to the most comprehensive tax liability and consequently do not qualify as treaty residents, where this article 4(1) is used in double tax agreements concluded by South Africa.²⁰²

A particular problem in relation to trusts is however, that in some jurisdictions trust are regarded to be “fiscally transparent” or “hybrid entities”, meaning that the trust itself is not taxed but other parties such as the beneficiaries or the settlor.²⁰³ The transparency of the trust may be completely or only partially and may also differ from one tax year to the next.²⁰⁴ However in instances where the trusts are treated as completely fiscally transparent year after year, such trusts can not be regarded as liable to tax and hence, are not resident in that jurisdiction.²⁰⁵ Baker states that it would be completely inconsistent for a state to allow the entity full fiscal transparency, yet assert jurisdiction to tax on the worldwide income of the entity.²⁰⁶

Various degree of fiscal transparency are recognised by states. Baker remarks that it would be too rudimentary to classify entities as either opaque or transparent as there is “spectrum of transparency.”²⁰⁷ He identifies four types of transparent entities on this spectrum:²⁰⁸

- *Complete transparency* – this term denotes that the entity has either no existence (eg a contractual joint venture) or where the entity itself is wholly disregarded for tax purposes; It appears unlikely that such entities would qualify as residents which view finds endorsement in the OECD’s Partnership report.²⁰⁹
- *Transparency with reporting obligations* – here the entity has a relationship with the fiscal authorities, so as to report the income or gains, but the tax liability that results is solely that of its participators. Again it would appear that these entities can not be classified as residents as the liability to tax would fall on the participators.²¹⁰

Companies under Tax Treaties and EC Law (2009) at par 19.5.1 at 714- 715.

²⁰² Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.1 at 715.

²⁰³ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 285.

²⁰⁴ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 287.

²⁰⁵ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 287.

²⁰⁶ Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities” 2002 GITC Review Vol II No 1 at 22.

²⁰⁷ Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities” 2002 GITC Review Vol II No 1 at 22.

²⁰⁸ Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities” 2002 GITC Review Vol II No 1 at 22.

²⁰⁹ OECD’s Report on Partnerships - Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities” 2002 GITC Review Vol II No 1 at 23.

²¹⁰ Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate

- *Optional transparency* – this describes the situation where the entity or its participators may choose transparency. There appears to be different views as to these entities, with one view that they are liable to tax as they fall within the jurisdiction of the state of incorporation, whilst the more preferred view is that once they have elected transparency and for the time period which this remains their status, they are not liable to tax.²¹¹
- *Partial transparency* – this term appears to be the most appropriate to the greater majority of discretionary trusts as elaborated upon below. It describes the situation where part of the income of the entity is taxed in the hands of the entity and part in the hands of its participators.²¹²

In South Africa, it would be recalled from chapter 2, that a distinction can be made according to the beneficiaries' rights and that essentially two types may be identified on this basis: discretionary trusts and vested/vesting trusts. With the latter type of trust, it is evident that where both capital and income are vested in the beneficiary, the trust cannot be regarded as liable to tax and hence would not be regarded as a "resident".²¹³ Where however in a vested trust not all the capital and income are vested, for example only the capital is vested, such partially vested trust could be regarded to be tax resident due to its partial liability to tax.²¹⁴ A bewind trust is a trust where ownership of the assets is vested, not in the trustees, but in the beneficiaries with only the control of such assets in the hands of the trustees. Consequently any income and gains would accrue to the beneficiaries as owners and the trust is completely fiscally transparent and could not be a resident for treaty purposes.

In relation to discretionary trusts, where often in colloquial terms such trusts are regarded to be "taxpayers of the last resort" and taxed only on their undistributed income, the question arises as to what status can be given to them? Honiball & Olivier regard such trusts to be partially fiscally transparent. Yet the fact that such trusts are not taxed on all of their income, but only on the undistributed income should not be decisive in determining whether they are 'liable to tax'. The authors conclude therefore, that such trusts would despite their partially fiscally transparency, in principle qualify as residents for purposes of South Africa's double tax agreements.²¹⁵ The authors

Entities" 2002 GITC Review Vol II No 1 at 23.

²¹¹ Baker, P "The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities" 2002 GITC Review Vol II No 1 at 22.

²¹² Baker, P "The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities" 2002 GITC Review Vol II No 1 at 22.

²¹³ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 287.

²¹⁴ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 287.

²¹⁵ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 287.

however do raise a word of caution as to discretionary trusts, where all income and gains are distributed year after year, as this may give rise to the perception that despite the terms of the trust deed stipulating the trust to be discretionary in nature, such pattern over consecutive years causes it to be in actuality a vested trust.²¹⁶ Despite such occurrence, they submit that regardless the trust could still be regarded as a liable for tax and a treaty resident as long as it trust deed decrees it to be a discretionary trust as based thereto, it would hold the potential to be liable for tax in future on undistributed income or gains.²¹⁷

The US Model Tax Convention has explicitly addressed the issue of such transparent/hybrid entities and in article 1(6) provides that ²¹⁸

“An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.”

A last problem in this respect is noted by Baker, in that countries may treat such entities differently and cites an example where one country treats the entity as opaque and the other as fiscally transparent in the other, this is then when the “most complex problems arise.”²¹⁹

7 4 3 The third issue - beneficial entitlement

A third issue that may turn the answer as to whether a trust may be a resident for treaty purposes, is the issue as to whether it can be regarded as beneficially entitled to the income. This requirement originates from double tax agreements, which apply a “limitation of benefits”- article, in terms of which a person can only be resident and entitled to the treaty benefits should this requirement of beneficial entitlement be fulfilled.²²⁰ In the South African context it could be argued that the trustees will never be beneficially entitled to the income, it could never be so resident. In Honiball & Olivier’s view, however such an argument could be trumped by the contention that as the trust is statutorily a separate person and taxpayer for domestic tax purposes and as tax law is on a yearly basis applicable, to the extent that in a particular year a trust does not distribute certain

²¹⁶ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 287.

²¹⁷ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 287.

²¹⁸ United States Model Income Tax Convention Of November 15, 2006.

²¹⁹ Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities” 2002 GITC Review Vol II No 1 at 22.

²²⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 288. This question is also raised by Avery Jones with the added query whether the term is to be given a domestic meaning by the states who use this term domestically or whether an universal expression is to be given to it.

income and gains, it is beneficially entitled to same and hence resident.²²¹ Similarly Avery Jones notes that the beneficial ownership is in respect of the income and is not concerned with the ownership of the capital.²²²

Baker similarly notes that this issues arises in the context of dividends, interests and royalties as per articles 10, 11 and 12 of the model convention. Particularly in common law jurisdictions, with their clear distinction between legal ownership and beneficial ownership, it is feared that courts in those jurisdictions, will wish to apply their domestic technical meaning and will shirk from regarding the trustee as beneficial owner.²²³ After all, it has been said that in common law countries, “the whole point of being a trustee, is that one is not a beneficial owner.”²²⁴ However it is argued that the term should be given a broader treaty specific meaning and that a trustee be regarded as such for purposes of the convention.²²⁵ Prebble comments that as the commentary of the OECD was amended in 2003 to specifically state that the term “beneficial owner” should not be interpreted in a “narrow technical sense,” and that “narrow technical sense” is only found in the common law of trust there is an implicit indication, that the OECD intended at least some trustees to be beneficial owners for purposes of these sections.²²⁶ There also appears to be an historical argument, that the OECD at the time of formulation of the initial drafts were concerned with more formalistic holders of rights, such as nominees and agents, as opposed to trustees whose ownership rights are more substantial, although not beneficial in nature.²²⁷ There is also a policy argument, particularly from a common law viewpoint, that as trustees will mostly not be the beneficial owners, then no trustee will ever be able to take advantages of the treaty provisions and be granted relief in respect of any double taxation, which clearly could not have been the intention.²²⁸ A last argument is based on the French text of the Model, which uses the expression “beneficiaire effectif” which includes both full owners and trustees.²²⁹

²²¹ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 288.

²²² Avery Jones, JF “The treatment of trusts under the OECD Model Convention: Part 1” B.T.R. 1989, 2, 41-60 at 70.

²²³ Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities” 2002 GITC Review Vol II No 1 at 15.

Prebble, J “Trust and Double Taxation Agreements” 2005 eJTR 10. He states that the very essence of trustee ownership is different from beneficial ownership.

²²⁵ Baker, P “The Application of the Convention to Partnerships, Trusts and Other Non- Corporate Entities” 2002 GITC Review Vol II No 1 at 15

²²⁶ Prebble, J “Trust and Double Taxation Agreements” 2005 eJTR 10

²²⁷ Prebble, J “Trust and Double Taxation Agreements” 2005 eJTR 10

²²⁸ Prebble, J “Trust and Double Taxation Agreements” 2005 eJTR 10

²²⁹ Prebble, J “Trust and Double Taxation Agreements” 2005 eJTR 10. The French and English texts are regarded as being equivalent authorities, and thus should have the same meaning.

7 4 4 The fourth issue - same meaning

The fourth potential issue arises from the fact, that liability to taxation is stated to arise from certain connecting factors identified in Article 4(1), "domicile, residence, place of management or other criterion of a similar nature." Whereas in South Africa, the connecting factor would be residence, this term in relation to persons who are not individuals, is statutorily defined to be when they have their place of formation or place of effective management is in South Africa.²³⁰ Thus the term "place of effective management" is used to determine whether such a person is resident under South African domestic tax law, and it may further be used in a tax treaty to resolve a situation of dual residency by establishing exclusive residence in one country.²³¹ The question therefore arises as to whether the term has the same meaning for both these purposes. Hattingh states that legal certainty would require it to do so, but the context may require differently.²³² So too does Gutuza²³³ state that-

"Although the term is used in both scenarios and should therefore prima facie have the same meaning, it is submitted that its intention or purpose varies in the context of a country using it to determine 'residency,' and a double taxation agreement country using it to determine the 'best residency from a choice of at least two residencies."

In a domestic tax context, residence as a connecting factor is determined in a policy context. According to Hattingh this means that in respect to the concept of place of effective management, South African courts can be expected to assign a meaning to the terms against the broad policy framework, that the entity should be subject to comprehensive income taxation in South Africa, when it has the benefit of the SA government for itself, its property and business.²³⁴ Juxtaposed herewith, in a tax treaty context the term's underlying purpose is to resolve double taxation, by

²³⁰ S 1. In other countries, residence for persons other than individuals are their effective seat, statutory or registered seat, location of its head office or its principle place of business. Sarig, S "The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule." *Intertax* 32 10 (2004) 460.

²³¹ The question becomes more complicated in the context of tax treaties concluded by SA prior to the changeover to a residence based taxation system in 2001. Prior thereto SA had specifically made a reservation to the OECD Commentary that by reason of its territorial tax system and consequently does not have the concept of residence, consequently it reserves the right to use the terms 'ordinarily resident' and "place of effective management" to identify residents of SA. Thus where in older treaties residents are so defined , three meanings for the same term of place of effective management may arise: to establish residence for domestic law purposes, to establish residence for treaty purposes and to resolve as treaty tie-breaker the residence in one particular country - Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.2 at 717.

²³² Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.2 at 717.

²³³ Gutuza, T "Analysis: Has Recent UK Case Law Affected the Interplay Between 'Place of Effective Management' and 'Controlled Foreign Companies?'" (2012) 24 *SA Mercantile Law Journal* at 426.

²³⁴ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.6 at 725. Reliance is made on the Robinson and Rhodesia Railways cases.

allocating the comprehensive taxing rights to only one contracting state, whilst the other would have but limited source taxing rights.²³⁵ The difference lies that in the latter context, it is assumed that each state has a legitimate claim as justified by their domestic tax policy.²³⁶ Whilst it therefore appears apparent that the function and aim of the term, and the policy scenes and contexts differ, there is however no clearcut answer as to whether it necessarily translates into different meanings assigned to the term.²³⁷

Burgstaller & Haslinger in reviewing the development of the term of “place of effective management,” note that the expression may be similar to the underlying concepts it originated from and whilst countries tend to interpret the concept with reference to their own domestic law, they are of the view that such an approach causes problems. Firstly, the application of different domestic criteria by the respective countries would bring about different results for the place of effective management. Secondly, it may also result in more than one place of localization, thus undermining the function of the tie-breaker to determine *only* one place of residence.²³⁸ They are adamant that the term must be subject to an autonomous interpretation, as a “common international understanding of the term,” is a necessity for it to fulfil its intended purpose.²³⁹

Locally the *Oceanic*-case²⁴⁰ may be perceived to have shed light on this aspect from a South African vantage. Here, despite there being an Interpretation Note setting out the South African fiscus’ meaning as to the term, which meaning was different from the interpretation of the OECD and international community’s view, the court paid no regard to it and instead endorsed the meaning attributed to it in the international arena.²⁴¹ Whilst such guidance is appreciated, it is not an aspect that is entirely resolved.

²³⁵ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.6 at 725.

²³⁶ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.6 at 725.

²³⁷ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.6 at 725.

²³⁸ They note that even countries which have the same criteria of residence do not have the same interpretation and in some countries it is possible to have more than one place of residence as the result, ie Germany. Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 379.

²³⁹ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 379. Russo, R et al *A Decade of Case Law* (2008) In the Executive Summary to Chapter 7 also notes that difficulties arise from the lack of an autonomous tax treaty definition and thus forces contracting states to refer to their domestic laws.

²⁴⁰ *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127.

²⁴¹ See also Gutuza who writes that in *Oceanic* the court made no distinction between these two different contexts. Gutuza, T “Analysis: Has Recent UK Case Law Affected the Interplay Between ‘Place of Effective Management’ and ‘Controlled Foreign Companies?’” (2012) 24 *SA Mercantile Law Journal* 424

7 5 Case law in a treaty context

South African courts are under an obligation to consider international law, when interpreting any legislation including a tax treaty as per the provisions of Section 233 of the Constitution of South Africa, 1996. An important aspect to such a mandate is therefore the consideration of international and foreign precedent.²⁴² In the past South African courts have resorted to the publications of the OECD when tasked with the interpretation of a South African tax treaty.²⁴³ A recent example from the judicial bench, that of the *Oceanic*-case, illustrates that they will also have regard to foreign decisions in respect of a particular treaty before them.²⁴⁴ It may therefore be of assistance to have regard to such cases, which is done in this section. It is particularly in the UK that the most significant cases on tax treaties have arose. At least two of these cases have featured trust and these are firstly discussed.

7 5 1 *Wensleydale's Settlement Trustees v Inland Revenue Commissioners*²⁴⁵

The first of these cases was *Wensleydale's Settlement Trustees v Inland Revenue Commissioners*, concerning what the Special Commissioners described as “a simple capital gains tax avoidance scheme upon which they make no criticism.”²⁴⁶ The facts were briefly that the settlor had established a trust in Ireland, of which the two trustees were an English lawyer and the wife of an Irish lawyer.²⁴⁷ The latter was legally qualified but had never taken up practice.²⁴⁸ At issue was the capital gains tax on a share disposal by the trust, which the UK revenue authorities sought to tax arguing that the trust was resident in the UK.²⁴⁹ The Trustees disagreed and the matter was referred to a Commissioner to give a decision in principle as to whether the place of effective management of the trust was in the UK or Ireland.

²⁴² Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.6 at 726.

²⁴³ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.2 at 730 where he cites several cases.

²⁴⁴ *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127..Hattingh states that foreign case law on tax treaties is directly relevant in establishing the meaning of place of effective management concept – especially when it is encountered as a tie-breaker South African tax treaties. Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.5 at 737.

²⁴⁵ [1996] S.T.C. (S.C.D.)241.

²⁴⁶ Zigmond, J “Untelrab and Wensleydale: reflections on company and trust residence” 1996 PCB (5) 320.

²⁴⁷ Anon “Case Analysis” form Westlaw International.

²⁴⁸ Zigmond states she had a domestic role in life - Zigmond, J “Untelrab and Wensleydale: reflections on company and trust residence” 1996 PCB (5) 320.

²⁴⁹ Anon “Case Analysis” form Westlaw International.

It was noted that there was but limited literature and guidance to assist as to the meaning of the term.²⁵⁰ The Commissioner considered that “effective” implies realistic positive management. To elaborate on this aspect, the following quote from the decision is appropriate-

“... I emphasize the adjective ‘effective’. In my opinion it is not sufficient that some sort of management was carried on in Ireland such as operating a bank account in the name of the trustees. ‘Effective’ applies realistic, positive management. The place of effective management is where the shots are called, to adopt a vivid transatlantic colloquialism.”

Applied to the facts, it was found that the Irish trustee did not actively take part in the transactions and although she attended meetings and signed documents, she gave no input and was a trustee in name rather than reality.²⁵¹ The place of effective management of the trust could therefore not be found to be in the Republic of Ireland.

It is said that the Commissioners in this case applied the test for place of effective management by focusing on the questions: was there “input” from the Irish Trustee and was she “calling the shots?”²⁵² It was particularly this lack of input by the Irish Trustee, which turned the result. Zigmond criticizes this approach as it is not entirely clear that *had* there been equal input from the Irish Trustee, it would have sufficiently constituted the place of effective management of the trust to be in Ireland.²⁵³

He argues that instead a two stage enquiry should be followed: firstly it must be ascertained *who* exercises effective management, and secondly *where* is the effective management exercised.²⁵⁴ Whilst he notes that the Commissioner easily concluded that in respect of the first question this was exercised by the English Trustee, it is not clear whether the second question was considered. There is no indication that it was taken into account, that the English trustee need not necessarily have exercised the management in his country of residence, as he could possibly have exercised this during his visits to Ireland and meetings held there.²⁵⁵ In relation to the Commissioner’s finding that the trustee signed all documents, but was a trustee in a name rather than reality, Zigmond ties

²⁵⁰ There was no reported decisions which had considered the phrase.

²⁵¹ Anon “Case Analysis” form Westlaw International.

²⁵² Zigmond, J “Untelrab and Wensleydale: reflections on company and trust residence” 1996 PCB (5) 322.

²⁵³ Zigmond, J “Untelrab and Wensleydale: reflections on company and trust residence” 1996 PCB (5) 322.

²⁵⁴ Zigmond, J “Untelrab and Wensleydale: reflections on company and trust residence” 1996 PCB (5) 323.

²⁵⁵ Zigmond, J “Untelrab and Wensleydale: reflections on company and trust residence” 1996 PCB (5) 323.

such actions to the concept of ‘general administration’ as found in the capital gains act (prior to amendment) and the ‘place of management’ (ie without 'effective'), commenting that these relate to only the administrative actions, the former being a weaker test than even the latter.²⁵⁶ Thus the test for place of effective management would require more than mere general administration or management actions.

7 5 2 *Re the Trevor Smallwood Trust; Smallwood and another v HMRC*²⁵⁷

The second and more recent case is that of *Re the Trevor Smallwood Trust; Smallwood and another v HMRC*. Here the final judgment was given in 2010 by the Court of Appeal, although it concerned incidents which occurred ten years prior thereto.

The trust in question had been established in 1989 by Mr Smallwood (a UK resident), for the benefit of himself and his family.²⁵⁸ In 2000, the trustee of the trust was a Jersey company. The principal assets of the trust were certain shareholdings, which had significantly increased in value. This prompted advisors to propose to the trustee and Mr Smallwood that it be sold and the investments of the trust be diversified.²⁵⁹ Yet if sold by the Jersey trustee, the resultant capital gain would in terms of the relevant capital gains attribution rules, be attributed to Mr Smallwood as UK resident settlor²⁶⁰ and whilst he would be entitled to an indemnity from the trustees for the tax paid,²⁶¹ the net result would be that capital gains tax would be payable on the gains resulting from the disposal of the shares.²⁶² This result was not desirable and to avoid this, a tax scheme, commonly referred to as a “round the world” scheme was to be implemented, which would take advantage of another section of the Act.²⁶³ According to authors, this scheme was a “relatively well known arrangement

²⁵⁶ Zigmond, J “Untelrab and Wensleydale: reflections on company and trust residence” 1996 PCB (5) 324.

²⁵⁷ [2010] EWCA Civ 778 (Court of Appeal (Civil Division)). This was an appeal by HMRC against the decision in the High Court by Judge Man on 8 April 2009 which had reversed the earlier decision by the Special Commissioners released on 19 February 2008 in favour of the HMRC and against the taxpayers, Mr and Mrs Smallwood. The subsequent appeal by the Smallwoods against the Court of Appeal’s decision was refused on 16 December 2010 by the Appeal Panel of the Supreme Court.

²⁵⁸ The facts are summarized in the judgment of Lord Patten.

²⁵⁹ Par 2.

²⁶⁰ The UK has special provisions which are applicable to the chargeable gains realized on disposals by non-resident trustees of trust in which the settlor retains an interest and is a UK resident for the relevant year of assessment. The relevant section in this particular instance was S 86 of the TCGA, 1992.

²⁶¹ Ito paragraph 6 of Schedule 5 to the TCGA, 1992.

²⁶² Par 4.

²⁶³ Par 5. The relevant section being S77 of the TCGA, 1992.

that became popular a decade or so back among high net-worth individuals with offshore trusts”²⁶⁴ and “was quite widely implemented.”²⁶⁵

The components to the scheme was as follows. The current Jersey Trustee would resign in favour of trustees which were, firstly resident in a jurisdiction which did not itself tax capital gains, and which secondly, had a double tax agreement with the UK, in terms of which the chargeable gains would only be taxable in the country wherein the trustees were resident. Once appointed, the new trustees would then dispose the shares, and thereafter resign in favour of UK resident trustees, before the end of the year of assessment in which the disposal took place. Thus, by this appointment of UK resident trustees, the application of the attribution section to the settlor would be defeated, as it requires that the trustees remained non-resident throughout the year.²⁶⁶ Nor would the further section relating to chargeable gains and its accrual to the trustees be capable of satisfaction, as the application of the double tax agreement would prevent the UK from taxing the trustees in that year of assessment, as the latter country would have the exclusive right to do so.²⁶⁷

The country chosen for this round the world-scheme was Mauritius. Thus the Jersey trustee resigned in December 2000, a Mauritian trust company was appointed in its place and it subsequently sold the shares in January 2001.²⁶⁸ In terms of the relevant treaty between the UK and Mauritius, such gains accruing on the disposal of the shares would *only* be taxable in the country in which the alienator is resident (Article 13(4)). Hence Mauritius had the exclusive right to tax, and as was known, fortuitously did not levy capital gains tax.²⁶⁹ The last leg of the scheme was completed when the Mauritian trustees resigned in March 2001 in favour of new UK resident trustees, Mr and Mrs Smallwood, all before the start of the new tax year. The result, in the words of the High Court Judge “...if the trick worked, would be that the sale would attract no capital gains tax...”²⁷⁰ In the trusts’ tax return, it consequently claimed double taxation relief in respect of the gains. However this the HMRC did not accept, instead serving a closure notice upon the trustees to amend the return and include the full gain, and a further notice upon Mr Smallwood as settlor to

²⁶⁴ Gordon, K M “Around the World in 73 Days” Tax Adviser September 2010 at 27.

²⁶⁵ Baker, P “The High Court Decision in Smallwood” GITC Review June 200 (Vol. VII INo 3) at 1. He states further that this case was brought as a test case by HMRC to challenge the scheme.

²⁶⁶ Par 6. The relevant section being S86(2) of the TCGA, 1992.

²⁶⁷ Par 6. S 77(1)(b) of the TCGA, 1992.

²⁶⁸ Par 7.

²⁶⁹ Par 13(4) of the Double Taxation Relief (Taxes on Income) (Mauritius) Order 1981 (SI 1981 No. 1121). The terms of the DTA are premised on the 1977 OECD Model Convention. Par 10. Consequently Mauritius’ exclusive right to tax meant that no amount would be chargeable to tax in the UK for purposes of S77(1)(b).

²⁷⁰ Par 1 per Justice Mann - *Re the Trevor Smallwood Trust; Smallwood and another v HMRC* [2009] EWHC 777 (Ch); [2009] STC 1222.

amend his personal return to include the gain in terms of the attribution section.²⁷¹ It was to these notices that the trustees and settlor appealed to the Special Commissioners and thereby set the judicial wheels in motion.

Much in the case turned on the relevant time to determine residence for treaty purposes.²⁷² The trustees' argument was that at the time of the disposal of the shares, they were resident in Mauritius and consequently that was the relevant time for the application of the article in the treaty.²⁷³ Essentially their argument was that treaty residence should be determined on a "snapshot basis," that at the time of disposal regard should be had to the factual residence of the trustees.²⁷⁴ As at that time the trustees were only resident in Mauritius, the tie-breaker provision need not be applied and the place of effective management not considered. The revenue authorities disagreed contending that treaty residence be tested in periods, again by looking to the factual residence of the trust. Thus there were consecutive periods of residence, first Mauritian residence and then UK residence, and whilst the disposal may have been effected during the former, the treaty does not preclude dual residence as the countries may have successive taxing rights of residence.²⁷⁵ The applicable treaty article, was argued to reserve the right to tax on the basis of residence for both countries and thus the resulting double taxation would consequently be relieved through the use of the credit provisions of the treaty. The exact practical application of the later was not clear and on HMRC's own acknowledgment a "bit obscure."²⁷⁶ Thus neither party put forward a case which necessitated the application of the tie-breaker, but held the view that should the tie-breaker be invoked, then on the facts, the place of effective management would be in the country which in the

²⁷¹ Par 8. The gain was substantial – in the order of £6,818,390.

²⁷² Loomer summarizes the pivotal question as being whether the trustees were at the time the shareholding was disposed resident for treaty purposes solely in Mauritius or were resident for treaty purpose simultaneously in the UK and Mauritius (dual residence) – if so, then the tie-breaker, place of effective management would become the subsidiary question to be ascertained. Loomer, G "Smallwood Settlement v HMRC: trust residence for treaty purposes located wherever and whenever the trustees take decisions" 2009 BTR (4) 378.

²⁷³ Their case was thereof that the article operated on a disposal- by- disposal basis - Gordon, K M "Around the World in 73 Days" Tax Adviser September 2010 at 27.

²⁷⁴ Lawrance, D "Smallwood v Revenue and Customs Commissioners: Part 1 – A Mauritian mission explained" 2011 PCB (1) 71.

²⁷⁵ Lawrance, D "Smallwood v Revenue and Customs Commissioners: Part 1 – A Mauritian mission explained" 2011 PCB (1) 71.

²⁷⁶ The Judge was less impressed stating as follows: "No-one sought to explain to me how that could work, and I do not see how it can. If a process of iteration is to work, one has to have a starting point. The starting point is not clear--is it to be Mauritius or the UK? That may not matter if there is a process of iteration which gives the same result no matter where one starts, but I do not understand what that process is. And if it were to work I cannot accept that this sort of process, which might be entertaining to mathematicians but not to anyone else, is a sensible basis for construing a Treaty which is supposed to have a practical application."

words of the High Court's judge "favoured them."²⁷⁷

The Special Commissioners who first gave judgment,²⁷⁸ did not appreciate either argument.²⁷⁹ According to them the relevant time for the application of the article was the tax year in which the disposal took place and that in the year of question there was a liability to tax in both countries on the basis of residence.²⁸⁰ This "liability to tax" constituted "residence" for purposes of the treaty (Article 4(1)) and resulted in the trustees being resident in both countries.²⁸¹ Some authors criticize this approach as it appears to by-pass the exact question it attempts to answer, in stating that a person is liable for capital gains tax based on his residence in the UK, it is then somewhat roundabout to define "residence" "for such purpose, by referring to the person's liability to tax."²⁸² So too did the High Court concluding that their reasoning was "questionable, both on the grounds of logic and circularity."²⁸³

However having concluded that this was an instance of dual residence, the Commissioners were of the view, that the tie-breaker must then be applied to determine in which of the two countries the place of effective management was situated. This required that it be asked in which country the "real top level management, or the realistic positive management of the trustee, qua trustee was during the period subsequent to the resignation of the initial trustee (the Mauritian period).²⁸⁴ They further observed that the word "effective" should be understood in the sense employed in French (*siège de direction effective*), which requires "real" management.²⁸⁵ In the arguments before them, the trustees had placed reliance on the case of *Wood v Holden*, where the court had stated that is very difficult to see how the test for central management and control differed from that of place of effective management and that for practical purposes they may yield the same answer.²⁸⁶ In the

²⁷⁷ Par 16 - [2009] EWHC 777 (Ch); [2009] STC 1222. Thus for the taxpayer, Mauritius, and for the HMRC, the UK.

²⁷⁸ This is the lowest level of tax tribunals in the UK Dr A N Brice & Dr JF Avery Jones. *Re the Trevor Smallwood Trust; Smallwood and another v HMRC* [2008] UKSPC 669; [2008] STC (SCD).

²⁷⁹ Baker notes that the decision of the commissioners was unusual as it was on a basis that neither of the two parties had argued (ie for single residence or consecutive residence. Instead the Commissioners regarded that there was concurrent residence. Inherent to their decision is therefore that one may have the benefit of hindsight and look to subsequent events to determine the person's residence at a time prior thereto. Baker, P "The High Court Decision in Smallwood" GITC Review June 200 (Vol. VII INo 3) at 2.

²⁸⁰ As the trustees were resident in the UK for part of the year in terms of S2 of the CGTA, 1992 they are chargeable to capital gains tax on all gains made in the year.

²⁸¹ Thus residence for treaty purposes is determined by taxability.

²⁸² Gordon, K M "Around the World in 73 Days" Tax Adviser September 2010 at 27.

²⁸³ Par 25. [2009] EWHC 777 (Ch); [2009] STC 1222

²⁸⁴ Par 131.

²⁸⁵ Par 112. French was the other official version of the Model.

²⁸⁶ Par 109.

Commissioners' view the two concepts served entirely different purposes. The former determines whether an entity is resident or not, thus it is a one-country test, whilst place of effective management is a tie-breaker, actively seeking to resolve dual residence by determining in which of the two states it is to be found and is concerned with what happens in both states.²⁸⁷ They also had regard to the Commentary on the OECD Model Tax Convention²⁸⁸ and identified the following approach to be adopted,

"The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time."²⁸⁹

The Commissioners accepted on the facts that the administration of the Trust moved to Mauritius and that there the necessary and appropriate tasks were attended to, as they conclude:²⁹⁰

... there was no doubt that all the actions of PMIL (the trustee) in Mauritius were carried out correctly and were well documented. The appropriate meetings were held; the appropriate resolutions were taken, the Trust was registered in the Register of Offshore Trusts, a bank account was opened, a tax residency certificate was obtained, and income tax was accounted for and paid. All the administrative matters were well attended to."

Yet it was found that and the influence of the UK settlor and in particular the "guiding hands" of the UK tax advisers were prevalent throughout this time.²⁹¹ It was noted that the tax planning scheme was devised by the tax advisers in the UK, that the appointment of the new trustees in Mauritius originated from the UK tax advisers, that the trustees were subsequently appointed by the UK settlor who retained the power to appoint trustees, that it was the UK tax advisers who briefed the new trustees about the tax planning proposals and eventual sale of the shares, that the activities regarding the sale of the shares and conclusion, involved the UK advisers to a large extent. Whilst

²⁸⁷ Par 111.

²⁸⁸ Par 119 -130.

²⁸⁹ Par 124. Although this Commentary(2000) was issued after the Treaty the Court found that it could still be adopted as it is not substantially differed from the previous Commentary (1977) which was in force when the Treaty was entered into) which had stated POEM to have the same reference to management and control in the old UK treaties which implied the test for central management and control –that is the top level of management. However that difference is geared towards a different situation – that is when there is different levels of corporate management and consequently the difference does not detract from its application here.

²⁹⁰ Par 132.

²⁹¹ Par 133.

the shares may have been on the day sold by the Mauritian trustees, it was but a lower level management decision, as the decision to sell the shares had already been made in the UK.²⁹² Thus in actuality, the real top level management decisions, or the realistic, positive management decisions of the Trust, to dispose of the shares in a tax efficient way, had already been and continued to be, taken in the United Kingdom.²⁹³ The “key” decisions were made in the UK and it was here that its place of effective management was stated to be.²⁹⁴

The High Court to which the case was appealed, disagreed with the conclusion that this was a case of dual residence.²⁹⁵ In the Judge’s view the correct approach was to commence with the treaty article, article 13 which provided that the gain would only be taxable in the country in which the trustees were resident. Consequently the relevant time to determine the trustee’s residence status was only at the time of the disposal.²⁹⁶ At that time the trustees were only resident in Mauritius and hence the matter was resolved in favour of the trustees.²⁹⁷ The place of effective management would not be relevant to such an enquiry, as dual residence did not arise.²⁹⁸

On appeal to the Court of Appeal²⁹⁹ this decision was reversed, the court finding that this was a case of dual residence, and in the view of the majority, that the place of effective management was in the UK. Judge Patten in his judgment set out the facts, as well as the approach to be followed. His first port of call was to comment on the interpretation of the double tax agreements, and that it necessitates that a clear meaning be ascertained, whilst remembering that a strict literal interpretation is not appropriate when interpreting an international treaty.³⁰⁰ The purpose for which the treaty articles are designed is also important, as this colors the interpretation of the provisions. In this respect, the provisions have as objective the provision of statutory relief to taxpayers against double taxation. It does not aim to alter the basis of taxation of the contracting

²⁹² Pars 138 – 144.

²⁹³ Par 145.

²⁹⁴ Par 143

²⁹⁵ Justice Mann -[2009] EWHC 777 (Ch); [2009] STC 1222

²⁹⁶ Consequently it endorsed the snapshot approach proposed by the taxpayer’s counsel.

²⁹⁷ Par 44.

²⁹⁸ Par 45- 47. There was no two jurisdictions vying for residence, and thus no tie to break.

²⁹⁹ [2010] EWCA Civ 778.

³⁰⁰ Par 26 -27. He quotes Mummery J in *Memec v IRC* [1998] STC 754, ‘The language of an international convention has not been chosen by an English parliamentary draftsman. It is neither couched in the conventional English legislative idiom nor designed to be construed exclusively by English judges. It is addressed to a much wider and more varied judicial audience than is an Act of Parliament which deals with purely domestic law. It should be interpreted... on broad principles of general acceptance.

countries in their domestic legislation, nor to dictate to them as to how they should tax events.³⁰¹ In line with the aforesaid, the starting point must consequently be article 13, which states the general rule: capital gains will be taxable only in the country of which the alienator is a resident.

To determine in which country the alienator is resident regard must be had to the definition of “resident of a contracting state” in article 4. There it is defined as “a person,³⁰² who is liable to taxation under the law of the relevant contracting state by reason of his domicile, residence, place of management or any other criterion of a similar nature.” This definition is further stated to be subject to article 4(3), which contains the tie-breaker provision. Thus the term “resident” to which article 13 refers, is the resident after the tie-breaker provision has been implemented and yielded a result.

The next step is therefore to consider the trustee’s residence. In the High Court, the snapshot approach of the residence at date of disposal was preferred based on the article which in their view pointed to a single jurisdiction in which the tax can be charged.³⁰³ The Court of Appeal differed, finding that there is nothing in the article that requires such a snapshot approach. Instead the article must be construed effectively. It was unlikely that the draftsman intended that capital gains that are taxable on the basis of residence, should exclusively depend on residence at date of disposal and exclude the rights of a contracting country to tax the gains, by reference to residence within the same year.³⁰⁴ Indeed the article is not intended to remove the right of either state, but on the contrary seeks to preserve it.³⁰⁵ On this basis, it was found that the trustees were chargeable to tax in both contracting states and thus the place of effective management must be ascertained to act as tie-breaker. It is in the ascertainment of this place, that the majority of the judges (Ward and Hughes) differ from Lord Patten. It must be noted that as it was appeal, the court could only make findings on the law and not on the facts, which had been determined by the special commissioners. Thus the question was whether the special commissioners’ decision on this issue was one which could not reasonably have been reached on the facts before them.³⁰⁶

³⁰¹ At Par 29, this is eloquently explained: “ Its purpose is to set out rules for resolving issues of double taxation which arise from the tax treatment adopted by each country’s domestic legislation by reference to a series of tests agreed by the Contracting States under the DTA. The criteria adopted in these tests are not necessarily related to the test of liability under the relevant national laws and are certainly not intended to resolve these domestic issues.”

³⁰² It was common cause between the opposing parties that the trust was “ a person.”In terms of the UK TCGA, 1992 the trustees are regarded as single person for capital gains tax purposes.

³⁰³ Par 36.

³⁰⁴ Par 40.

³⁰⁵ Per Hughes LJ at par 65.

³⁰⁶ Gordon, K M “Around the World in 73 Days” Tax Adviser September 2010 at 28. He describes this as

Lord Patten commenced by referring to the Special Commissioners' interpretation on the term, namely that this is the place which is the centre of top-level management, where the key management and commercial decisions are made. This is premised on the Commentary on the OECD Model Convention and was endorsed as the correct test in the *Wensleydale's* case. A further leading case is that of *Wood v Holden*,³⁰⁷ which similarly concerned a tax-planning arrangement and had found that there was no material distinction between the concept of place of effective management and central management and control. For Lord Patten, the importance of this case was to be found in the analysis of what would be capable of constituting management and control of a company, by persons who are not the company's directors. Following a discussion of this case, he found that it was essential to make a distinction between instances where the management and control is exercised through the authorized persons, and cases where these functions are "usurped."³⁰⁸ A further important distinction to make relates to the third party's role. On the one hand, this role may be making proposals, advising and influencing the decisions of the authorized person whilst in another instance, the third party dictates the decisions to be taken.³⁰⁹ It is only when the decision-making functions are usurped, that the residence would not correlate with the place where those decisions are then formally made.

Consequently the question was whether the effective decision by the Mauritian trustees to implement the tax scheme and sell the shares were taken by the board of directors of that company, albeit on the advice and request of UK tax advisers, or whether it had ceded its discretion by agreeing to act in accordance with their instructions in the tax planning exercise.³¹⁰ In Lord Patten's view, the findings of fact indicate only that the Mauritian trustee accepted the advice of the UK tax advisers, to implement the tax plan in the interest of the beneficiaries.³¹¹ They retained their rights and duties as trustees to consider the matter at the time of alienation, and did not compromise their discretion in that they would act only on the instructions received from the UK tax advisers. An important finding of fact in this regard was that there was no agreement that the Mauritian trustees would behave in a certain way as *quid pro quo* for the introduction of the trust and they had an ultimate right to decline to sell the shares.³¹² Thus he found it difficult to accept that the commissioners having reached such conclusions, could then properly found the place of

a task that is "notoriously difficult." In this he is supported by Goldberg, D "Some Thoughts on Corporate Residence" GITC Review June 200 (Vol. VII INo 3) at 41.

³⁰⁷ Par 59 [2006] EWCA Civ 26.

³⁰⁸ Par 59

³⁰⁹ Par 59.

³¹⁰ Par 61.

³¹¹ Par 62.

³¹² Par 62.

effective management to be in the UK rather than in Mauritius.³¹³

However, in so finding he was not supported by his further judges on the bench, whose view would determine the result. The judgment written by Hughes (with whom Ward agreed) firstly made an interesting observation, by commenting that should one only review the place of effective management of the trust company trustee during the Mauritian period, then it may be that the Commissioners on the reasoning of *Wood v Holden* erred, as their findings did not go so far as to reflect that the functions of the trustee was wholly usurped.³¹⁴ Yet such an approach would in his view be to ask the wrong question and to return to the rejected snapshot approach.³¹⁵ Instead the focus must be on the trustees as a continuing body and thus the place of effective management must be that of the trustees as continuing body, thus looking holistically throughout the year. If so viewed, then the place of effective management can be found to be in the UK.

In the Judge's view the scheme was one that was "carefully orchestrated" from the UK, one that relied on the trust being exported for a brief temporary period to Mauritius and then be returned within the fiscal year to the UK, which was perfectly executed.³¹⁶ It was a scheme that went "above and beyond the day to day management exercised by the trustees" and of which, the control of it was located in the UK.³¹⁷ Consequently the residence of the trust was found to be in the UK. This was the final say in the matter, as the Smallwoods were refused leave to appeal to the Supreme Court.³¹⁸

Emslie observes that this "see-sawing in three tribunals" is evidence that the meaning of the concept of place of effective management is far from clear.³¹⁹ Some have criticized the judgment, seeing it as "opening a can of worms"³²⁰, finding it "questionable" as well as "regrettable that the issue will not receive further judicial scrutiny."³²¹ Indeed whilst there is endorsement of the court's

³¹³ Par 65.

³¹⁴ Par 68.

³¹⁵ Par 69.

³¹⁶ Par 70.

³¹⁷ Par 70.

³¹⁸ Applications for Permission to Appeal, *Smallwood and another (Appellants) v HMRC (Respondent)* UKSC 2010/0164, December 22, 2010. Available at: <http://www.supremecourt.gov.uk/docs/PTA-1012.pdf>.

³¹⁹ Emslie, T "The Court of Appeal on 'Place of Effective Management' 2011 *The Taxpayer* March at 42.

³²⁰ Garnham, C & Aubin-Parvu, N "Seeing the Wood for Trees...Again –Trustees of Trevor Smallwood Trust v HMRC" *STEP Journal* (July 2008).

³²¹ Lawrance, D "Smallwood: Part 2 – Poetic Justice?" 2011 *PCB* (2) 77. See also Cleave who comments that it has left a "number of questions in the air" - Cleave, B "The Treaty Residence of Trusts in the UK and Canada" 2011 *BTR* (6) 705.

conclusions on the term “residence”, it is particularly their decision regarding “the place of effective management” which is not supported, specifically as it is not aligned with the *Wood v Holden*’s case (discussed in the next section), which was decided by the same court.³²²

Lawrance writes that some commentators now surmise, that the test for place of effective management for a trust may therefore be significantly different to the test for a company.³²³ In his view, when assessing the place of effective management of the trust, regard should only be had to the strategic decisions taken by the trustees during that time and ascertain whether any of them were effectively taken by an outsider. If this approach is correct, then he finds that there is an apparent contradiction between the findings of fact, that indicate that the trustees were not bound to behave in a certain way, or behooved to make certain decisions.³²⁴ Consequently the court’s determination of the place of effective management only seems acceptable if the *Wood v Holden* case is wrong, or a different test is followed for trusts, or that it somehow allowed to assess the place of effective management of an entity, by referring to strategic decisions outside the period under review.³²⁵ He further submits that one is left with the impression that the place of effective management test is regarded by the judicial bench as providing an ‘equitable jurisdiction’ in the sense of allowing the tax to be charged where it should be, as opposed to applying it a legal test, a tendency which he submits undermines legal certainty as well as the rational development of this area of law.³²⁶

Loomer also states that it may be speculated that the fact that all real control was in the UK, regardless where formal residence may have been, influenced the commissioners’ decision. In his view where such tax avoidance schemes are implemented, a more substantive and realistic view of trust residence should be taken.³²⁷ He finds neither the reasoning of the majority or the dissenting judgment as “wholly satisfactory.”³²⁸ The former considered the place of effective management of the trust for the whole of the fiscal year, whilst the latter imported a more formal test of central management and control applicable to companies, which focuses on the more “ceremonial act” and which test in the commissioners’ expressed view, served a different purpose to that of the

³²² Lawrance, D “Smallwood: Part 2 – Poetic Justice?” 2011 PCB (2) 77.

³²³ Lawrance, D “Smallwood: Part 2 – Poetic Justice?” 2011 PCB (2) 77.

³²⁴ Lawrance, D “Smallwood: Part 2 – Poetic Justice?” 2011 PCB (2) 82.

³²⁵ In his view there were only two strategic decisions during the relevant period: the decision to sell the shares and the decision to retire as trustees. Lawrance, D “Smallwood: Part 2 – Poetic Justice?” 2011 PCB (2) 82.

³²⁶ Lawrance, D “Smallwood: Part 2 – Poetic Justice?” 2011 PCB (2) 78.

³²⁷ Loomer, G “Smallwood Settlement v HMRC: trust residence for treaty purposes located wherever and whenever the trustees take decisions” 2009 BTR (4) 384.

³²⁸ Loomer “Smallwood Trust v HMRC: Diverging Opinions on Offshore Residence of a Trust” 2010 BTR (5) 475.

concept of place of effective management. Schwarz also endorses the observation, stating that the decision of the majority appear to be unduly influenced by the existence of a tax avoidance scheme and prevents principles of general application to be formulated.³²⁹

Goldberg³³⁰ comments on the degree of influence, and finds the error by the court to lie in this aspect. Whilst he agrees that the influence from the UK may have been effective, it did not necessarily constitute management, nor yet effective management –

“I have more difficulty in seeing how the effective influence was management of the trust: before you can have effective management, you must have management, and I cannot see any actual management of the trust in the United Kingdom in the relevant period; calling what happened in the United Kingdom “real” management does not actually make what happened here management.”

So too does Gordon find the decision, or at least the approach of the majority to be wrong. Similarly referring to *Wood v Holden*-case, he feels that on a true analysis, notwithstanding the intended retirement of the Mauritian trustees following the sale of the shares, it is improbable that they, in their decision to sell the shares, would be doing so under the instruction of the UK-based advisers as opposed to merely taking heed of their advice.³³¹

Locally, Hattingh is of the view that the special commissioners in reaching their conclusions did perceive the trust to have several layers of management and that the decisions taken by the Mauritian trustees were on a lower level of management, with persons other than the appointed formal trustees, constituting the real top centre of management for the trust.³³² This is problematic as without an appointment contractually, there is no legal basis for such persons to take part in the management of the trust.³³³ In his view, the correct approach to have followed, was to once it was established that the Mauritian trust company had its place of effective management in Mauritius as trustee, whether they were but a pretence for persons situated elsewhere that *de facto* sought to exercise the powers and attributes of the office of trustee, whilst creating the impression to the outside that they were not involved in the management of the trust. If so, the necessary legal basis could be attributed, in South Africa at least, on the basis of the *plus valet* or substance over form

³²⁹ Schwarz, J Booth and Schwarz: *Residence, Domicile and UK Taxation* (2010) 14th ed at 125

³³⁰ In simple terms he explains that whilst it is clear there were people in the UK who wanted the shares to be sold and had decided that they be sold, it is also clear that the only people with the right to sell the shares were the trustees in Mauritius. Goldberg, D “Some Thoughts on Corporate Residence” *GITC Review* June 2008 (Vol. VIII No 3) at 49 -50.

³³¹ Gordon, K M “Around the World in 73 Days” *Tax Adviser* September 2010 at 28.

³³² Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 742.

³³³ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 742.

doctrine.³³⁴ Whilst on the facts the conclusion may have been reached that the UK advisors and not the Mauritian trustee managed the trust, without a legal basis, the decision creates uncertainty as legitimate transactions cannot then accordingly be expected to have their normal consequences. The finding by the special commissioners that the transactions were motivated by tax planning reasons seems also to have played a crucial role in their decision. Based on this overreaching tax planning motivation, the commissioners decided that the location of the trust's effective management would be the place where the plan was initiated and conducted.³³⁵

Garnham & Aubin-Parvu had following the initial judgement, expressed concerns that the case had left professional advisers in an invidious position.³³⁶ They explain that realistically should advisers indicate to trustees that a particular course of action would be advantageous, it would be improbable that the trustees would ignore such advice and it would be foolish to do so. Thus most transactions and plans proposed by advisers would then appear to be inevitable, similar to the present instance, where it was found that the sale of the shares was but a "lower level management decision", as it was "undoubted" that they would be sold. Yet this does not necessarily mean that the trustees would not decide differently, should factors arise making the original plan less beneficial.³³⁷

In Grundy's note on the case, he raises another aspect and criticizes the commissioners for their error in focusing on the trust and not its trustees.³³⁸ He explains that a trust can not make decisions nor dispose of assets. Only a trustee is able to fulfill these functions. Consequently the question they should have addressed, is what is the place of effective management of the trustee - in the present instance, thus the Mauritius trust company, and should they have had considered this question their answer may have been different. Thus the focus should be on the company's business as a whole and where its directors reached their decisions and not how a particular job is

³³⁴ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 747.

³³⁵ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at 748.

³³⁶ Garnham, C & Aubin-Parvu, N "Seeing the Wood for Trees...Again –Trustees of Trevor Smallwood Trust v HMRC" *STEP Journal* (July 2008).

³³⁷ Garnham, C & Aubin-Parvu, N "Seeing the Wood for Trees...Again –Trustees of Trevor Smallwood Trust v HMRC" *STEP Journal* (July 2008).

³³⁸ Grundy, M "Case Note: Smallwood v Revenue & Customs Commissioners" *GITC Review 2008 VolVII No 2* at 27. Cleave discusses such an enquiry into the corporate trustee's residence further. In his view it would require a two level approach. On the first level would be the decisions relating to the acceptance of the mandate as trustee, the terms and conditions, remuneration etc – on the basis of which it would most likely coincide with the country where it is incorporated. On the second level, the decisions relating to the administration and particular transactions to the relevant trust would lie and it is here where the answer may be different. Cleave, B "The Treaty Residence of Trusts in the UK and Canada" 2011 *BTR* (6) 713..

managed.³³⁹ Following this reasoning however, it would mean that in all instances where a trust company is appointed as trustee, the trust's residence would always follow where all of the trust's company business effectively managed.³⁴⁰

In summation however it is also evident, that despite all the retort and criticism, the case provides "an illuminating analysis of the residence of a trust"³⁴¹ and in particular, of the concept of place of effective management. It is further to be agreed with those who regard it as "significant"³⁴², a "big case"³⁴³ and certainly one that is likely to be of "lasting importance."³⁴⁴

Indeed, in this respect its impact have even been felt on South African shores, where locally the test was endorsed and applied in the first case³⁴⁵ on the place of effective management in South Africa. It would be recalled from the discussion of the *Oceanic*-case previously, that the court there followed an approach to first identify the key features of the *Smallwood*-case of relevance in determining the place of effective management, and then applied it as a test to the case before it, concluding that in "applying the *Smallwood* test, the facts to the extent that they have been established, do not, ... establish that the POEM of *SISM* was in Mauritius, and not in South Africa."³⁴⁶ One is therefore able to infer that our judiciary does regard the case as having authority and providing guidance in the determining of the place of effective management. Our local revenue authorities have also included it in their recently published Discussion Paper.³⁴⁷ In the Paper it is cited a recent development to favour a "holistic approach in determining the place of effective management, one that is focused on where the key management and commercial decisions necessary for the conduct of the entity's business in substance are made."³⁴⁸

³³⁹ Grundy, M "Case Note: *Smallwood v Revenue & Customs Commissioners*" *GITC Review* 2008 Vol VII No 2 at 29.

³⁴⁰ Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.5.7.5.4 at 743.

³⁴¹ Loomer, G "*Smallwood Settlement v HMRC: trust residence for treaty purposes located wherever and whenever the trustees take decisions*" 2009 BTR (4) 378.

³⁴² Sekar, KR "Court Places Trust's Effective Management in the UK" *International Tax Review* (October 2008)

³⁴³ Lawrance, D "*Smallwood v Revenue and Customs Commissioners: Part 1 – A Mauritian mission explained*" 2011 PCB (1) 71.

³⁴⁴ Lawrance, D "*Smallwood: Part 2 – Poetic Justice?*" 2011 PCB (2) 77.

³⁴⁵ *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127.

³⁴⁶ Par 58. The case was discussed in detail in Chapter 6.6.

³⁴⁷ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 7.3.

³⁴⁸ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 7.3.

7 5 3 Wood v Holden³⁴⁹

Similarly to the *Smallwood*-case, this case also concerned a complex scheme aimed at the avoidance of capital gains tax, carried out against a “background of several detailed statutory provisions” and involving a “number of quite intricate transactions.”³⁵⁰ A further similarity was that it turned on the question of “residence” and that several millions were at stake.³⁵¹ The more specific facts provide aspects of dissimilarity – for one it involved a company, and not a trust. The sophisticated scheme and its exact mechanisms will not be discussed in detail, and only the following is relevant here.³⁵²

In issue was the residence of a particularly company incorporated in the Netherlands, Eulalia, which featured as part of the tax plan.³⁵³ It is here that the conflict arose between the taxpayers’ view that the Eulalia's residence was in the Netherlands and on the revenue authorities’ view, that it was in the UK. Eulalia was a wholly owned subsidiary of another company registered in the British Virgin Islands.³⁵⁴ Its sole director was a trust company which was part of well-known banking and financial group in the Netherlands and there was a management agreement for the trust company to manage Eulalia day-to-day.³⁵⁵ Eulalia’s books and records, its registered and postal address as well as business address were all located in the Netherlands.³⁵⁶ The particular function of Eulalia was to acquire a specific shareholding in a UK company, then enter into agreements related thereto and sell the shares, all of which was performed in due course. The sole director of the company acted upon the advice provided by UK based advisers,³⁵⁷ and signed several documents to give effect to the transactions.³⁵⁸

³⁴⁹ 2006 EWCA Civ 26 (Court of Appeal); 2005 EWHC 547 (High Court); 2003 Case no SPC00422 (Special Commissioners).

³⁵⁰ Par 3 (High Court). It appears that the project name assigned to the transactions was aptly called “Project Marvel.”

³⁵¹ The resulting chargeable gain was apportioned over £27 million to Mr Wood and almost £3 million to Mrs Wood as per the initial assessments by HMRC. The gains related to disposal of shares in a greeting cards business built up by Mr Wood. Par 1 & 6 (Special Commissioners). In particular the focus was on the liability itself rather than the quantum.

³⁵² Statement of Agreed Facts is set out in par 9 with the primary facts found by the Commissioners set out at par 15 -68, 83-85. See also the High Court decision par 6 – 17 and par 29 -34.

³⁵³ In the High Court Judge’s words it was established or acquired “to implement particular parts in the wider tax scheme of which the architects were PWC (the UK Tax Advisers). Par 39 (High Court).

³⁵⁴ Par 3 (Special Commissioners)

³⁵⁵ Par 9 of the Statement of Agreed Facts as well as Par 37.

³⁵⁶ Par 70 (High Court).

³⁵⁷ This was mainly a firm of chartered accountants. They had been tasked to assist initially in finding a purchaser for the business, to manage the negotiations and advise on the transaction and assist with tax planning. (Par 17)

³⁵⁸ Par 123(Special Commissioners) narrate the involvement of the advisers in detail from the intitial

In the revenue authorities' viewpoint Eulalia was centrally managed and controlled from the UK, due to the fact that the Netherlands director merely took instructions from UK advisers. Should it be correct, the company would be dual resident³⁵⁹ and the tie-breaker clause in the treaty between the countries invoked.³⁶⁰ This was the place of effective management and it would be required to determine in which country the latter was located for purposes of awarding it the taxing rights.

The Special Commissioners commenced by looking at the test for residence in relation to companies not incorporated in the UK, namely that of central management and control. This test was historically set out in the *De Beers*-case,³⁶¹ which states the basic principle that a company resides where its real business is carried out "and the real business is carried on where the central management and control actually abides."³⁶² The use of the word "actually" is crucial, as in a further case the principle was refined to mean that "it is the actual place of management, not that place in which it ought to be managed, which fixes the residence of a company."³⁶³ It was in the latter case that the parent company usurped the power of the boards of its subsidiaries; the latter simply stood aside and did not even meet any further. This was not the case in this matter as it was found that the directors here was not "by-passed nor did they stand aside since their representative signed or executed the documents."³⁶⁴

Yet when the commissioners reviewed facts in further detail, and focused on the decision-making in particular, they found (broadly) two deficiencies impacting on the effectiveness of such decisions, and thus on the place where the central management and control was. The first deficiency can be said to be, that there was not sufficient involvement and consideration to the matter by the trust company and that the latter had "simply fell in with the wishes" of Mr Wood, as expressed by his advisors and also agreed to by its parent company.³⁶⁵ The fact that it had no other business than the acquisition, holding and sale of the shares, "there was nothing else to manage",³⁶⁶ was a factor to consider. Also the fact that whilst there may have been strong commercial reasons for the acceptance of the terms of the sale by Eulalia, particularly where it was acceptable to Mr Wood and

arrangements with the trust company and introduction, to obtaining information and documents, providing advice, specifying prices etc.

³⁵⁹ The Dutch Tax authorities had in 2003 in writing declared Eulalia to be a resident of the Netherlands for purposes of Article 4.

³⁶⁰ 1980 Double Taxation Treaty between the UK and the Netherlands.

³⁶¹ *De Beers Consolidated Mines Ltd v Howe*(1906) AC 455.

³⁶² *Unit Construction Co Ltd v Bullock* 38 TC at 729.

³⁶³ Par 118 (Special Commissioners).

³⁶⁴ Par 119 (Special Commissioners).

³⁶⁵ Par 142 and preceding paragraphs from 132 – no evidence that the trust company considered the price, reviewing the accounts, disclosure letters or warranties.

³⁶⁶ Par 147(Special Commissioners).

the managers, there was no real consideration given to the matter.³⁶⁷ The second deficiency was that the decision was not an adequately informed one.³⁶⁸ The following extract summarized the commissioners' reasoning:

"The only acts of management and control of Eulalia were the making of the board resolutions and the signing or execution of documents in accordance with those resolutions. We do not consider that the mere physical acts of signing resolutions or documents suffice for actual management. Nor does the mental process which precedes the physical act. What is needed is an effective decision as to whether or not the resolution should be passed and the documents signed or executed and such decisions require some minimum level of information. The decisions must at least to some extent be informed decisions. Merely going through the motions of passing or making resolutions and signing documents does not suffice. Where the geographical location of the physical acts of signing and executing documents is different from the place where the actual effective decision that the documents be signed and executed is taken, we consider that the latter place is where "the central management and control actually abides." ³⁶⁹

It was accordingly held by the Commissioners, that the taxpayers had failed to discharge their onus that the central control and management of Eulalia was not in the UK. This then give raise to the question of where the place of effective management was situated.³⁷⁰ It was agreed with revenue's counsel that in the present context, there was no difference between the two concepts of central management and control, and place of effective management. The latter being thus where the effective management decisions were taken.³⁷¹ It was concluded that there was no indication that any of the effective management decisions were taken in the Netherlands and that it had not been shown that Eulalia was not resident in the UK for tax purposes.³⁷²

The matter was appealed to the High Court,³⁷³ where it was decided in favour of the taxpayers. As it is an appeal, it was no longer open to the court to make a finding on the facts, only questions of law. In this particular instance the High Court overturned the decision on the basis that the conclusion the commissioners had reached, was not one which was open to them on a correct application of the law to the facts.³⁷⁴ The Court similarly reviewed the authorities on residence, commencing with the historical cases such as De-Beers and concluding that in all normal instances, the central control and management is identified with the control which the board of directors of the company has over its business and affairs, so that the principle almost always follows that a

³⁶⁷ Par 140. (Special Commissioners).

³⁶⁸ Par 145. (Special Commissioners).

³⁶⁹ Par 145. (Special Commissioners).

³⁷⁰ Par 146 (Special Commissioners).

³⁷¹ Par 146 (Special Commissioners).

³⁷² Par 147 (Special Commissioners).

³⁷³ 2005 EWHC 547 (High Court).

³⁷⁴ Par 4(High Court).

company is resident in the jurisdiction where its board meets.³⁷⁵ This statement, that residence may be in a territory even should the board not meet there- derived from the case of *Unit Construction v Bullock*, was in the judge's view a "highly exceptional case in terms of the result."³⁷⁶ This was not a case where the local boards still exercised central management and control, even if under the guidance and influence of the parent company in the UK. Instead it was that the local boards completely stood aside and the parent company usurped their functions, an abnormal situation as between a parent company and its subsidiaries.³⁷⁷ This led the Judge to conclude that two distinctions must be made:

- a distinction between *exercising* management and control and on the other hand, *being able to influence* those who exercise the management and control
- a further distinction between on the one hand, *usurping* the power of the board, and on the other, *ensuring* that the local board *knows* what the parent company wishes its decisions to be.³⁷⁸ (own emphasis)

A further factor that must be taken cognisance of is the nature of the particular company. Some companies have but limited functions to perform, does not have active continuing businesses, nor required to remain in existence for long. These are often referred to as special purpose vehicles.³⁷⁹ Whilst they have an important role to play (often within international group structures), they tend to not have much outward activity, and often do not need frequent and lengthy board meetings.³⁸⁰ One may draw an analogy to a trust here, which may be an investment holding trust and thus passive by nature. Four cases were then discussed that exhibited the common features of being established to fulfil particular purposes, ancillary to the activities of those who caused them to be established. All the local managements responded to proposals presented to them, as opposed to taking initiatives of their own accord, and further implemented these as was the confident expectation at the time of their establishment.³⁸¹ Whilst the transactions involved were of

³⁷⁵ Par 21(High Court); *De Beers Consolidated Mines Ltd v Howe* (1906) AC 455; *Calcutta Jute Mills Co Ltd v Nicholson* 1 TC 83, and *Cesena Sulphur Co Ltd v Nicholson* 1 TC 88.

³⁷⁶ Par 22 &23 (High Court); – the following quote from the case indicates what had happened, the managing director of the parent company having concluded that "the situation of the African subsidiaries was becoming so serious that it was unwise to allow them to be managed in Africa any longer, and that their management must be taken over by the directors of [the parent company] in London."

³⁷⁷ Par 23 &24 (High Court).

³⁷⁸ Par 25 (High Court).

³⁷⁹ Par 25 (High Court).

³⁸⁰ Par 25 (High Court).

³⁸¹ Par 26-27 (High Court). The four cases were: *Re Little Olympian Each Ways Ltd* [1995] 1 WLR 560,

substantial quantum, their functions did not require much activity, and there were therefore no particular need for frequent exercise of central management and control. All of these could be distinguished from the *Bullock's* case and its usurpation of power by the parent, on the basis that here the parents “while telling the local boards what they wished them to do, left it to the local boards to do it.”³⁸² In relation to the argument that the trust company did not in fact take decisions, but did as it was told, it was concluded that there was no evidence that the settlor ever told the trust company anything. “He was a businessman, and it is overwhelmingly likely that he would leave the contacts with [the trust company] to his expert professional advisers.” Nor did the UK tax advisers propose things in the style of telling the trust company what to do – “professional advisers... are in no position to give orders to major banks and trusts companies.”³⁸³

There was also an unacceptable discrepancy between the finding on the facts by the commissioners that all the legal formalities were carried out abroad, including both the meetings whereby the transactions were approved, as well as the signature of the documents, and their conclusion that the company did not have its central management and control abroad.³⁸⁴ It was insufficient to prove central control and management in another jurisdiction simply by reason of the fact that Eulalia was participating in accordance with the overall plan for a tax scheme, devised and attended to by personnel in the UK.³⁸⁵ The decisions taken by the trust company as director of Eulalia were not “immaterial legal formalities”, but fundamentally necessary to the agreements being concluded.³⁸⁶

Although the judge therefore concluded that Eulalia was resident in the Netherlands, and thus the tie-breaker clause need not be invoked, he was prepared to consider the instance where his

Esquire Nominees Ltd v Commissioner of Taxation (1971) 129 CLR 177, *New Zealand Forest Products Finance NV v Commissioner of Inland Revenue* (1995) 17 NZTC 12,073, *Untelrab Ltd v McGregor* [1996] STC(SCD) 1.

³⁸² Par 27 (High Court).

³⁸³ Par42(ii) (High Court).

³⁸⁴ Par 43 (High Court).

³⁸⁵ In the Court of Appeal this was noted in the context that the Revenue had not produced positive material to show where the central management and control was located – it was not enough for them to criticize the lack of evidence from the taxpayers’ side, nor to state that it were part of a single tax scheme of which the architects was in the UK (Par 32)(Court of Appeal).

³⁸⁶ Par 43 & 65 (High Court). The Judge expresses his astonishment in such reasoning as follows, “... it is extraordinary that the Commissioners, having made that statement, came to the conclusion that Eulalia was resident in the United Kingdom, or at least came to the conclusion that it had not been shown that Eulalia was resident in the Netherlands. The making of the board resolutions and the signing and execution of documents which the Commissioners say were the only acts of management and control of Eulalia all took place in the Netherlands. A company is resident where its central management and control are situated. How, therefore, can Eulalia have been resident in the United Kingdom? How can it have been resident anywhere other than the Netherlands?”

conclusion should be found to be wrong, namely that the company was resident in the UK by reason of central management, and that to resolve the situation, the place of effective management would then need to be determined.³⁸⁷ These statements are therefore *obiter*. In his interpretation of the term, it is required that a “place” of effective management be identified. Whilst it may therefore be enough to say for domestic residence, that the central management and control was in the UK. Without identifying specific premises, it would not do for treaty purposes and a particular place must be identified. In respect of the role-players, the Settlor and tax advisers the Judge found that the place could not be said to be located at either. In respect of the Settlor, the Judge found it difficult to conceive his home or office as the place of effective management. In relation to the UK tax advisers, it was to be expected that they would strongly resist “any suggestion that, because a client is relying on them for, and is following, professional guidance which they are providing on a sophisticated scheme, which extends over several months. Their offices are a place of effective management of the client.”³⁸⁸ Instead in the view of the Judge, whilst not much effective management was required for Eulalia, the place where this was carried out, was at its director’s offices (the trust company) in the Netherlands.³⁸⁹ It was consequently concluded that Eulalia was resident in the Netherlands for purposes of tax residence, as well as for purposes of the tie-breaker.³⁹⁰ The conclusion as to the tax residence was upheld by the Court of Appeal.

In the Court of Appeal the analysis of the law by the High Court was endorsed, as well as the distinction made between cases, where the management and control of the company is exercised through its own constitutional organs and cases where the functions of these organs are “usurped” – ie management and control is exercised independently of, or without regard to these constitutional organs.³⁹¹ In instances which can be classified as the former, an essential distinction must also be made in respect of -

“the role of an “outsider” in proposing, advising and influencing the decisions which the constitutional organs take in fulfilling their functions and the role of an outsider who dictates the decisions which are to be taken. In that context an “outsider” is a person who is not, himself, a participant in the formal process (a board meeting or a general meeting) through which the relevant constitutional organ fulfils its function.”³⁹²

It further agreed with the High Court’s view, that the conclusion reached by the special commissioners on the facts they had found was wrong. Two of the fact findings were particularly

³⁸⁷ Par 73 (High Court).

³⁸⁸ Par 76 (High Court).

³⁸⁹ Par 81 (High Court).

³⁹⁰ Par 81 (High Court).

³⁹¹ Par 27 (Court of Appeal).

³⁹² Par 27 (Court of Appeal).

crucial hereto. Firstly, that the directors of Eulalia were not by-passed. Secondly, that their representatives signed the documents, both of which made it clear that the director of Eulalia did sign and executed the documents and in fact must have decided to do so.³⁹³ Consequently the case can not be treated as if they made no decision and there was no evidence that that anyone dictated the decision to them.³⁹⁴ In the Court of Appeal's view, there were two flaws in the commissioners' approach. The first legal flaw was to treat the decision made by the director, as not an "effective decision" by a constitutional organ, exercising management and control. It was not correct to refuse the decision as effective, because they made no other decisions. There were two critical decisions to be made, and both were in fact made by the director.³⁹⁵ The second flaw was to treat the decisions as not "effective", as they were made without proper information and consideration.³⁹⁶ The court's words in this respect provide valuable guidance –

"a management decision does not cease to be a management decision because it might have been taken on fuller information; or even, as it seems to me, because it was taken in circumstances which might put the director at risk of an allegation of breach of duty. Ill-informed or ill-advised decisions taken in the management of a company remain management decisions."³⁹⁷

For these reasons, it was found that Eulalia was not tax resident in the UK. This made the place of effective management unnecessary to be considered. In respect of the latter, the court did however state that it was not clear whether the test differ in substance, and if they do differ in substance, how in the present circumstances they could lead to different answers.³⁹⁸ Although this was technically an obiter statement, it would be recalled that in *Smallwood* reference was made to this statement and in particular that the special commissioners did not agree with such a statement, with the distinction laying in the function each is to serve.

Russo *et al* identify five important lessons from the case. Firstly, that an intention to reduce or avoid taxes is irrelevant, as neither the tax authorities or the court were influenced by the objective of the transaction, which was to reduce or avoid the resulting capital gains tax from the sale of the shares.³⁹⁹ Secondly, that a short interval of time between the various steps of a tax planning

³⁹³ Par 40 (Court of Appeal).

³⁹⁴ Par 41 (Court of Appeal). Per Staughton, they "might have had every incentive to carry it out, but it had the right to refuse if it wished, and had the power to do so." (Par 50).

³⁹⁵ Par 42 (Court of Appeal).

³⁹⁶ Par 43 (Court of Appeal).

³⁹⁷ Par 43 (Court of Appeal).

³⁹⁸ Par 6 & 44 of the judgment written by Chadwick, LJ. The further judges, Moore-Bick LJ did not present a separate written judgment but stated his agreement whilst Sir Staughton also agreed and endorsed it with a short judgment.

³⁹⁹ They note that court was clearly aware that the interposition of Eulalia was done with this aim, but that it did not form a factor in their judgment. Russo, R et al *A Decade of Case Law* (2008) at

structure is not necessarily a concern.⁴⁰⁰ Thirdly that substantial activities or personnel are not essential but rather to ability to conduct its business and factually do so.⁴⁰¹ Fourthly that the opinion of third parties may influence management decisions⁴⁰² and lastly, the place of effective management and central management and control may coincide.⁴⁰³ However the guidance from the case also comes with limitations. Firstly, it is a UK decision and other countries' courts are not bound to follow. Secondly, it was based on the facts in front of the court and further facts may have yielded an entirely different result. Thirdly, the application to such tax planning exercises of general or specific anti-avoidance legislation contained in the domestic law of countries, or in the treaty itself, was not considered. Fourthly, the impact of the technological improvements may render its application difficult in future, as the place where documents are signed, or decisions taken, may be multiple when parties utilise electronic mediums and are located in different countries simultaneously.⁴⁰⁴ Lastly, they also point out that the case's demonstration of how the concept of central control and management overlaps with place of effective management, reveals a further shared functional and structural deficiency, that both concepts may yield that the person's place of effective management or central management and control is in two countries.⁴⁰⁵

Meyerowitz highlights a further central feature of the case: that the company in question was only required to perform limited activities and those activities were conducted by management outside the UK.⁴⁰⁶ Thus he states that "amount of activity undertaken is not critical, provided the ultimate

7.2.4.2.1. Schwarz, J also concludes in discussing *Smallwood* that the question of avoidance is immaterial -Schwarz, J "How Tax Treaties Really Work" (2009) *Tax Adviser* September at 19.

⁴⁰⁰ The authors note that such a short period of time could be indicative of artificiality. Indeed here only 3 months had passed between the acquisition and sale of the shares and despite same, the court did not question the ownership nor did it have an impact on whether the benefits of the treaty should be granted to the entity. Russo, R et al *A Decade of Case Law* (2008) at 7.2.4.2.2. However this is in contrast with the *Smallwood*-case where the trust was "exported" for a very short period and returned which added to the court's conclusion that the trust's residence remained in the UK throughout.

⁴⁰¹ Most often such a question arises in the context of so-called letterbox companies. Here Eulalia's only purposes was to acquire, hold and then sell the shares. A minimum structure was required for this and as the board made the decisions relevant to these aspects and observed the formalities, the court gave acknowledgement to same. Russo, R et al *A Decade of Case Law* (2008) at 7.2.4.2.3.

⁴⁰² The question is whether the board is actually taking decision or but adopting the decision by others in which case such outsiders have usurped the function – which did not happen in the present instance. Russo, R et al *A Decade of Case Law* (2008) at 7.2.4.2.4.

⁴⁰³ On the fact the court found that they would have coincided. This then indicates that whilst there may be conceptual differences between the terms, they also exhibit similar characteristics and may in a given situation be difficult to distinguish. Russo, R et al *A Decade of Case Law* (2008) at 7.2.4.2.5.

⁴⁰⁴ Russo, R et al *A Decade of Case Law* (2008) at 7.2.4.3.

⁴⁰⁵ Russo, R et al *A Decade of Case Law* (2008) at 7.3.

⁴⁰⁶ Meyerowitz, DM "The Place of Effective Management" 2007 *The Taxpayer* 81 at 85. Gordon, K "Resident either here or there" *Tax Adviser* July 2006 points out that whilst the commissioners look

decisions on the key operations are genuinely taken in the jurisdiction.”⁴⁰⁷ Thus by analogy to a trust where there may be limited tasks to perform, should those who are authorised properly apply their mind to such tasks, then arguments that outsiders dictated their decisions will fail, and effective management of the trust, will be located where those decisions are made.⁴⁰⁸

7 5 4 *Indofood- cases*

The facts in this case are even more intricate, yet they were essentially not tax cases. Consequently only the issues relevant to the place of effective management and the meaning assigned to it in each of the courts⁴⁰⁹ will be discussed. At issue was the residence of company to be established, which would be interposed between an Indonesian Parent company and a Mauritian company. The interposition was part of a financial restructuring that was in part necessary due to the Indonesia/Mauritius Double Tax Agreement terminating at the time. The new interposed company was to be incorporated in the Netherlands, where all its records regarding trading, incorporation, shareholding or otherwise would be kept. Its accounting would be done by Netherlands auditors and all Netherlands registration requirements be complied with. It would have no fixed place of business of Indonesia.⁴¹⁰ Whilst the nationality of the directors may not be Indonesian, all would be resident in Indonesia.

In determining the question whether this company would be resident in Netherlands, the relationship between a parent company and a subsidiary was investigated in the High Court.⁴¹¹ Although the parent company may control a subsidiary through the exercise of its power to appoint and remove directors, it was still the board of the subsidiary company, which actually controlled the trading operation of the company and owes fiduciary duties to the company.⁴¹² As such it is they who will be held accountable for the actions of the subsidiary company in law. In the greater majority of cases, the subsidiary’s board will accept and carry out the policy of the board of the

holistically and found the company in question but to be a “mere cipher in the overall scheme,” their approach was rejected by High Court which had held that regardless of the function of the entity, as in their words its “residence is still the central control and management test: it is not the law that that test is superseded by some different test if the business of a company is such that not a great deal is required for central control and management of its business to be carried out.’

⁴⁰⁷ Meyerowitz, DM “The Place of Effective Management” 2007 *The Taxpayer* 81 at 85.

⁴⁰⁸ Meyerowitz, DM “The Place of Effective Management” 2007 *The Taxpayer* 81 at 85.

⁴⁰⁹ Citation for the High Court case *-Indofood International Finance Ltd v JPMorgan Chase Bank, N.A., London Branch* [2005] EWHC 2103 (Ch), and for the Court of Appeal *Indofood International Finance Ltd v JPMorgan Chase Bank, N.A., London Branch* [2006] EWCA Civ 158.

⁴¹⁰ Par 20 (High Court).

⁴¹¹ Par 35 (High Court).

⁴¹² Par 35 (High Court).

parent as its commercial interests will coincide.⁴¹³ Yet there may be occasions, where the subsidiary's board will stand out to the point of resignation against the wishes of its parent. In relation to this last point, the court found authority in the case of *Wood v Holden*.⁴¹⁴

On appeal the court disagreed. On the assumption that the new company is treated as resident in the Netherlands, based on the place where it will be incorporated and on the further assumption that the Indonesian Tax authorities also regard it as resident, then the tie-breaker, the place of effective management, would be invoked. Thus the court referred to the OECD commentary on the article and in particular, that it finds this place to be the "place where the key management and commercial decisions are made."⁴¹⁵ Whilst it was argued that the company would be sought to conduct the management in the Netherlands, by taking decisions as to the keeping of its books and audit, the handling of interest and equity capital, in the Netherlands, this was not in the court's view enough and were not "key" decisions.⁴¹⁶ In fact, the provisions of the trust deed and the note conditions showed clearly, that key decisions relating to the company would be taken by the parent company. It was in the courts' view "plain", that residence of the new company would be in Indonesia where the parent company would effectively manage it.⁴¹⁷

7 5 5 *News Datacom Ltd & News Data Security Products Ltd v Revenue & Customs*

Although the term "place of effective management" did not feature in the *News Datacom*-case⁴¹⁸, the issue of residence did, and the case is included here for its endorsement of the *Wood v Holden*-case.⁴¹⁹ In this case, the court noted that for the test of residence there is the generally accepted

⁴¹³ Par 35 (High Court).

⁴¹⁴ Par 35 (High Court).

⁴¹⁵ Par 55 (Court of Appeal).

⁴¹⁶ Par 56 (Court of Appeal).

⁴¹⁷ Par 57 (Court of Appeal).

⁴¹⁸ *News Datacom Ltd & News Data Security Products Ltd v Revenue & Customs* [2006] UKSPC SPC00561 (06 September 2006). The decision was made in principle. The relevance of the question of residence here lay in the effect that should the relevant company be regarded as resident at the time that it disposed of its business then it would together with a further company be regarded as forming a chargeable gains group and an exit charge would arise on the transfer of shares underlying the departure of the one company to the group. (Par 7).

⁴¹⁹ The relevant company was a company incorporated in Hong Kong of which 60% of the shares were held by UK resident company forming part of the News Group, whilst the remaining 40% were held in Israel who had the real technical expertise to advance the company's purpose being a joint venture to pursue commercial applications of certain mathematical codes. The majority of its directors were resident outside the UK. All board meetings were held in foreign destinations save for one meeting held in London held on the completion of the buy-out of the minority. In the commissioners view, this meeting was but a discussion of ministerial matters and of good housekeeping, and was not concerned with policy strategic or management matters relating to he

test, as established in the *De Beers* case and that there is now also the assistance of the *Wood v Holden* case.⁴²⁰ The court followed the test laid down in the latter case, by first looking at the two categories between which a distinction must be made – ie where the management and control is exercised by the company’s own constitutional organs and secondly, where the functions are “usurped.”⁴²¹ In the present instance, a finding on the facts indicated that there was no usurpation as per the second category. Once so determine, it must, per the historical authorities, be determined where the management and control, in the sense of the exercise of its controlling brain, was exercised outside the UK or not.⁴²² In the present instance, all of the board meetings took place outside the UK. The one meeting that did take place in the UK, was found to be a purely ministerial or of a housekeeping nature and is to be disregarded for purposes here.⁴²³ Consequently, it was found that the relevant company was resident outside the UK.

7 5 6 *Laerstate BV v Revenue & Customs*

A more recent case in 2009 was that of *Laerstate BV v Revenue & Customs*.⁴²⁴ In particular the two questions before the court was, whether a Dutch incorporated company was a UK resident for tax purposes and secondly, whether for purposes of the UK-Netherlands double taxation agreement, it was also resident in the UK on the “place of effective management” as tie-breaker.

The court commenced its decision in respect of the first question, with reference to the established legal test for corporate residence. Thus the precedent cases on the issue were cited, and the guiding principles in the court’s view extrapolated from each. In relation to the *De Beers* case, the court commented that there is no rule, that “central management and control” must follow where

conduct of the business. It was not a manifestation of the controlling brain or where the business was really carried. (Par 23- 30, 54 – 64). It had been the revenue’s case, that at the meeting the quorum was changed which is central to the management and control of the company’s business as it determines who can carry out the management and control. It could therefore not be said to be merely ministerial. It was also their submission that the *Wood v Holden* case does not change the test, in that the focus can not only be on the location of directors meetings, but must be where it “actually abides” and “keeps house.”(Par 129-139) An executive committee was however also in existence, and this committee convened most of its meetings in the UK. This committee was however found to be concerned with day-to-day operational matters and did not exercise the controlling brain of the company. (Par 65 -66) Insofar as there were external influences these originated from the USA and Israel, and not the UK. (Par122)

⁴²⁰ Par 144-145.

⁴²¹ Par 147-148.

⁴²² Par 149 -151.

⁴²³ Par 157 -158.

⁴²⁴ [2009] UKFTT 209 (TC).

the directors meet, it remains entirely a question of fact.⁴²⁵ If the company is managed by its directors in board meetings, it will be found where the board meetings are held. Should the management be carried out outside the board meetings, then it must be determined who was managing the company through making high level decisions and where, even should the latter be in contravention of the company's constitutional documents.⁴²⁶ The test is also not confined to a consideration of the particular actions of the company, should in a given case, a broader general overview of the course of business and trading of the company demonstrate, that the central management and control abide in the UK.⁴²⁷ This is to be derived from the words of Lord Loreburn in the test "upon a scrutiny of the course of business and trading."⁴²⁸ Residence will not oscillate between countries, simply by reason of individual acts of management and control taking place in different countries. The whole picture must be considered in each case.⁴²⁹

In relation to the case of *Bullock v The Unit Construction*,⁴³⁰ it was concluded that it illustrated that it would be an exception for a parent company to usurp control of its subsidiary.⁴³¹ The comments made in the *Wood v Holden*⁴³² case was reiterated. In that case the decisions had all been made at meetings outside the UK, by the managing director of the company and these meetings could not in the court's view be dismissed as immaterial legal formalities.⁴³³ However mere physical acts of executing resolutions or documents do not constitute actual management.⁴³⁴ This brought the court to its next point, the consideration of the influence of third parties such as a majority shareholder, parent company etc and found that the determining line is whether the directors are making the decisions, or are not making any decision at all.⁴³⁵

They concluded that it is possible to differentiate between the extent of such influence on a scale:

- On the extreme end of this scale is where an agreement is placed in front of the directors open at the signature page and they sign it regardless; a case thus of "mindless signing."⁴³⁶
- Secondly is the instance where the directors know what they are signing, but are

⁴²⁵ Par 27.

⁴²⁶ Par 27.

⁴²⁷ Par 28.

⁴²⁸ Par 28.

⁴²⁹ Par 29.

⁴³⁰ [1960] AC 351.

⁴³¹ [2005] STC 789 (High Court decision).

⁴³² Par 31.

⁴³³ Par 32.

⁴³⁴ Par 33.

⁴³⁵ Par 34.

⁴³⁶ Par 34.

signing it without consideration as to whether they should sign or not. To test this objectively the question can be posed whether the directors have the absolute minimum amount of information required, to make a decision to agree to follow the wishes of the shareholder, or decide not to sign. If not, there would still be no decision.⁴³⁷

- A further alternative is where the directors follow the wishes of the shareholder, after considering whether or not to follow them, and have the absolute minimum information at their disposal. Yet this level of information would still be less than what a reasonable director would require, to make a sensible decision on whether to embark on the course of action as wished by the shareholder. This is the case of “ill-informed or ill-advised decisions. “ Yet they remaining management decisions – even if ill-informed.⁴³⁸
- At the other end is where the directors have sufficient information to make an informed decision. Factors such as whether the directors would have declined to do something improper or inadvisable, which they did not agree with, is examples in this category.⁴³⁹

Upon application of the law to the facts, it was felt that it was necessary to distinguish between two parts. The first where the central role-player, Mr Bock was a director of the company, and the second part where he was not, but remained the sole shareholder.⁴⁴⁰ In respect of the first part, it was found that central management and control of the company was in the UK. This was not based on the fact that Mr Bock was as individual resident in the UK, but rather on an affirmative answer to the question, whether he was as director of the company exercising the central management and control in the UK.⁴⁴¹ Whilst it was argued on his behalf that all acts of management and control took place outside the UK, that only matters of good housekeeping and ministerial matters, such as meetings with lawyers and advisers took place in the UK, the court concluded differently - finding that Mr Bock’s activities went beyond this level in the UK and were certainly concerned with policy strategic and management matters, including decision-making.⁴⁴²

⁴³⁷ Par 35.

⁴³⁸ Par 36.

⁴³⁹ Par 37.

⁴⁴⁰ Par 38 & Par 3 of agreed statement of facts.

⁴⁴¹ Par 39.

⁴⁴² Par 40 – 41.

In respect of the second part, here too it was found that despite Mr Bock ceasing to be a director, the company itself was resident in the UK. The director at this time was a Mr Trapman and it was his signature on behalf of the company, that would constitute a binding act. The question was therefore when doing so, on which point of the spectrum his actions lie.⁴⁴³ It would need to be determined whether he acted on Mr Bock's instructions without considering the merits, or whether he considered Mr Bock's wishes and made the decision himself, whilst in possession of the minimum information necessary for anyone to be able to decide whether or not to follow them.⁴⁴⁴ In particular the actions or inactions of the company on three particular occasions were therefore considered, and in all of these it was found by the court that Mr Trapman did not make the decision to do any of them.⁴⁴⁵ The decision was that of Mr Bock, whilst Mr Trapman signed the documents necessary to give effect to the decisions, such decisions were dictated by Mr Bock. There was no change perceivable in the way the company was managed prior, or subsequent to retirement of Mr Bock as director.⁴⁴⁶

As the conclusion was reached that the company was resident in the UK, and on account of its incorporation in the Netherlands, would also be regarded as resident in that country, the double taxation agreement between the countries was activated. The tie-breaker to the agreement where a company is found resident in both states, was stated in article 4(3) to be the place of effective management. The court referred in this respect to the approach followed by the special commissioners in *Smallwood v HMRC*.⁴⁴⁷ The court adopted their reasoning and conclusions as to the distinction between 'central management and control' and 'place of effective management'.⁴⁴⁸

The parties did however disagree as to the time over which the issue of 'place of effective management' should be applied. For the appellant, it was argued that it should be at the time of each of the relevant events, whilst revenue contended that it should be applied throughout the period of dual residence.⁴⁴⁹ The court ventured that this may be a distinction without a difference because it is of the nature of the concept of 'place of effective management', as it is with 'central

⁴⁴³ Par 42.

⁴⁴⁴ Par 42.

⁴⁴⁵ Par 42-44.

⁴⁴⁶ Par 45.

⁴⁴⁷ Par 48.

⁴⁴⁸ Par 48. In particular that "CMC determines whether a company is resident in the United Kingdom or not; POEM is a tie-breaker the purpose of which is to resolve cases of dual residence by determining in which of two states it is to be found. CMC is essentially a one-country test; the purpose is not to decide where residence is situated, but whether or not it is situated in the United Kingdom...POEM, on the other hand, must be concerned with what happens in both states since its purpose is to resolve residence under domestic law in both states..."

⁴⁴⁹ Par 49.

management and control', that it must be applied by reference to the facts taken over a period. However the need to decide this issue was obviated by the fact that, whichever period is applied here, the result will be the same.⁴⁵⁰ As it had been found that Mr Bock's activities were concerned with policy, strategic and management matters throughout the whole period. Thus whilst he was a director and even when he ceased to be, it was found that his activities constituted the real top level management, the realistic positive management of the company.⁴⁵¹ This was in contrast to Mr Trapman's activities who although the director, were limited to the signature of documents upon instruction and dealing with routine matters. The place of effective management of the company, was thus also held for purposes of the treaty residence, to be in the UK.⁴⁵²

Davis in discussing the case, remarks that its significance lies therein that it developed a substantive test. Whilst the legalities of the structure may have shown the taxpayer to be formally managed and controlled in one country, in substance the mind of the entity was exercised through the decision-making process of Mr Bock, residing in another country and this trumped the formal structure.⁴⁵³ Khvat & Ross note that decision-making is central focus of the case and that it reaffirmed, that the "dividing line" is to be drawn at the point where the decisions is made, whether it is informed or ill-informed.⁴⁵⁴ However a further feature of previous cases is important in that a distinction may be made between decisions concerning ministerial matters and substantive issues. The authors refer to the *Wensleydale's Settlement*-case, where the decision to open a bank account was not regarded as effective management, similarly the *News Datacom*-case indicated that meetings dealing with housekeeping such as the change to a quorum, or the registration of share transfers are insufficient.⁴⁵⁵ Lastly, they conclude that the problem with both place of effective management and central management and control is, that they are premised on the assumption that strategic and policy decisions will occur, and this renders them impracticable when such decisions cease to occur regularly.⁴⁵⁶

⁴⁵⁰ Par 49.

⁴⁵¹ Par 50.

⁴⁵² Par 51.

⁴⁵³ Davis, D "The Case of Effective Management" 2010 *The Taxpayer* (1) at 5.

⁴⁵⁴ Khvat, L & Ross, J "Authorities take corporate residency win" (2009) *International Tax Review* November at 43. This is also highlighted by Davis in that where there is no absolute minimum information there is no decision, but by contrast where there is an absolute minimum information, whether such decision is ill-informed or not, it remains a decision.

⁴⁵⁵ Khvat, L & Ross, J "Authorities take corporate residency win" (2009) *International Tax Review* November at 43.

⁴⁵⁶ Khvat, L & Ross, J "Authorities take corporate residency win" (2009) *International Tax Review* November at 43.

7 6 Conclusion

In SARS' Interpretation Note, it is encouraged that "international precedent and interpretation" be utilized to ascribe a meaning to the "place of effective management" and particular mention is made in the Note of the OECD's publications.⁴⁵⁷ A further publication is the UN Model Tax Convention. Consequently in formulating an interpretation of the second criteria of the test for residence "place of effective management" in the context of trusts, guidance should be sought from these publications.

The contents of the UN Model Tax Convention bear great similarity to that of the OECD' Model Tax Convention. The discussion above has however also revealed a further shared characteristic between these conventions, namely the omission to address trusts specifically. The guidance one is able to extract from the UN's publication lies in its comments on "place of effective management." This it perceives to be on a very high level of management, by requiring that it be the "place where the decision-making at the highest level on the important policies essential for the management... the place that plays a leading part in the management from an economic and functional point of view..."⁴⁵⁸

So too does the OECD Model Tax Convention not consider trusts specifically. Indeed in the convention itself and the accompanying commentary, there is but the briefest of mention of trusts, and no detailed guidance is provided by any of its other publications or special reports.⁴⁵⁹ Honiball & Olivier elaborate on this aspect by referring to the OECD's Partnership Report, which states that many of the principles discussed in the report would be applicable to trust, but does not then identify which principles would apply.⁴⁶⁰ Baker holds a similar view, concluding that the OECD Model and its Commentaries "give virtually no guidance as to the application of double taxation conventions to trusts, trustees or their beneficiaries."⁴⁶¹ Avery Jones too is of the view that this is a "subject that is virtually ignored in the OECD Model and its Commentaries."⁴⁶²

⁴⁵⁷ SARS "Interpretation Note No. 6: Resident: Place of effective management (persons other than natural persons)" issued 26 March 2002.

⁴⁵⁸ Par 10 of Article 4 of the Commentary to the Convention - United Nations "United Nations Model Double Taxation Convention between Developed and Developing Countries" (2001) at 67. The authority for that last consideration is not cited anywhere in the text.

⁴⁵⁹ In the commentaries trust are mentioned under real estate investment trusts (REITS) and following the last 2010 update, also in respect of collective investment vehicles as such structures are amongst other entities, often also held in a trust.

⁴⁶⁰ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 283; OECD *The Application of the OECD Model Tax Convention to Partnerships* (adopted on 20 January 1999).

⁴⁶¹ Baker, P "The Application of the Convention to Partnerships, Trusts and Other Non- Corporate

Of late, the OECD's last two reports have improved on this reputation as these concern trusts to a certain extent, but specialized forms thereof, namely the real estate investment trust as well as the collective investment vehicle. The OECD's Model Tax convention therefore gives but limited guidance to the issue at hand, in the form of the general application of the concept of "place of effective management" and it is to this aspect, the discussion was dedicated.

The discussion commenced with a review of the historical development of the OECD's Model Tax Convention, particularly focusing on the evolution of the concept of "place of effective management." From such discussion it was clear that since the preparation of the first drafts a century ago, the concept has always required a factual approach. One that is focused on what is real as opposed to formal criteria. There also appears to be evidence that with the introduction of the term, it was intended to be a "notion distinct and independent"⁴⁶³ from the various criteria, that member states were applying in their domestic law, and that a different meaning should be assigned to it. However as Burgstaller & Haslinger⁴⁶⁴ concludes

"The history seems to show that the meaning of place of effective management was never clear. The unfortunate feature of it is that the expression is sufficiently close to practically every country's domestic law that they all consider that it means the same as their domestic law expression."

The OECD has attempted to provide clarity, by providing a possible meaning for the term in its commentary. However such meaning also appears to be in a state of flux. In particular the 2000 OECD Commentary stated that the place of effective management would be the "place where key management and commercial decisions necessary for the conduct of the entity's business are made." However, in their further elaboration on the term, they placed the emphasis on the place where the most senior person or group of person would meet and where actions for the entity as a whole are determined. Owing to a fast modernizing world characterized by technological developments, the definition has since been amended. Preceding such amendment were two discussion papers, which focused on the impact of the communications revolution and the place of effective management. Certain proposals had been made in these Discussions Paper to replace the

Entities" 2002 GITC Review Vol II No 1 at 12-13.

⁴⁶² Avery Jones, JF "The treatment of trusts under the OECD Model Convention: Part 1" B.T.R. 1989, 2, 41-60 at 41.

⁴⁶³ Sarig, S "The evolution of Article 4(3) and its impact on the place of effective management tie breaker rule." *Intertax* 32 10 (2004) 460.

⁴⁶⁴ Burgstaller, E & Haslinger, K "Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects" 2004 *Intertax* (32) 8/9 at 381.

place of effective management with other criteria, namely place of incorporation (or place where the law applies governing the establishment of the entity), place where the directors or shareholders reside, and place where the economic nexus is the strongest. An alternative proposal was to refine it, and lastly to replace it with a hierarchy of test.

The 2008 Update to the Commentary contained the outcome of these proposals. It preserved the place of effective management as tie-breaker and further also retained the equation of the place of effective management, with the place where key management and commercial decisions as a whole are made, but the reference to the senior persons or group of persons was deleted. Furthermore an alternative tie-breaker was inserted, namely one of mutual resolution by the competent authorities of the contracting states. In chapter 5, the change in SARS' approach has been discussed. It will recalled that current Interpretation Note is focused on where the strategic decisions and policies are executed and implemented, rather than where they are taken, thus causing such view not be *en par* with the international view. The endeavours by SARS to align our approach with the OECD and international community were also discussed there and it was noted SARS' intended approach would still include focusing on the second level of management, but its primary emphasis would be on those top personnel who "call the shots", those who exercise realistic positive management by actually developing or formulating key operation, or commercial strategies and policies, and ensuring that those strategies and policies are carried out.⁴⁶⁵

Whilst the different levels of management is important in a corporate setting, it is not necessarily appropriate or even relevant in a trust setting. In a trust setting other issues of greater significance arise, particularly in a treaty context. Four such issues were discussed, which will have an influence on whether the trust can be said to be resident. Firstly, whether the trust may be regarded as a person for purposes of the treaty. Secondly, whether the trust can be said to be liable to taxation. Thirdly, whether the trust may be regarded as beneficially entitled to the income. The fourth issue is one which arises particularly in the South African context, where the term "place of effective management" is used as criteria, to attribute residence domestically and consequently when a tie-breaker based on this term is invoked, whether a different meaning should be applicable.

Case law however appears to provide the most valuable guidance to the meaning of the term. Firstly considered, was the case of *Wensleydale's Settlement Trustees v Inland Revenue*

⁴⁶⁵ SARS "Discussion Paper on Interpretation Note 6" September 2011 at par 8.1.

Commissioners,⁴⁶⁶ which set the precedent of equating the place of effective management to the colloquial place “where the shots are called”, and emphasizing that “realistic positive management” is required. A second case where a trust featured, was the case of *Smallwood and another v HMRC*.⁴⁶⁷ This case denounced a snapshot approach to be followed when determining the residence of the trust, preferring a holistic approach. It furthermore also provides insight to the interchange between management and influence, and is an example where the influence of outsiders (parties other than the trustees) were such, that it overshadowed the management by the trustees, rendering the place of effective management of the trust and its residence, to be located in the place from where such influence was exerted. Locally, in the recent *Oceanic*-case,⁴⁶⁸ express reference was made to the case and the court in reaching its conclusion, applied the test set out in this case, thus enhancing its precedential value.

The importance of “influence in a management context, is an issue that was first raised in the case of *Wood v Holden*.⁴⁶⁹ Here the Special Commissioners held that the term “place of effective management”, was similar to “central management and control”, with the latter requiring actual and effective control. They concluded that the mere physical acts of signing resolutions or documents are insufficient for actual control.⁴⁷⁰ In the appeal case, certain insightful observations were made by the High Court. Firstly, that two important distinctions should be made. The first being the distinction between *exercising* management and control and on the other hand, *being able to influence* those who exercise the management and control, with a further distinction between an instance where the power of the board is *usurped*, and on the other, an instance where it is *ensured* that the local board *knows* what the parent company wishes its decisions to be. Furthermore that the nature of the particular entity, whether it has an active continuing business, or but limited functions, should be taken into account. The Court of Appeal endorsed the High Court’s conclusions, also emphasizing the difference between “the role of an “outsider” in proposing, advising and influencing the decisions, which the constitutional organs take in fulfilling their functions and the role of an outsider who dictates the decisions which are to be taken.”⁴⁷¹ It further reviewed the importance of insufficient information, finding that it does not necessarily detract from such decision’s status.

⁴⁶⁶ [1996] S.T.C. (S.C.D.)241.

⁴⁶⁷ [2010] EWCA Civ 778 (Court of Appeal (Civil Division)).

⁴⁶⁸ *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127.

⁴⁶⁹ 2006 EWCA Civ 26 (Court of Appeal); 2005 EWHC 547 (High Court); 2003 Case no SPC00422 (Special Commissioners).

⁴⁷⁰ Par 145. (Special Commissioners).

⁴⁷¹ Par 27 (Court of Appeal).

Next in line were the *Indofood*-cases⁴⁷² and the reflection in that case on what would constitute “key” decisions. The *News Datacom*-case⁴⁷³ endorsed the distinction made in the *Wood v Holden*-case, between a situation where management and control is exercised by those legally authorised to do so and a situation where it is usurped. The last case discussed, the *Laerstate*- case,⁴⁷⁴ also confirmed the *Wood v Holden*-case and elaborated on this by introducing a scale upon which the influence of outsiders could be measured.

These cases and the above discussion has illustrated that the “place of effective meaning” does not have an universal meaning⁴⁷⁵ and that there are many difficulties surrounding its interpretation and application. Yet as Burgstaller & Haslinger conclude, “Despite the difficulties that may be involved in determining the place of effective management, it is a well-established concept, due in part to a long tradition of court cases and tax literature, most cases of dual residency will be solved by applying this tie-breaker rule.”⁴⁷⁶

To conclude, it is in South Africa’s interest to be aware of and keep abreast of the international community’s viewpoint. This will prevent isolation and stagnation of our local law. This chapter’s discussion of the development of meaning attributed to the term “place of effective management” by the OECD and foreign courts will assist in achieving these goals by informing our local understanding of the term. That such a consideration of international case law and commentary does hold value for our interpretation, is implicit to the endorsement of the *Smallwood*-case by our local judicial bench,⁴⁷⁷ and demonstrates the importance of such an exercise.

⁴⁷² Citation for the High Court case *-Indofood International Finance Ltd v JPMorgan Chase Bank, N.A., London Branch* [2005] EWHC 2103 (Ch), and for the Court of Appeal *Indofood International Finance Ltd v JPMorgan Chase Bank, N.A., London Branch* [2006] EWCA Civ 158.

⁴⁷³ *News Datacom Ltd & News Data Security Products Ltd v Revenue & Customs* [2006] UKSPC SPC00561 (06 September 2006).

⁴⁷⁴ [2009] UKFTT 209 (TC).

⁴⁷⁵ SARS “Discussion Paper on Interpretation Note 6” September 2011 at 3.

⁴⁷⁶ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 381.

⁴⁷⁷ *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127.

CHAPTER EIGHT:**THE “RESIDENCE” OF TRUSTS FOR FISCAL PURPOSES IN OTHER JURISDICTIONS****8 1 Introduction**

Upon commencing this chapter, the question immediately arises as to why regard should be had to other jurisdictions and the manner in which they have dealt with this issue, as the term “residence” is after all the connecting factor South Africa has chosen. Thus in founding its jurisdiction, it will be the understanding of the term as embodied in the statutory definition formulated by the South African legislature and elaborated upon by the South African fiscus and judiciary. Furthermore conducting such an exercise of comparing the domestic law with those of other countries, has its disadvantages and risks, as was aptly summarized by Judge Pillay¹,

“Not having precise information, not knowing the socio-economic and political context in which the foreign law operates and not having the luxury of time to delve sufficiently into foreign laws and the context in which they are applied, lead to inappropriate comparisons and consequently incorrect application of foreign law.”

Yet these disadvantages and risks do not entirely negate the value such an exercise holds. Indeed the approach of other jurisdictions may assist in improving and advancing our local approach, interpretation and practical application. It may also reveal inadequacies and deficiencies for which assistance and insight may be gleaned from the manner in which same has been addressed in such countries. It may also prevent stagnation and isolation of local law. Perhaps the importance of such a comparative exercise has best been stated by Justice O’Regan² -

“It would seem unduly parochial to consider that no guidance, whether positive or negative, could be drawn from other legal systems’ grappling with issues similar to those with which we are confronted. Consideration of the responses of other legal systems may enlighten us in analysing our own law, and assist us in developing it further... To forbid any comparative review because of those risks, however, would be to deprive our legal system of the benefits of the learning and wisdom to be found in other jurisdictions. Our courts will look at other jurisdictions for enlightenment and assistance in developing our own law. The question of whether we will find assistance will depend on whether the jurisprudence considered is of itself valuable and persuasive. If it is, the courts and our law will benefit. If it is not, the courts will say so, and no harm will be done.”

It would also appear that in the specific context of fiscal residence, there is express encouragement to conduct such a comparative exercise. This is particularly so in the context of the second criteria

¹ *Jafta v Ezemvelo KZN Wildlife*[2008] 10 BLLR 954 (LC) at par 79-81, 91; see also *Pyott v CIR* 1945 AD 128 at 136 where Davis, AJA stated “the decisions of other countries must be cautiously approached.”

² *K v Minister of Safety and Security* 2005 (9) BCLR 835 (CC) at par 35.

of the test for residence, that of “place of effective management” as the Interpretation Note expressly states “is not defined in the Act, the ordinary meaning of the words, taking into account *international precedent and interpretation*, will assist in ascribing a meaning to it.”³ Such a method would be in accordance with the constitutional obligation placed upon our local courts in terms of section 233 of the Constitution of South Africa.⁴ The latter section mandates local courts in their interpretation of legislation, to give preference to “any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.” The Income Tax Act as well as double tax agreements entered into between our governments and those of other countries, would fall within the ambit of such “legislation”, where this interpretational manner must be adhered to.⁵

It is for these reasons that this chapter is dedicated to this task. The chapter commences by reviewing the approach to the fiscal residence of trust in various jurisdictions, culminating in the consideration of the approach applied in Canada and the United Kingdom. As was stated in the introductory chapter, the reason for selecting these two countries is two-fold. Firstly, there appears to be sufficient similarities for such a comparison. Both countries recognise the trust as a legal institution (albeit not legal person) and furthermore apply residence-based taxation. Secondly, in such countries there has in recent times been a marked increase in the attention by their legislature and judiciary to the residence of the trust. It is thus hoped that their insight and conclusions to this issue will be helpful, to improve and advance our own structures and understanding. Mindful of the cautious approach to be followed in respect of a comparative exercise, we now embark on this journey.

8 2 The Fiscal Residence of Trusts in other jurisdictions

Countries have very divergent approaches to determine the residence of a trust. Yet even where countries have the same criterion of residency, their interpretations may still differ.⁶ The discussion below illustrates this statement and briefly looks at several countries. Firstly discussed is the position in civil law countries, then examples of countries located in typical “low tax” jurisdictions

³ Interpretation Note No. 6: Resident: Place of effective management (persons other than natural persons) issued by SARS on 26 March 2002 at par 2.

⁴ Constitution of South Africa, Act 108 of 1996

⁵ Double tax agreements if approved by Parliament and published in the Government Gazette are treated as if they were effectively enacted in the Act per the provisions of s 108 (1) –(2). Oguttu, AW “Resolving double taxation” 2008 (41) CILSA at 102.

⁶ Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 Intertax (32) 8/9 at 379.

follow, and lastly the approach in two common law countries, the USA and Australia is considered. Thereafter, the two jurisdictions selected for a more in-depth study in this thesis, Canada and the United Kingdom, are discussed.

8 2 1 Civil law countries

The trust being a common law invention, is mostly found in countries which have such a heritage, the so-called Anglo-Saxon jurisdictions. Thus, in Europe, where the greater majority of countries have a civil law tradition, they most often do not have the trust in their domestic law. This is in part attributed to the fact that during the years of the trust's initial development, these countries had strong monarchies, which protected the potential for land reversion to the crown.⁷ Where trusts were found on the Continent, it was in the ownership of land by the Church. When there was later a movement to complete codify these countries' laws, referred to as the civil codification, these codes specifically rejected trusts from a progressive viewpoint, that the Church was a substantial landowner through trusts of property on the continent, as well as the fact that certain aspects of trusts were irreconcilable with established principles of their law. For example the trustees' discretion to apportion property, conflicted with their entrenched principle of forced heirship.⁸ Following the introduction and subsequent acceptance by several of these countries of the Hague Convention on the Recognition of Trusts,⁹ the trust has however become a more recognisable institution in these countries. Countries that have ratified the Convention and accepted the trust, will then also need to address the taxation of the trusts.¹⁰

Italy, for example, was the first civil law country which ratified the Hague Convention on the Recognition of Trusts.¹¹ One writer states that "the Italian experiment has been marked by great

⁷ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 241.

⁸ King R, Victor B et al *Estate Planning & Fiduciary Services Guide 2013* (2013) at 241-242.

⁹ Convention on the Law Applicable To Trusts And On Their Recognition, The Hague on 1 July 1985. For example, Belgium does not recognise the trust in its civil and fiscal laws, yet its courts may recognise an overseas trust unless it breaches law and order; France was also reluctant to accept the concept and initially sought to compare it to civil law concepts, but have, from a corporate point of view introduced the concept of a trust with the introduction of the fiduciary system in 2007; in Germany the uncertainty still persists and an approach to analyse the trust deed and how it can be made to fit in with existing German principles is followed. Saunders, R *International Tax Systems and Planning Techniques* (2010) at 74, 154, 220..

¹⁰ Avery Jones, JF "The treatment of trusts under the OECD Model Convention: Part 1" B.T.R. 1989, 2, 41-60 at 41.

¹¹ Ratified in 1992. Smith L *Re-imagining the Trust: Trust in Civil Law* – Chapter 2 Graziadei, M Recognition of common law trusts in civil law jurisdictions under the Hague Trusts Convention with particular regard to the Italian experience at 32-33; E-book available at <http://ebooks.cambridge.org.ez.sun.ac.za/pdf>. Last accessed on 01/05/2013.

success and it is not uncommon to find trusts, which (but for the proper law) are exclusively connected with Italy.”¹² Italy can therefore be regarded as a leader in this respect, and their approach may offer indications as to the treatment other civil law countries may adopt in dealing with trusts.¹³

In Italy, trusts are treated similarly to companies and consequently will be taxed should they be resident or have Italian source income.¹⁴ Trusts are regarded to be resident in Italy should either

- Their legal seat or
- the place of management; or
- the main business of the trust be located in Italy for the greater part of the tax year.

Regarding the interpretation of these criteria, it is regarded that the actual place of management would be at such place as where the trust utilises a specific organisation structure (premises or employees) in the attainment of its purpose, and in the absence thereof, such place would be deemed to coincide with the trustees’ tax residence.¹⁵ The default residence of a trust is therefore presumed by the tax authorities to be the trustee’s country of residence.¹⁶

In respect of the main business purpose criterion, this is interpreted to strictly relate to the particular trust’s purpose ie where the purpose of the trust is to hold immovable property, regard is had to where such property is situated, if entirely in Italy, then the trust will resident there, if in different countries, the principle of primacy is applied.¹⁷

Lastly a deeming provision is also included, so that a trust will be regarded as resident, should the trust *not* have been established¹⁸ in a country which appears on the “white list” of countries which

¹² Noseda, F “Recent Changes in Italy affecting Trusts: an Italian Earthquake” 2007 PCB (5) 335.

¹³ Noseda, F “Recent Changes in Italy affecting Trusts: an Italian Earthquake” 2007 PCB (5) 335.

¹⁴ Noseda, F “Recent Changes in Italy affecting Trusts: an Italian Earthquake” 2007 PCB (5) 335.

¹⁵ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 289.

¹⁶ According to Maisto the local fiscus has indicated that the place of administration of the trust must coincide with the fiscal domicile of the trustee. Maisto, G “Italy” in PLC ‘s Cross-Border tool – available at <http://crossborder.practicallaw.com/7-515-3348?q=private+client> (last accessed on 07/05/2013).

¹⁷ Alternatively if it is understood that should the trust assets consist of personal property, the main business purpose of the trust would be the actual activity of the trust itself. Saunders, R *International Tax Systems and Planning Techniques* (2010) at 289.

¹⁸ The term used for this is “*istituto*” However although crucial to the application of this section, Noseda notes that it is not entirely clear what factor determines whether the trust is established in a particular country : place where the trust deed is executed, or where the assets are transferred, or the proper law of the trust, or the residence of the trustees. Noseda, F “Recent Changes in Italy affecting Trusts: an Italian Earthquake” 2007 PCB (5) 334.

exchange information with Italy *and* one of the following conditions is met: (a) at least one of the settlors and one of the beneficiaries is resident in Italy or (b) after its establishment, an Italian resident transferred immovable property or rights related to property in Italy.¹⁹ This is a rebuttable presumption and a taxpayer can produce evidence to the contrary.²⁰

Three types of trust for tax purposes are distinguished. *Opaque* trusts where the trust income is taxed at the trust level according to Italian tax rules applicable to commercial entities. *Transparent* trusts where the beneficiaries have a current entitlement or fixed interest and whilst the income is determined at trust level, it is taxed at the beneficiary level. Lastly *interposed* trusts, which are disregarded for tax purposes and the underlying assets are regarded to belong to either the settlor or beneficiaries and is taxed in their hands.²¹

Whilst Italy therefore follows an approach to treat trusts similar to corporate entities and reviews the main activities of the trust, in another civil law country, Belgium an entirely different approach is followed. Belgium has no domestic trust legislation, and thus local trusts will not be in issue. In respect of foreign trusts, it is stated the settlor may elect the governing law for the trust, provided such law recognises the trust, and in the absence of the settlor specifying the governing law, the law of the country in which the trustee was habitually resident when the trust was constituted applies.²² The election of the governing law of the trust to found jurisdiction is unique, with most common law countries such as the UK, Canada, Australia, and the US regarding it as irrelevant.²³

In Switzerland the residence of the trust is deemed to be at the place of its administration as specified in writing in the trust instrument, or in any other form that can be evidenced in writing, failing such specification, it will be where the trust is effectively managed.²⁴ Avery Jones postulates that in the Netherlands and Germany the residence of the trust is likely to be determined on a basis similar to that of corporate entities, so that it will be at the place where the daily effective

¹⁹ Thus a territorial link between the trust and Italy is created -Saunders, R *International Tax Systems and Planning Techniques* (2010) at 289.

²⁰ Nosedo, F "Recent Changes in Italy affecting Trusts: an Italian Earthquake" 2007 PCB (5) 334.

²¹ Maisto, G "Italy" in PLC 's Cross-Border tool – available at <http://crossborder.practicallaw.com/7-515-3348?q=private+client> (last accessed on 07/05/2013).

²² Nijs, A & Slaets, S "Foreign Trusts – Belgium" in PLC 's Cross-Border tool – available at http://crossborder.practicallaw.com/1-500-9212?q=*%&qp=%&qo=%&qe (last accessed on 07/05/2013).

²³ Avery Jones, JF "The Treatment of Trusts under the OECD Model Convention (Part1)" 1989 BTR(2) at 43.

²⁴ Art 21 PILA; Liatowitsch, M and Vischer, B "Switzerland" in PLC 's Cross-Border tool – available at http://crossborder.practicallaw.com/4-500-9866?q=*%&qp=%&qo=%&qe (last accessed on 07/05/2013).

management of the trust's operation is carried out.²⁵

8 2 2 Low Tax Countries

In Malta, a sovereign island state regarded to be an offshore financial centre, it is sufficient for taxation purposes should at least one of the trustees be resident.²⁶ So too in the Isle of Man, similarly a low tax country, should at least one trustee be resident in the Isle of Man, or the administration of the trust be conducted in the Isle of Man, it would fall within the income tax net. Should none of the beneficiaries or the settlor be resident, the trust would be exempted from tax.²⁷ In the Bahamas, a trust will be resident where it is managed or controlled. However, trusts (excluding business trusts) are exempted from taxes, rates, duties, levies and other charges with non-resident beneficiaries similarly exempted.²⁸ In Mauritius, resident trusts are taxed, but where the trust has a non-resident settlor and all of the beneficiaries are non-resident, the trust will be exempted from income tax, provided that it has deposited a declaration of non-residence with the Mauritius Revenue Authority.²⁹ It therefore appears that in these jurisdictions it is quite easy to establish "residence", which is after all desirable as the trust would then be resident in a low tax regime.

8 2 3 Common Law Countries - the USA and Australia

In the USA, trust is regarded as a separate taxable entity.³⁰ A distinction is made between "domestic" and "foreign" trusts, with the former taxed on its worldwide income.³¹ A trust will be classified as a "domestic trust" should -

- a court within the USA be able to exercise primary supervision over the trust's administration (*the court test*); and

²⁵ Avery Jones, JF "The Treatment of Trusts under the OECD Model Convention (Part1)" 1989 BTR(2) at 44.

²⁶ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 371.

²⁷ Stuart Smalley Co LLC and Douglas Trustees Ltd "Offshore Trusts Briefing" available at <http://www.law-man.com/media/Publications/Offshore%20Trusts.pdf>. -last accessed on 07/05/2013. Saunders, R *International Tax Systems and Planning Techniques* (2010) at 1069.

²⁸ Evans, VJN Lockhart-Sawyer, T & Evans, KS "Bahamas" in PLC 's Cross-Border tool – available at available at <http://crossborder.practicallaw.com/0-521-8287?source=relatedcontent> (last accessed on 07/05/2013).

²⁹ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 1083.

³⁰ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 406.

³¹ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 755. The conduit principle is also applied so that whilst the trust is taxed as an individual entity it would be eventually only taxed on the income accumulated in it with income distributed to beneficiaries credited.

- one or more US persons have the authority to control all substantial decisions.(*the control test*).³²

Should either test not be met, the trust will be regarded as a foreign trust. It is therefore possible for a trust with an US Settlor, or where all its assets are situated in the USA, or where all its beneficiaries to be resident in the US, to be regarded as a foreign trust.³³

This definition was statutorily promulgated in 1996 and is said to have established “a two-part objective test”. Prior thereto, ascertaining whether a trust was domestic or foreign, was more subjectively determined and this led to uncertainty.³⁴ As there was no definition, the residence of the trust depended upon the facts and circumstances of each case, with judicial precedent establishing that factors such as the citizenship and residence of the settlor and beneficiaries were irrelevant, whilst factors such as the nature and location of the assets, the residence and nationality of the trustees and the place used for the principal administration of the trust’s administration, was important.³⁵ This would not however give rise to “clear results in a broad range of cases”³⁶ and the definition now inserted aims to address this. The regulations further provide guidance as to the interpretation of the tests and illustrate the practical application with examples.

In relation to the court test, it is stated that the term “court”³⁷ denotes any federal, state or local court within the USA³⁸ and it is required that such court must have the authority under applicable law to issue orders or judgments concerning the *administration* of the trust.³⁹ The “primary

³² Treasury Regulation § 7701 (a)(30)(E). Both requirements must be met.

³³ McCall, JJ “United States” in PLC Cross Border Planning Tool –available at <http://crossborder.practicallaw.com/7-515-3348?q=private+client> (last accessed on 07/05/2013).

³⁴ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 755.

³⁵ Tillinghast, D “ A Matter of Definition: “Foreign” and “Domestic” Taxpayers” *International Tax and Business Law* (1984) 239 at 254. Langstraat and Brucks name these six factors as being(1) country under whose laws the trust was created (2) situs of the trust’s corpus (3) nationality and residence of the trustee (4) situs of the trust’s administration (5) nationality and residence of the settlor (6) nationality and residence of the beneficiaries. None of which were conclusive although IRS emphasized factors 2,3 and 5.Langstraat, CJ & Brucks, C E “The long Arm of Uncle Sam: Taxation of Foreign Trust and Their Beneficiaries” 19 *Int.L Tax J* (1993) 68 at 70. Colburn, SC and Englebrecht, TD “New Rules to Ensure Better Reporting by Foreign Trusts 24 *Int.L Tax J* (1998) at 42.

³⁶ Tillinghast, D “ A Matter of Definition: “Foreign” and “Domestic” Taxpayers” *International Tax and Business Law* (1984) 239 at 255.

³⁷ §301.7701-7 (c)(3)(i).

³⁸ §301.7701-7 (c)(3)(ii) – used in a geographical sense.

³⁹ §301.7701-7 (c)(3)(iii). There is also a “safe harbor” provided for, in that a trust will be regarded as satisfying the court test should the trust instrument not direct that the trust be administered outside the US, the trust is in fact administered I the US, the trust is not subject to an automatic migration provision (§301.7701-7 (c)(1)(i)-(iii)). Similarly a trust will meet the court test should the trustees/beneficiaries of an inter vivos take steps to cause the administration of the trust to be

supervision” requirement, means that the court has or would have the authority to determine substantially all issues regarding the administration of the trust.⁴⁰ The Court would be regarded as having such supervision, regardless of the fact that another court has jurisdiction over a trustee, beneficiary or trust property.⁴¹ The administration of the trust is also defined, it means “the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors and determining the amount and timing of distributions.”⁴² The focus on the ‘location of the administration’ of the trust, is a feature that predates this definition as prior thereto, court cases, in the absence of a clear statutory definition, had determined the residence of the trust, by reference to the location of the administration of the trust and its assets.⁴³

In relation to the control test, it is required that one or more US person,⁴⁴ must have the authority to control (by vote or otherwise) all the substantial decisions of the trust.⁴⁵ Control would be present, should no other person have the power to veto any of such decisions. Consequently this would required that it be determined who has the authority to make substantial decisions of the trust, which may not always be only the trust fiduciaries (trustees).⁴⁶ The term “substantial decisions” is also defined, meaning those decisions that persons are authorized, or required to make in terms of the trust instrument and applicable law, but which are not ministerial.⁴⁷ Ministerial decisions are decisions concerning the bookkeeping, collection of rents, execution of investment decisions etc.⁴⁸ Substantial decisions are regarded as meaning the following (but not limited thereto):⁴⁹

“(A) Whether and when to distribute income or corpus;

subject to the primary supervision, or in the case of a testamentary wher all the trustee have been duly qualified under a probated Will in the US, or the fiduciaries have registered the trust in a US court similar to the Uniform Probate Code. §301.7701-7 (4)(3)(A-C).

⁴⁰ §301.7701-7 (c)(3)(iv).

⁴¹ §301.7701-7 (c)(3)(iv). Even should both a US court and foreign court both be able to exercise primary supervision over the administration of the trust, the trust will meet the court test - §301.7701-7 (c)(4)(D).

⁴² §301.7701-7 (c)(3)(v).

⁴³ *BW Jones Trust v Commissioner of Internal Revenue* (1943) 132 F 2d 914, 43-1 U.S.T.C.; *Revenue Ruling* 60-81, IRB 1960-19; *Revenue Ruling* 70-241, 1970 -1 CB 89; *Maximov v US* (1962) 299F 2d 565.

⁴⁴ §301.7701-7 (d)(1)(i). Denotes a US person as defined in S7701(a)(3o). It would include a domestic corporation regardless of whether its shareholders are US persons.

⁴⁵ There is again a “safe harbor” specifically provided for certain employee benefit and investments trusts.

⁴⁶ §301.7701-7 (d)(1)(iii)

⁴⁷ §301.7701-7 (d)(1)(ii)

⁴⁸ §301.7701-7 (d)(1)(ii)

⁴⁹ §301.7701-7 (d)(1)(ii)

- (B) The amount of any distributions;
- (C) The selection of a beneficiary;
- (D) Whether a receipt is allocable to income or principal;
- (E) Whether to terminate the trust;
- (F) Whether to compromise, arbitrate, or abandon claims of the trust;
- (G) Whether to sue on behalf of the trust or to defend suits against the trust;
- (H) Whether to remove, add, or replace a trustee;
- (I) Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and
- (J) Investment decisions; however, if a United States person under section 7701(a)(30) hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will."

In the USA in determining the residence of the trust, the focus is on the legal as well as actual control over the trust.

It is further interesting to note that apart from the federal approach, to determine the tax residence of trusts in the different states, a variety of concepts are applied. Some states subject a trust to tax, where the trust has at least one resident trustee or beneficiary, or if it is administered in the state. Oregon for example applies "major part of administration", Virginia will tax any trust created by a Virginia resident and Idaho considers a trust resident, if three out of the following five factors are met: settlor lives in Idaho, trust is governed by Idaho law, trust property is located in Idaho, trustee is located in Idaho, or the trust is administered in Idaho.⁵⁰

Across the ocean, in Australia, also a common law country with strong historical and current ties to the UK, the trust is similarly regarded to play an important role.⁵¹ It is particularly noted that trusts are commonly utilised as an entity through which active business operations are conducted.⁵² Australia similarly has a residence based jurisdiction. Resident taxpayers are taxed on an unlimited basis, whilst non-residents are taxed only on income derived from sources in Australia and certain

⁵⁰ Redd, C A "State Income Tax Issues with Trusts" available at <http://www.naepc.org/journal/issue08d.pdf> (last accessed on 07/05/2013).

⁵¹ Gillies, P *Australia - Trusts, Topical Analyses IBFD* available at <http://www.ibfd.com>- last accessed 11/07/2012. Par 1.1. Said to be a common feature of the legal landscape – PLC in their Cross-Border Country Q&A tool as available at http://crossborder.practicallaw.com/9-520-8967?q=*&qp=&qo=&qe= (last accessed on 07/05/2013).

⁵² Gillies, P *Australia - Trusts, Topical Analyses IBFD* above. In the introduction Gillies quotes the most recent statistics published by the Australian Taxation Office (2007/8 year) which indicate that the registered number of company taxpayers was 772,435 whilst discretionary trusts did not lag far behind at 504, 983. Saunders adds to this stating that they are generally used in family business arrangements and as a collective investment vehicle for investing in property, cash or equities. Saunders, R *International Tax Systems and Planning Techniques* (2010) at 828.

capital gains.⁵³ Reference is not made to a trust, but to the “trust estate” and this trust estate may be regarded as tax-resident, where

- the trustee was a resident at any time during that year, or where there is two or more trustee, any one of those trustees was a resident at any time during that year; or
- the central management and control of the trust estate was in Australia at any time during that year.⁵⁴

To determine whether the first criterion is met, regard must be had to the type of the trustee, ie whether the trustee is a natural person or a company, and then to apply the relevant resident rules to the trustee to determine whether they are resident in Australia.⁵⁵ The fact that the test requires only one trustee to be resident for the trust’s residence to be attributed, regardless that the majority of the trustees could be resident elsewhere, sets quite a strict test.⁵⁶

The alternative test posed, that of central management and control is also applicable in relation to companies and has in case law been established to be a factual question, one which requires that it be determined who the person/s are who make the critical decisions and the location where these decisions are taken.⁵⁷ The views of the revenue authority has also been expressed in a Taxation Ruling TR 2004/15. The Australian Government had in November 2011, released an initial Consultation Paper on the proposed Modernisation of The Taxation of Trust Income, the aim of which was stated to be the improvement and simplification of the taxation of trust income in Australia.⁵⁸ In the consultation paper, the topic of the residence of the trust is however only briefly addressed and just two issues raised. Firstly, that the current test may pose problems for a trust with multiple trustees.⁵⁹ The second and potentially more significant problem was, within the context of double taxation agreements where trusts are often not explicitly recognised and no

⁵³ Gilies, *P Australia - Trusts, Topical Analyses IBFD* at par 1.4.

⁵⁴ Sec 95(2), Income Tax Assessment Act, 1936.

⁵⁵ For example in relation to individuals this statutorily defined to include four tests: the ordinary concepts test, the domicile test, the 183 day test, the super fund test. (S 6(1) of the ITAA, 1936. A company would be resident should it satisfy one of three tests: the incorporation test, the voting power test, the central management and control test (S 6 (1), ITAA 1936). Gilies, *P Australia - Trusts, Topical Analyses IBFD* at par 4.1.2.

⁵⁶ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 56.

⁵⁷ Gilies, *P Australia - Trusts, Topical Analyses IBFD* at par 4.1.2

⁵⁸ The Treasury, Australian Government “Consultation Strategy” available at <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/modernising-taxation> –last accessed 07/05/2013. The focus would be on the particular statutory section being Division 6 of Part III of the Income Tax Assessment Act, 1936.

⁵⁹ The Treasury, Australian Government “Consultation Paper on the Modernisation of the Taxation of Trust Income – Options for Reform” available <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/modernising-taxation> – last accessed 07/05/2013. Par 3.2.4.

residency rules for trust contained, thus impairing the ability to apply the tie-breaker rules.⁶⁰ However in the further contents of the paper, no proposals or suggested improvisations were made in relation to this aspect and there is no indication that the current test for residence will be amended.⁶¹ Subsequent thereto a Policy Options Paper was published in October 2012⁶², but focused entirely on the two model options for the taxation of the income. A Final Report on the Taxation of Discretionary Trust⁶³ has also been presented by the Board of Taxation to the Treasurer and the Minister of Revenue in November 2012, but again remained silent on this issue. Thus it appears that any proposed changes to the residence aspect are kept indefinitely in abeyance.

It would therefore appear that from such a brief overview of various countries, that there is no uniform approach followed by countries in their domestic fiscal approaches, to determining the “residence” of a trust, with each selecting its own definition and application. We now turn to the two jurisdictions earmarked for a more in-depth consideration.

8 3 Canada

8 3 1 Background to the Canadian tax system

The history of the Canadian Income Tax Act is an example of the profound effect a social and political event may have on the area of taxation. This event, to which reference is made, is that of the First World War. Already in 1867, the British North America Act empowered the federal government of Canada to levy taxes, but for the following 50 years, it did not do so.⁶⁴ However, as a temporary measure to help finance the First World War, federal income tax was introduced in

⁶⁰ The Treasury, Australian Government “Consultation Paper on the Modernisation of the Taxation of Trust Income – Options for Reform” available at <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/modernising-taxation> – last accessed 07/05/2013 .Par 3.2.4

⁶¹ The target date for the implementation of the new legislation was extended from the initial target date of 1 July 2013 to 1 July 2014 so as to allow more time for the development and consultation on the proposed changes.The Treasury, Australian Government “Consultation Summary” available at <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/modernising-taxation..>

⁶² The Treasury, Australian Government “Taxing Trust Income – Options for Reform: Policy Options Paper” available at http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2012/Modernising%20taxation/Key%20Documents/PDF/Options_paper.ashx – last accessed 07/05/2013 .

⁶³ Board of Taxation “Taxation of Discretionary Trusts: A Report to the Treasurer and the Minister for Revenue and Assistant Treasurer” available at http://www.taxboard.gov.au/content/reviews_and_consultations/taxation_of_discretionary_trusts/report/downloads/discretionary_trusts_final_report.pdf. – last accessed 07/05/2013 .

⁶⁴ McKie, AB “Canadian Tax Commentary: A Question of Residence” 27 *Tax Executive* 1974-1975 at 263. During this period customs and excise taxes formed the main revenue sources.

Canada in 1917.⁶⁵ The Income Tax Act promulgated at that time, is said to have been “a relatively simple document of some 10 pages in length.”⁶⁶

From the date of inception to the 1960’s, income tax however became an important revenue stream for the government.⁶⁷ Developments to the tax were effected *ad hoc*, and increasing dissatisfaction with such a “resulting system” culminated in the establishment of a Royal Commission (called the Carter Commission) in 1962, which was tasked to undertake a comprehensive study of the Canadian tax system.⁶⁸ The Commission presented its Report in 1966, recommending fundamental changes to the legislation, such as taxing on a comprehensive tax base and including capital gains.⁶⁹ The consequence of this Report was a complete overhaul of the existing legislation.⁷⁰ This reformed system was regarded to be more sophisticated and the legislation technically more complex.⁷¹ Further substantial changes were effected in 1987 and 1991, with the “fine tuning” of the Act following every annual Budget.⁷² From a mere 10 pages, the Income Tax Act⁷³ is now over 2000 pages in length and is the largest Canadian statute.⁷⁴

Whilst the Canadian federal government has unlimited powers of taxation, each of Canada’s provinces are also empowered to levy direct taxation on the income earned in the province and on the income of the persons resident within its borders.⁷⁵ All ten provinces plus the three territories do so. The federal income tax rebates this in its levy of taxes.⁷⁶

Canada therefore has a ‘residence based’ system of taxation as both its federal and provincial governments impose tax on the worldwide income of residents, and in respect of non-residents on

⁶⁵ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 23.

⁶⁶ Anon *Canadian Master Tax Guide: A guide to Canadian Income Tax* 65th ed (2010) at 725. Mckie *op cit* 1 notes that many of the basic principles of that first taxing act was borrowed from the UK Income Tax Act then in force.

⁶⁷ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 23.

⁶⁸ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 23.

⁶⁹ Anon *Canadian Master Tax Guide: A guide to Canadian Income Tax* 65th ed (2010) at 725.

⁷⁰ Referred to as “one massive reform” by Mckie *op cit* 1; Anon *Canadian Master Tax Guide: A guide to Canadian Income Tax* 65th ed (2010) at 725.

⁷¹ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 23.

⁷² Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 23.

⁷³ Income Tax Act, R.S.C, 1985, c.1 (5th Supplement)

⁷⁴ The authors also note a peculiarity in respect of the drafting and review of the Act which is done by professionals of the Department of Finance, whereas the Department of Justice attends to all other federal legislation – see Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 28.

⁷⁵ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 23.

⁷⁶ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 23.

income derived from Canadian sources.⁷⁷ The founding provision to tax ‘residents’ is contained in section 2(1) of the Act which provides that:

“An income tax shall be paid, as required by this Act, on the taxable income for each taxation year of every person resident in Canada at any time in the year.”⁷⁸

By virtue of section 3 of the Act, taxable income includes the taxable portion of any capital realized in the year.⁷⁹

A trust is not recognized as a “person” in the Canadian common law.⁸⁰ Yet a trust is expressly deemed for purposes of the Act to be in respect of the trust property an “individual,”⁸¹ and is thus a person for purposes of the Act.⁸² The Act further recognizes the distinction between testamentary⁸³ and *inter vivos* trusts.⁸⁴ Importantly, and similarly then to South Africa, for tax purposes, a trust is treated as a separate taxable entity, although it is not recognized as a legal entity in law.⁸⁵

A trust may consequently be a resident in Canada, and if so, will, generally speaking, be taxed on income (including capital gains) received by it, which is *not* payable to a beneficiary but

⁷⁷ Anon *Canadian Master Tax Guide: A guide to Canadian Income Tax* 65th ed (2010) at 700.

⁷⁸ 2(3) provides that “Where a person who is not taxable under subsection 2(1) for a taxation year (a) was employed in Canada, (b) carried on a business in Canada, or (c) disposed of a taxable Canadian property, at any time in the year or a previous year, an income tax shall be paid, as required by this Act, on the person’s taxable income earned in Canada for the year determined in accordance with Division D.”

⁷⁹ S3. In respect of non-residents the taxable or a capital gain arising from the disposition of property will be included if it meets the definition of “taxable Canadian property”, unless the property also meets the definition of “treaty-protected property.” See s 2(3), 115 (1), 248(1) and 110(1)(f)(i).

⁸⁰ *Fundy Settlement v Canada* 2012 SCC 14, Judgment delivered on 12 April 2012. In the Federal Court this was explained as follows: “Conceptually, the trust is embodied in the trustee as the person who generally has legal title to the trust property, and who has the powers and discretions granted by the trust documents and the law, concerning the trust property. It is the trustee who is required on behalf of the trust to comply with all filing and reporting requirements under the Income Tax Act to whom all assessments and other official notifications are sent, who has the legal status to object to assessments and to appeal, and who is responsible for paying the tax debts of the trust.” at par 5.

⁸¹ S 104(2). It is interesting to note that where there is more than one trust and the following two criteria are met (a) substantially all of the property of the various trusts has been received from one person; and (b) the various trusts are conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary, or group or class of beneficiaries, then the Minister may designate such of the trustees be an individual whose property is the property of all the trusts and whose income is the income of all the trusts.

⁸² S 248 in respect of the definition of individual and person. Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.5.

⁸³ S 108(1) is defined as a trust that arises on and as a consequence of the death of a person.

⁸⁴ S 108(2) defines it as a personal trust other than a testamentary trust. Hausman, JS “The Taxation of Trusts and Beneficiaries of Trusts under the Canadian Income Tax Act” (1988) *Int’l Bus L J* 935 at 937.

⁸⁵ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 689.

accumulated in the trust.⁸⁶ It is taxed as if it were an individual but without the allowance of personal exemptions or standard deductions.⁸⁷ Where it receives such income and it is payable to a beneficiary, such income is included in the beneficiary's income and deductible by the trust.⁸⁸ The general policy is therefore formulated that "income and capital gains are to be taxed in the hands of the beneficiaries whenever practicable and where tax would not be unduly deferred, otherwise income and capital gains will be taxed in the trust."⁸⁹ In relation to trusts, the federal tax imposed is uniform for all provinces.⁹⁰ In the respective provinces, however the tax rates may differ, for example in respect of *inter vivos* trusts, interest retained in the trust would be taxed at the highest rate in Nova Scotia at 48.25% and the lowest in Alberta at 39%. For taxable dividends retained, the highest would be Prince Edward Island at 24.44% and the lowest again in Alberta at 14.55%.⁹¹

The "residence" of the trust is therefore important on both a federal level and provincial level, as it is the basis upon which taxes are levied. So too, could it also be attempted to be manipulated on two levels, for example to minimize taxes by utilizing a non-resident trust in a low-tax jurisdiction outside Canada's borders, alternatively, within the country's borders, by opting for a lower tax provincial jurisdiction.⁹²

Yet non-resident trusts do not so easily escape the taxation net, as there are provisions in the Act whereby such a trust can be deemed to be a Canadian resident. These non-resident rules are described as "very complex and technical."⁹³ Unfortunately this has been aggravated by a confusing state of affairs, which has arisen by the proposed modification of these rules. Indeed draft provisions for the new rules have been prepared, and it was announced that the old rules would be

⁸⁶ Anon *Canadian Master Tax Guide: A guide to Canadian Income Tax* 65th ed (2010) at 930 & 7260.

⁸⁷ Anon *Canadian Master Tax Guide: A guide to Canadian Income Tax* 65th ed (2010) at 930.

⁸⁸ Anon *Canadian Master Tax Guide: A guide to Canadian Income Tax* 65th ed (2010) at 930.

⁸⁹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 5.

⁹⁰ *Inter vivos* trusts pay a flat rate at the highest personal rate, whilst testamentary trusts are taxed at the graduated personal rates. Hausman, JS "The Taxation of Trusts and Beneficiaries of Trusts under the Canadian Income Tax Act" (1988) *Int'l Bus L J* 935 at 937.

⁹¹ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner's Guide 2010* (2009) at 588 in respect of the 2009 marginal tax rates. Varying tax rates are also set for actual capital gains and business income.

⁹² This will only be possible should the structure not attract the application of anti-avoidance provisions. Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner's Guide 2010* at 132 refer to it as "provincial rate shopping" reporting that the Canadian Revenue Agency has from 2007-8 become more aggressive in their review of same.

⁹³ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner's Guide 2010* at 348. Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.3.2(c). Rochweg, M "Tax Effective Cross-Border Will Planning" Presentation delivered on 27-28 February 2012. Accessed online at http://www.millerthomson.com/assets/files/article_attachments2/M-Rochweg_Tax-Effective-Cross-Border-Will-Planning-Feb-27-2012.pdf – last accessed 07/05/2013 describes it as "unworkable, broad and unnecessarily complex."

in force until 31 December 2006.⁹⁴ Despite such date passing, and various revisions of the proposed new rules since, they have not as yet been signed into law, although whatever date they may be enacted, it is said that they will be retrospectively applicable from 1 January 2007.⁹⁵ The Canadian government acknowledged the “significant backlog of outstanding measures”⁹⁶ and in October 2012, new draft legislation was released, revising the previous draft rules issued in 2010 and despite it marking it the “eighth iteration of proposed changes to the Non-Resident Trust rules”⁹⁷ such legislation is regarded to be the final version.⁹⁸

Under the old rules as set out in section 94 of the Act, a non-resident trust is deemed to be resident should it satisfy essentially two conditions. Firstly, that the non-resident trust has a Canadian resident beneficiary at some time in the year (“the beneficiary test”). Secondly, there must be a Canadian resident from whom the trust acquired property who is related to the beneficiary, or is an uncle, aunt, niece, or nephew of a Canadian resident beneficiary (“the contribution test”).⁹⁹ If this Canadian transferor was not resident in Canada for more than 60 months and particularly not resident for the 18 months prior to the tax year, then an exemption is applicable.¹⁰⁰ To ensure the collection of the tax on these entities outside its jurisdiction, joint and several liability is imposed upon the Canadian settlor and the Canadian beneficiaries for the tax payable by the trust.¹⁰¹

⁹⁴ Anon *Canadian Master Tax Guide: A guide to Canadian Income Tax* 65th ed (2010) at 7394. For an Overview see the “Explanatory Notes in Respect of Legislative Proposals Relating to the Income Tax Act and Related Acts and Regulations” Published by the Hon. J M Flaherty, Minister of Finance (September 2010) available online at <http://www.fin.gc.ca/drleg-apl/ita-lir10n-eng.asp> - last accessed 07/05/2013.

⁹⁵ Tamaki notes that already in 1999, these changes were announced and the first draft legislative provision to effect the changes issued in 2001 – Tamaki, P “Foreign Commercial Trusts: The Latest Non-Resident Trust Proposals” Available at <http://www.blakes.com/english/resources/bulletins/pages/details.aspx?bulletinid=1230> – last accessed 07/05/2013. Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 348. Tax Specialist Group “Residence of Trusts” Published 05/04/2012 at http://www.taxspecialistgroup.ca/_public/taxtips.asp?n=12-10&site=tsg – last accessed on 07/05/2013; See S 94(1)(a) of the Act.

⁹⁶ Department of Finance, Canada – Media release entitled “Government of Canada moves to implement outstanding tax amendments” issued 24 October 2012 and available at <http://www.fin.gc.ca/n12/12-129-eng.asp> – last accessed on 07/05/2013.

⁹⁷ Again these measures will be retrospectively applicable to 1 January 2007. Notice of Ways and Means Motion to amend the Income Tax Act, the Excise Tax Act and related legislation to be entitled with a short title as the Technical Tax Amendments Act, 2012, available at <http://www.fin.gc.ca/n12/12-129-eng.asp> – last accessed on 07/05/2013.

⁹⁸ Anon, “Canadian Non-Resident Trust Rules: New Draft Legislation” published 03/12/12, available at <http://www.stikeman.com/cps/rde/xchg/se-en/hs.xsl/17070.htm> – last accessed on 07/05/2013

⁹⁹ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 348. See S94(1)(b) of the Act. Ridout, PHH & Bowman, SW “Canadian Beneficiaries of Trusts Created by US Residents” (1991) 5 *Prob & Prop* 46 at 47.

¹⁰⁰ S 94(1)(c) of the Act.

¹⁰¹ Hausman, JS “The Taxation of Trusts and Beneficiaries of Trusts under the Canadian Income Tax Act” (1988) *Int’l Bus L J* 935 at 945.

Under the new rules the essential criterion is that the non-resident trust must have a resident contributor who has been resident for more than five years.¹⁰² The presence of a resident beneficiary is demoted to be of significance only where there is no resident contributor.¹⁰³ Furthermore the imposition of joint and several liability is extended. Any person who is resident in Canada and has contributed to the trust may be liable for the tax levied on the trust.¹⁰⁴

It is not the intention here to investigate the intricate workings of these rules in further details, as the crucial question remains, whether the trust is resident or not. This must first be determined before such deeming rules are activated, when the answer reveals the trust to be non-resident. Thus we now turn to the question of residence and how this is determined under the Canadian income tax system.

8 3 2 Determining the fiscal residence of a trust in the Canadian tax context

Despite the extraordinary length of the Act, there is no definition for “residence” in the Act in relation to trusts, nor provisions setting out the manner in which residence is to be determined. This is unlike the case for individuals and corporations.¹⁰⁵ The Act does contemplate that a trust can be resident or non-resident, with different consequences ensuing, but gives no guidance.¹⁰⁶ Instead, its meaning is to be determined on the basis of case law as well as the views expressed by the revenue authorities of Canada (the Canadian Revenue Agency) in its Interpretation Bulletin.¹⁰⁷

This was emphatically explained by Judge Gibson in the *Thibodeau Family Trust*-case¹⁰⁸ -

“In so far as individuals and corporations are concerned, there are statutory rules in the Income Tax Act and judicial decisions whereby their residences may be determined. But there

¹⁰² The term “Contributor” is defined in the proposals. Saunders, R *International Tax Systems and Planning Techniques* (2010) at 695 states that the new rules are essentially premised on the concept that the trust may be deemed to be a resident trust if the trust benefitted economically from a person.

¹⁰³ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 350.

¹⁰⁴ It is regarded to be “by far the most far reaching provision ever proposed in Canada for joint and several liability under which a person can be liable for another’s taxes.” It is to be anticipated therefore that this rule will be challenged. Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 350 & 372.

¹⁰⁵ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.3.5. South African laws refer to “companies”, however as the term “corporate” and its derivatives are employed in Canada and this particular text of the study deals with Canada, the latter is used.

¹⁰⁶ Morgan, L & Bush, K “Canada relies on Trust to save immigrant taxes” 3 *Int’l Rev* (1991-2) at 12

¹⁰⁷ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 177.

¹⁰⁸ [1978] FCJ No 607 also cited as 78 DTC 6376 sub nom *Dill v The Queen*.

are no statutory rules or judicial decisions establishing any formula that may be employed in determining whether or not a trust is resident in Canada. The Income Tax Act however, envisages there being trusts resident in Canada and trusts non-resident, but the Act is silent as to how to determine this fact.”¹⁰⁹

Prior to considering such case law and the guidance from the authorities, it is first reflected on the historical development of the term.

8 3 2 1 Historical overview

Historically, the generally accepted view is that the residence of a trust is determined by the “residence of the trustees” of the trust. Ettinger explains that this view has its origins in the common law definition of a trust as read together with certain provisions in the income Tax Act, and lastly, influenced by an old English decision.¹¹⁰

In the Canadian common law, a trust is regarded as an equitable obligation, involving several elements: the settlor, trustee, beneficiary and trust property.¹¹¹ A trust is described as the relationship between these persons relative to the property held under that relationship.¹¹² A formal definition for a trust is that it:

“A trust... is the relationship which arises whenever a person called the trustee is compelled in equity to hold property, whether real or personal, and whether by legal or equitable title, for the benefit of some persons (of whom he may be one, and who are termed beneficiaries) or for some object permitted by law, in such a way that the real benefit accrues, not to the trustees, but to the beneficiaries or other objects of the trust”¹¹³

As it is a relationship, it is not recognized as a legal entity in the Canadian common law.¹¹⁴ This is similar to the position to South Africa. It is the trustee/s who are the principal/s in respect of the property that they hold, subject to the trust obligation. The trustee/s that has the legal title to trust property and is responsible for its preservation and income production.¹¹⁵ Consequently it is clear that of all the parties to the trust, it is the trustee/s that plays the pivotal role.

¹⁰⁹ Par 3.

¹¹⁰ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes: A Comparative Analysis and Recommendations for Reform* Dissertation submitted for the degree of Masters of Law at the University of Alberta (1993) at 56.

¹¹¹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 56.

¹¹² Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 3.
Hausman, JS “The Taxation of Trusts and Beneficiaries of Trusts under the Canadian Income Tax Act” (1988) *Int’l Bus L J* 935 at 936.

¹¹³ Keeton, WW & Sheridan, LA *The Law of Trusts* 10ed at 3.

¹¹⁴ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 178.

¹¹⁵ Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 83.

In the Income Tax Act, Section 104(1) provides that a “reference to a trust shall... be read to include a reference to the trustee.... having ownership or control of the trust property”, whilst subsection 104(2) deems the trust to be an individual.¹¹⁶ The purpose behind these sections is to segregate the trust income from the trustee in his personal capacity.¹¹⁷ From these sections the emphases is therefore on the trustee/s, and the trustees’ position in relation to the trust property. On the language of the Act, the question to be asked is “who are the trustees that have ownership or control of the trust property?”¹¹⁸ The Act is then taken to be an indication that where these trustees should be resident, the trust will be resident.¹¹⁹

The old English case, to which reference is made, is the case of *Inland Revenue Commissioners v Gull*¹²⁰ decided in 1937 in the King’s Bench Division. It concerned a charitable trust established in a Will, wherein the testator had bequeathed the balance of his property in England and Russia for purposes of establishing a charitable home in Ontario. In the Will, the testator had appointed three trustees, two of whom were resident in the United Kingdom and one in Canada. A Canadian Trust Company was later appointed as trustee in the place of the initial Canadian trustee. The English trustee although anxious to transfer the English and Russian assets to the Canadian trustee in Ontario, could not obtain the necessary indemnity and whilst resolving this, was taxed for English income tax. To this, he claimed an exemption averring that the income was payable to a charity. To make use of the exemption, it was required that the charity be established in the United Kingdom. The court found that as two of the original trustees had been resident in the United Kingdom and one was still so resident, the trust was established in the United Kingdom and the exemption could be availed of. This case is then viewed as authority that the residence of the trust should be determined by the residence of the trustees, or where more than one, where the majority of trustees reside.

8 3 2 2 Carter Commission

In 1966, the Carter Commission tabled its report to Parliament and included in its findings and recommendations, also proposals in relation to the residence of trusts.¹²¹ The recommendations

¹¹⁶ Income Tax Act, R.S.C, 1985, c.1 (5th Supplement)

¹¹⁷ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 56.

¹¹⁸ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.5.

¹¹⁹ McKie, AB “Canadian Tax Commentary: A Question of Residence” 27 *Tax Executive* 1974-1975 at 269.

¹²⁰ [1937] 4 All ER 290

¹²¹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 87.

were in some respects regarded to be similar to those found in tax legislation in the United Kingdom at that time.¹²²

In its Report it promoted the development and inclusion of a statutory definition of residence which should be expressed “as precisely as possible to enable the taxing jurisdiction to be readily determined.”¹²³ It concluded that the test for residence for a trust, should be maintained on the basis of primarily the residence of the trustees.¹²⁴ It however wished to extend this test, and proposed that a trust be taxed as a Canadian resident in either of the following circumstances:

- When the trustees, a majority of the trustees, or a controlling group of the trustees are resident or ordinarily resident in Canada;
- When the trust carries on substantially all of its business in Canada or where substantially all of its property is situated in Canada¹²⁵

It did not intend the aforesaid formula to be applied as “hard and fast rules.”¹²⁶

These recommendations include two very startling propositions, if compared to the general accepted view of residence, determined according to the residence of the majority of the trustees. The first is that it includes an element of *de facto* control – should the controlling group of trustees of a trust be resident in Canada, then notwithstanding that they may not form the majority of trustees, the trust may be found to be resident in Canada.¹²⁷ Secondly, it contains a criterion of a trust being resident where uniquely, substantially all of its property or business is located in Canada, regardless of where the trustees reside.¹²⁸

The recommendations of the Carter Commission were however not adopted and no definition was introduced in the Act for the “residence” of trusts. Thus it is still from case law that guidance must be sought to the interpretation of the term. The first such case under consideration is that of

¹²² Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 88.

¹²³ Carter Commission *Report of the Royal Commission on Taxation* 1966(4) at 195.

¹²⁴ Carter Commission *Report of the Royal Commission on Taxation* 1966(4) at 195 states that “We have considered a number of other bases for jurisdiction over trusts, but have decided that the test for jurisdiction should continue to be primarily the residence of the trustees.”

¹²⁵ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 88.

¹²⁶ Carter Commission, *Report of the Royal Commission on Taxation* 1966(4) at 196. A further proposal was that a trust administered by a Canadian incorporated trustee not be regarded as resident in Canada for a taxation year should it have received substantially all of its property from a non-resident, all or substantially all of its assets were situated outside Canada, and all or a majority (Rest of the footnote?)

¹²⁷ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 88.

¹²⁸ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 89

*Thibodeau Family Trust v the Queen*¹²⁹, which had for many years been the only case on this important issue.¹³⁰

8 3 2 3 *Thibodeau Family Trust v The Queen*

To start with the facts in chronological order: in 1968, the Thibodeau Family trust was created between a settlor and Mr Thibodeau as one of the two Canadian resident trustees.¹³¹ Shortly after its establishment, the trust acquired a minority interest in a Canadian railway corporation, of which the majority interest was held by Mr Thibodeau.¹³² In 1970, one trustee retired and the remaining trustee, as empowered by the trust deed, appointed two trustees, both residents in the Island of Bermuda.¹³³ Thus the majority of trustees were now resident in Bermuda. In terms of the Deed whereby the trustees were appointed, it was further stated that “the assets and administration of the Trust were removed to the Islands of Bermuda; and on that same day, the Bermuda Trustees took delivery of the aforementioned shares.”¹³⁴

In 1972, the trust’s shares in the railway corporation (including that of the majority shareholder, Mr Thibodeau) were sold.¹³⁵ This give rise to a substantial capital gain, as well as income earned in relation to a partial settlement of the purchase price received, which had received interest in escrow.¹³⁶ It was this capital gain and interest which the revenue authorities sought to tax and issued assessments accordingly.¹³⁷ The crucial issue in this case was therefore whether the trust was resident or not in Canada, for if resident, then the Canadian authorities would be able to tax the trust on its worldwide income.

The trustees did not agree with the proposition that the trust was resident in Canada, and in

¹²⁹ [1978] FCJ No 607 also cited as 78 DTC 6376 sub nom *Dill v The Queen*
¹³⁰ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.5 WeirFoulds Estates & Trust Newsletter. Est. L. Nws. 2012-04. Available online at Westlaw International – last accessed on 14/06/2012. PricewaterhouseCoopers “Supreme Court of Canada rules on trust residence – St Michael Trust Corp v The Queen” Tax Memo Published 12 April 2012 at http://www.pwc.com/en_CA/ca/tax-memo/publications/pwc-garron-family-trust-2012-04-en.pdf last accessed 07/05/2013.

¹³¹ Par 5.

¹³² Par 5.

¹³³ Par 6.

¹³⁴ Par 6.

¹³⁵ Par 7.

¹³⁶ Par 7.

¹³⁷ Par 2.

support of their averment that it was resident in Bermuda set out the following arguments¹³⁸:

- a) Since the transfer of the assets and administration to Bermuda, the Bermuda Trustees have been in possession or control of all the trust assets. Further all trustees' meetings were held in Bermuda, and decisions relating to the trust's administration and assets were taken at those meetings;
- b) Two of the trustees were residents of Bermuda and have been so prior to the transfer of the trust's assets and their appointment
- c) Banking accounts for the Trust were opened at banks in Bermuda, and the books and records have been maintained in Bermuda. The Trust's accounts were prepared by a Bermuda accounting firm.
- d) The Bermuda Trustees receive an annual fee for their professional services rendered as Trustees
- e) The investment advisor to the trust was initially after the transfer, a company in Bermuda, but was replaced by a New York company in 1973 and again substituted by a firm incorporated in New York in the subsequent year.
- f) In the year of the disputed transaction, the trustees agreed that Mr Thibodeau be authorized to suggest investments telephonically to the bank, the investment advisor company and the Bermuda Trustees. Only should the latter approve of his proposals, then they would confirm their decision by a written direction of the investment advisor company who would then act accordingly.
- g) The Trustees also cited several practical and actual examples where the Bermuda Trustees have ruled against and overridden the investment proposals made by Mr Thibodeau – for example, the latter had suggested an investment of substantial trust funds in gold bullion in respect of which the Trustees refused to authorize an investment of more than 25% of trust funds in gold
- h) The Trustees have also as non-residents paid withholding taxes as required and have not realized any further taxable gains in Canada nor carried on business in Canada

The revenue authorities'¹³⁹ viewpoint was that as there was not in the law, any statutory or judicial authority on this point, the court should in deciding the question of residence follow the reasoning of a corporate tax cases and establish rules and principles for a trust as has been established for a

¹³⁸ Par 13.

¹³⁹ Minister of Revenue would be the cited party. The Canadian Revenue Agency (CRA), formerly Revenue Canada is responsible for the tax administration of the country.

corporation, referring to the De Beers-case¹⁴⁰ where the “central management and control” test was applied. Its further argument was that the trust was capable of having a dual residence, and thus even if the court should find the trust to be resident in Bermuda, it should at the same time be find it to be resident in Canada.¹⁴¹ Again it referred to corporate tax cases in support.¹⁴²

In application of the principles enunciated in these cases on the facts, the following factors were highlighted by the Revenue Authorities for the court to take into consideration:¹⁴³

- a) One of the trustees was and still is a resident of Canada (Mr Thibodeau)
- b) This Trustee had sole power to appoint other trustees
- c) That this Trustee took a very active interest in the trust’s affairs and was the principal initiator of the investment programme
- d) The Bermuda Trustees were limited in their handling of certain banking accounts
- e) One of the other companies which was fully owned by the Trust had this Trustee as its CEO and the corporation was used as a medium for payment of the trust’s expenses, so that in a way the corporation’s bank account was the bank account of the trust
- f) That the principal activity of the trust was undertaken by this Canadian Trustee in negotiating the sale of the shares
- g) That this Canadian Trustee took certain decisions on behalf of the Trust and conveyed same later to the Bermuda Trustees¹⁴⁴

Certain legal arguments were also raised by the revenue authorities, but all of these arguments were dismissed.¹⁴⁵

The court further dismissed the argument of dual residence, which had at its core that the trust should have a residence in Canada as “at least a part of the paramount or supreme authority of the Thibodeau Family Trust” was exercised in Canada.¹⁴⁶ In the court’s view, the judicial formula in relation to corporations is not of possible application to trusts, as trustees cannot delegate their

¹⁴⁰ Par 14.

¹⁴¹ Par 15.

¹⁴² *Union Corporation, Ltd v Inland Revenue Commissioners* at 660-662; *Unit Construction Co. Ltd v Bullock* (Inspector of Taxes)

¹⁴³ Par 16. Flannigan submits that if these facts are viewed against the facts raised by the trustees, then it is probable that the court had at felt it did not establish Canadian rather than Bermuda residence. Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 91.

¹⁴⁴ Two examples were giving: payment made in anticipation of a trust investment being made and an instruction to a solicitor to negotiate the tax problem with the tax authorities.

¹⁴⁵ See Par 17, namely that the appointment and discharge of the trust was not validly effected, that the wording of the deed by which the administration and assets were transferred was defective and that the only way of transfer was governed by a specific Act. See court’s conclusion par 19-22.

¹⁴⁶ Par 22.

authority to co-trustees. Particularly, a trustee cannot adopt a policy of masterly inactivity.¹⁴⁷ On the evidence in any event, none of the trustees have adopted such a policy. Thus it is not possible for a trust to have dual residence, nor to find that part of the paramount of superior and directing authority of the trust is and was in two places.¹⁴⁸

To determine the issue of residence then, and in the absence of a statutory formula, the court stated that it had to devise and “employ a judicial formula applicable to the facts of the case alone,” albeit it regarded it as not a desirable course of action.¹⁴⁹

The court then identified certain of the facts from which the criteria to propound such formula may be made:¹⁵⁰

- “(1) that the majority of the Trustees of the Trust are and were at all material times resident in Bermuda;
- (2) that the trust document of constitution permitted a majority decision on all matters of Trustees' discretion;
- (3) that the Department of National Revenue by the assessment in discounting the value of the said shares in Thibodeau Express Limited held by the Trust by 10% as being a minority interest have admitted that Leo J. Thibodeau, the Canadian Trustee of the Trust and the majority shareholder of the shares of Thibodeau Express Limited at the material time did not control the shares held by the Trust and was not, as pleaded, “the guiding mind and will of the Thibodeau Family Trust” at the material time...
- (4) that the *res* of the Trust in the main was in Bermuda at all material times;
- (5) that some of the beneficiaries resided the whole or part of the year, 1972, in the United States; (Canada was their residence during the other times); and
- (6) that the Thibodeau Family Trust did not in 1972 or at any other relevant time carry on business in Canada.”

Two of the aforesaid criteria were then selected to found the judicial formula to decide the issue of the residence of the Thibodeau Family Trust, being firstly that the *majority of the trustees were resident* in Bermuda at all material times and secondly, that the trust document permitted a *majority decision* on all matters of trustee’s discretion.¹⁵¹ Thus for the year in question, the trust was found to have its residence in Bermuda for Canadian income tax purposes.¹⁵²

¹⁴⁷ Par 22

¹⁴⁸ Par 22.

¹⁴⁹ Par 23.

¹⁵⁰ Par 24. Extrapolated the factors are thus (a) residence of the majority of the trustees (b) ability of the trustees resident in a particular place to determine matters within their discretion (c) existence and residence of a guiding mind and will (d) location of the trust property (e) residence of the trust beneficiaries (f) residence in which the trust carried on business if any – See Morgan, L & Bush, K “Canada relies on Trust to save immigrant taxes” 3 *Int'l Rev* (1991-2) at 12.

¹⁵¹ Par 25.

¹⁵² Par 25.

Comments on the case

Some observations on the case may be made.

A first observation is one that is exclusive to this case and in particular the facts here. As one of the factors identified in its formula, the court found that as the revenue authorities had on the facts allowed the shares to be assessed as a ‘minority interest’, they had thereby admitted that Mr Thibodeau, the Canadian Trustee and the majority shareholder did not control the shares and was not “the guiding mind and will of the Thibodeau Family Trust”.¹⁵³ The court’s rationale appears to be, that if the Canadian Trustee also controlled the trust’s shares, all shares of the corporation would have been controlled by the same individual and there would be no minority interest.¹⁵⁴ Thus implicit to Revenue’s finding otherwise, was the recognition that the major shareholder was not this “guiding mind.” This can be criticized as in so doing the court failed to recognize that a trustee’s role and obligations are separate from those of the trustee in his personal capacity.¹⁵⁵ Flannigan explains “there is nothing the bare fact of a trustee personally owning a majority of shares in a particular corporation which gives any related status to shares of that same corporation held on trust by the trustee.”¹⁵⁶ The viewpoint is therefore expressed that the issue of minority interest were irrelevant to the question of residence.¹⁵⁷

The second relates to the comments by the court on the issue of dual residence and the rejection of the possibility of the application of corporate rules, to determine residence in a trust context. This was the main argument advanced by the revenue authorities. Even should the trust be resident in Bermuda, it was also resident in Canada as part of the supreme authority was exercised there.¹⁵⁸ The court was unwilling to apply the principles laid down in corporate cases, as “trustees cannot delegate any of their authority to co-trustees.”¹⁵⁹ This is in accordance with the principles of trust law, by which the trustees must own the trust property jointly and unless the trust instrument provides otherwise, must act unanimously.¹⁶⁰ According to Ettinger this implies that the test the court used was *de iure* control, which she submits, would be contrary to the established principle in

¹⁵³ Par 24.

¹⁵⁴ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 83.

¹⁵⁵ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 62.

¹⁵⁶ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 83.

¹⁵⁷ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 90. Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 62.

¹⁵⁸ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 90.

¹⁵⁹ Par 23.

¹⁶⁰ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.5.

relation to individuals and companies, that residence is a question of fact, and in the corporate context, *de facto* control is determinative.¹⁶¹ In the case however, the trustees had both *de iure* and *de facto* control and thus the remarks made by the court were *obiter*.¹⁶² Thus, whilst application of a *de iure* concept may be implied from the case, it does not provide firm authority therefore.

Flannigan is also of the opinion that the delegation rule is not really relevant to the question of dual residence, but rather to whether “residence” is a *de iure* or *de facto* concept.¹⁶³ Similarly he is of the view that the judge departed from the established principle, that residence is determined factually. He refers to the corporate arena where it is irrelevant where central management and control ought to be *exercised*, as the important aspect is where the control *is* exercised.¹⁶⁴ The court provided no reason to justify this deviation from the factual approach. He also stresses that as the facts did not give rise to such a delegation, and the court did not expressly address the issue, the comments made by the court are not authoritative.¹⁶⁵

Locally Honiball & Olivier formulate the view that as the South African trust concept is effectively a relationship and a trustee may delegate his or her powers to another trustee within the boundaries of the trust deed, then a South African trust can be dual resident. Their submission is that in terms of South African trust law the prohibition is upon the delegation of the trustee’s fiduciary responsibility.¹⁶⁶ However as our statutory definition of “residence” specifically excludes the instance of dual residence by invoking the tie-breaker, the issue appears to be academic.¹⁶⁷

The case is further criticized as “although it is the only Canadian decision to date dealing directly with the issue of residence of a trust, it is remarkably unhelpful.”¹⁶⁸ The court had lamented that there were no statutory rules relating to the residence of a trust, and although it did refer to section 104, which deems a reference to a trust as a reference to its trustee having ownership or control, did not find it to be of assistance, stating that –

“The language of subsections 104 (1) and (2) ... touches on the matter, but these subsections whether read separately or conjunctively provide no guide as to the circumstances when a trust may be determined to be resident in Canada or when non-resident. Accordingly, it is

¹⁶¹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 62.

¹⁶² Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 63.

¹⁶³ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 92.

¹⁶⁴ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 92.

¹⁶⁵ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 92.

¹⁶⁶ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 292.

¹⁶⁷ Honiball M & Olivier L *The Taxation of Trusts in South Africa* (2009) at 295.

¹⁶⁸ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 63.

impossible to construe and apply literally the statutory words employed in those subsections or either of them to determine the issue raised in this appeal. Some other method must be employed.”

So, instead the court opted to develop its own judicial formula, but one that it decreed was *only* to be applicable to the facts of the case.¹⁶⁹ This could be said to open the door for a multitude of different judicial formulas to be developed, where the facts differ from this case. In so doing, the decision is criticized as that it “only contributes to the uncertainty surrounding the question.”¹⁷⁰

In devising the court’s formula, certain factors were first identified that were considered to be relevant to the enquiry and then two factors, being the majority of the trustees resident in Bermuda and the trust instrument requiring majority decisions, were selected for founding residence.¹⁷¹ Yet no reasons were given for this selection.¹⁷² In respect of the two factors so selected, it can be viewed that they would reflect where the control of the trust assets was exercised. Avery Jones states that the “the court by basing the decision on the power to act of a majority of the trustees, seems impliedly to have given weight to the fact that it was the majority of the trustees in Bermuda who had the central management and control.”¹⁷³ Ettinger notes however there is no express statement that control is the key issue and the words in the Act “ownership and control” are not used.¹⁷⁴ Thus the arbitrariness with which the factors were chosen, remain.

Furthermore the case is so facts-specific, that it does not give any guidance as to potential problems which may arise, where the trust instrument instead required that the Canadian trustee be part of the majority for decision-making, or should it have required that decisions be made unanimously.¹⁷⁵

Yet despite the criticism on the case, for over three decades this case was seen to be the authority on the issue of residence of a trust and the foundation on which the understanding was built that a trust’s residence is determined by the residence of the majority of its trustees.¹⁷⁶

¹⁶⁹ Par 23.

¹⁷⁰ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 92.

¹⁷¹ Pars 24-25.

¹⁷² Flannigan, RM states that “he arbitrarily chose two... in his article, “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 83.

¹⁷³ Avery Jones, JF “The Treatment of Trusts under the OECD Model Convention (Part1)” 1989 BTR(2) at 42.

¹⁷⁴ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 64.

¹⁷⁵ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 64.

¹⁷⁶ WeirFoulds Estates & Trust Newsletter. Est. L. Nws. 2012-04. Available online at Westlaw International – last accessed on 14/06/2012. PricewaterhouseCoopers “Supreme Court of Canada

8 3 2 4 Income Tax Interpretation Bulletin IT-447: Residence of a Trust or Estate¹⁷⁷

Not long after judgment was issued in the *Thibodeau*-case, the Canadian revenue authorities issued an Interpretation Bulletin on the issue of the residence of a trust or estate. Ettinger submits this was because “Revenue Canada was of the view that the *Thibodeau* decision failed to clarify the issue of residence.¹⁷⁸ Similar to South Africa, these Interpretation Bulletins do not have the force of law. In eleven paragraphs, it sets out the Revenue’s view, the relevant considerations to determine residence and variations that may arise practically.

At the outset, it stresses the factual nature of the enquiry, stating that “the residence of a trust is a question of fact, determined according to the circumstances in each case.”¹⁷⁹ This is immediately followed by the general proposition that a trust is generally considered to reside “where the trustee who manages the trust or controls the trust assets resides.”¹⁸⁰ To determine who the trustee is who has management *and* control of the trust, a list of powers or responsibilities this person will have is provided, being¹⁸¹ -

- a) Control over changes in the trust’s investment portfolio,
- b) Responsibility for the management of any business or property owned by the trust,
- c) Responsibility for any banking, and financing, arrangements for the trust,
- d) Control over any other trust assets,
- e) Ultimate responsibility for the preparation of the trust accounts and reporting to the beneficiaries of the trust
- f) Power to contract with and deal with trust advisors, e.g auditors and lawyers.

Ettinger states that the general test as formulated, places emphases on the management and control of the trust, which is interesting as it has no basis in either the Income Tax Act.¹⁸² or the

rules on trust residence – St Michael Trust Corp v The Queen” Tax Memo Published 12 April 2012 at http://www.pwc.com/en_CA/ca/tax-memo/publications/pwc-garron-family-trust-2012-04-en.pdf last accessed 07/05/2013.

¹⁷⁷ Issued by the Canada Revenue Agency, date 30 May 1980. Modified 1995-01-01.

¹⁷⁸ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 64. See also Flannigan which is of the view that the revenue authorities did not regard the statute or the Thibodeau decision to provide a general test as their view coincides with neither -Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 96.

¹⁷⁹ Par 1.

¹⁸⁰ Par 1. This is said to find implicit support in s104(1) which provides that a reference to a trust shall be read as a reference to the trustee having ownership or control of the trust property. Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.5.

¹⁸¹ Par 2.

¹⁸² S 104(1) uses the words “ownership or control of the trust assets.”

Thibodeau-case.¹⁸³ Similarly for the list of factors provided, no authority was provided. These factors were not the topical factors identified in the *Thibodeau*-case. She submits however that there is similarity between these factors and the factors considered for the “central management and control” in the corporate context.¹⁸⁴

Flannigan notes that it says “management or control” and thus, if “management” must be distinguished from “control,” and a meaning of “administration” is then attributed to it, then this a novel concept. However, he submits that the term was probably intended to resemble the “central management and control test” of corporations.¹⁸⁵ Like Ettinger, he finds supports for this in the factors identified in the Bulletin to indicate management and control. In particular he is of the view that few of these powers are administrative and by and large they would correspond to a “central management and control” concept as they relate to the highest authority governing the trust assets.¹⁸⁶

It is also interesting to note that there is a discrepancy between the first paragraph where reference is made to “manages or controls”, to the rest of the document where “management and control” is used. There is no explanation provided for this in the Bulletin.

Next the Interpretation Bulletin seeks to deal with variations that may result practically where trustees reside in different jurisdictions. It establishes the following guidelines:

1. Where more than one trustee may be involved in the management and control over the trust, and one trustee clearly exercises a more substantial portion of the management and control than the other, the trust will reside where that trustee resides.¹⁸⁷
2. Where there are two or more trustees exercising relatively equal portions of the management and control, and the trustees exercising more than 50% of the management and control reside in one jurisdiction, the trust will reside in that jurisdiction.¹⁸⁸
3. Where it is not clear who has management and control then the Department will examine other factors relating to the residence of the trust. The most important of these are:
 - (a) the location where the legal rights with respect to the trust assets are enforceable, and

¹⁸³ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 64.

¹⁸⁴ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 66.

¹⁸⁵ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 96.

¹⁸⁶ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 97.

¹⁸⁷ Par 3.

¹⁸⁸ Par 3.

(b) the location of the trust assets.¹⁸⁹

It does not however address the issue of dual or multiple residence.

The residence of the trust's beneficiaries and the domicile of the settlor are not considered to be relevant factors.¹⁹⁰ There is however one exception and that is where the 'normal' situation is not present. Normal being where the trustee or trustees exercise management and control of the trust.¹⁹¹ This is where the "facts may indicate that a substantial portion of the management and control rests with some other person, such as the settlor or the beneficiaries." In these situations the residence of this other person may be considered to be the determining factor for the trust regardless of any contrary provisions in the trust agreement."¹⁹² Thus the test is not only limited to trustees, but regard may be had to other "persons." Ettinger is of the view this establishes that the Canadian Revenue considers the *de facto* control to be the relevant test.¹⁹³

For this "some other person" two examples are given in the Bulletin: the settlor and beneficiaries. It is however an open question as to whether it would also include other persons, such as the employees or agents of the trustees, where they conduct the administration of the trust in a different jurisdiction.¹⁹⁴ It is also not clear whether it would include a protector. Ettinger is of the view that it was not intended to include a protector.¹⁹⁵ She emphasizes certain characteristics of the protector

"The protector generally has the power to remove trustees and appoint new trustees, to move the trust to a new jurisdiction and change its governing law. The purpose of the appointment of the protector is to ensure that the trust continues to operate in the most advantageous manner and jurisdiction regardless of what future events may transpire. While a protector may be given additional powers to control the administration of a trust, he or she does not generally engage in the day-to-day management or administration of the trust."¹⁹⁶

She therefore concludes that although a protector may be regarded as having ultimate *de iure* control, he or she would not generally be viewed as exercising management and control of the trust as *de facto* the term is intended in the Bulletin.¹⁹⁷ Saunders however notes that a number of authors are of the opinion, that the revenue authorities may successfully take the view, that a

¹⁸⁹ Par 4.

¹⁹⁰ Par 5.

¹⁹¹ Par 5.

¹⁹² Par 5.

¹⁹³ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 67.

¹⁹⁴ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 67.

¹⁹⁵ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 68.

¹⁹⁶ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 67.

¹⁹⁷ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 68.

protector with substantial powers is really the trustee. One such author warning that even anything more than an obligation to consult the protector, could create a problem.¹⁹⁸ In this regard, the discussion of the case of the later decided *Garron/St Michael's/Fundy Settlement*-case will prove helpful as to the Supreme Court's view of the impact of the protector on the trust's residence.¹⁹⁹

Also in relation to this aspect of "other person" the question may be posed, what would be the effect where a trust instrument appoints a managing trustee in the instrument, or provides a mechanism to do so, or the trustees amongst themselves resolve and execute a document delegating the role of managing trustee to one of them?²⁰⁰ In such an instance, Frostiak *et al* state that it would be necessary to determine, whether the managing trustee does in fact manage the trust and control its assets. Where this is answered in the negative, they submit that the revenue authorities may disregard the terms of the trust and determine the trust's residence based on the residence of such person with whom the management and control rests.²⁰¹

In concluding, once management and control of a trust has been determined, and such person is an individual, the Interpretation Bulletin provides that the residence of such individual is determined, based on the normal factual tests for determining residence of an individual.²⁰² Where it is found to be a corporation, then the residence is again determined based on the normal factual tests for determining residence for a corporation. The latter is subject to one exception, where the control and management is exercised by a branch office, like a branch of a trust company. In such instance, residence will be in the jurisdiction where the branch office is located, although the corporation itself may be resident outside the jurisdiction.²⁰³ It may then be that notwithstanding another country may consider the trust to be resident in that country, after examining all factors, it be

¹⁹⁸ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 689. See for example Le Vesconte, P (Royal Bank of Canada Trust Company (International) Limited) "Power to the Protector: How much Power is too much power? - accessed online at www.rbcwmfiduciarynews.com/getfile.php?id=16 (Last accessed on 07/05/2013) which warns that where the protector is given too much powers, tax residence may be attributed in the country of the protector.

¹⁹⁹ See in particular par 68 of the Federal Court's judgment where it was found that it is a common characteristic of ordinary trusts and insufficient on its own to locate residence.

²⁰⁰ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner's Guide 2010* at 179 and footnote 13. The extent to which this delegation may be made will be subject to the terms of the trust instrument. The authors submit that this is not delineated well in the trust law, and becomes complex where the trust instrument does not expressly allow for it, thus inviting possible challenges as a result.

²⁰¹ Par 5 - Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner's Guide 2010* at 179.

²⁰² Par 6.

²⁰³ Par 7.

determined that the trust is resident in Canada.²⁰⁴ Reference is also made to the non-resident deeming provisions, whereby a trust not resident in Canada may be deemed as such.²⁰⁵

An open-ended statement is made last, by concluding that these considerations are viewed as relevant in determining the residence of a trust. However, where the purported residence appears to have been motivated by reasons of tax avoidance, regard may be had to other factors.²⁰⁶

Comments on the Interpretation Bulletin

The Interpretation Bulletin is not without criticism – this can be summarized as follows:

- No authority is given for the purported introduction of the management and control test.²⁰⁷
- The inclusion of factors to determine who has management and control are not justified as to why they were considered important.²⁰⁸
- Further factors could also be suggested for consideration²⁰⁹
- It does not address the issue of multiple trustees in differ jurisdictions adequately. The possibility of multiple or dual residence is not discussed. For example, there is no clarity on the circumstance where there are two trustees acting jointly in two jurisdictions. Alternatively where there are multiple trustees and it is required that they act unanimously. Where the latter is required, Ettinger submits that then management and control would be shared equally.²¹⁰ Instead, the Interpretation Bulletin can be said to assume that there will always be a controlling trustee/s to identify.

Despite these shortcomings, it could be regarded as “a valiant effort on the part of Revenue Canada to provide effective guidelines for determining the residence of a trust.”²¹¹ However it does not have the force of law, and therefore its effectiveness is questionable. This is more so as none of the reported cases dealing with this important issue of the residence of trusts, even make reference to it. Thus, case law remains vital and it is to the more recent judgments on this issue we turn shortly.

²⁰⁴ Par 8.

²⁰⁵ Par 9.

²⁰⁶ Par 11.

²⁰⁷ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 68.

²⁰⁸ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 69.

²⁰⁹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 69.

²¹⁰ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 68 – 69.

²¹¹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 68.

However prior thereto, regard is first had to this test of “central management and control”, which had received attention in the *Thibodeau*-case as well as implicitly in the Interpretation Bulletin.

8 3 2 5 “Central Management and Control”

In explaining this term, most often reference is made to the *De Beers Consolidated Mines Ltd v Howe*²¹² case, which had already in 1906 expounded the meaning. In that case the test was formulated by relying on precedent already 30 years old at that time²¹³, stating that -

“...In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad. ...I regard that as the true rule, and the real business is carried on where the central management and control actually abides... this is a pure question of fact to be determined, not according to the construction of this or that regulation or bye-law, but upon a scrutiny of the course of business and trading.”

This test was similarly adopted in Canada in relation to corporations and although a statutory incorporation rule was promulgated in the 1960’s, this *de facto* control test remains applicable.²¹⁴

As in South Africa, corporate law in Canada confers the legal power to manage the affairs of the corporation to the board of directors.²¹⁵ Thus the central and management will in ordinary cases, be where the corporation’s board of directors meet, as this will be the place where they manage the corporate entity.²¹⁶ The *De Beers*-case is an example thereof – the corporation was incorporated in South Africa, had its head office in South Africa, conducted its mining operations in South Africa, but its board of directors always met in England and made major policy decisions there and most of the directors were resident in England.²¹⁷ Consequently the residence of the corporation was determined to correlate with the latter factors and the corporation was found to

²¹² *De Beers Consolidated Mines Limited v Howe* (1906) AC 45.

²¹³ *Calcutta Jute Mills v Nicholson and the Cesena Sulphur Co v Nicholson* ((1876) 1 Ex.D. 428

²¹⁴ The statutory deeming rule is that if a corporation is incorporated after 26 April 1965, it is deemed to be resident. The De Beers test forms part of the common law. Brooks K in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 14.3.4

²¹⁵ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.4(a).

²¹⁶ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 689..

²¹⁷ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.4(a).

be resident in England. Similarly, shareholders are not empowered to manage the affairs of the corporation. Yet they do own the corporation and often possess some significant powers, such as the power to elect or remove directors.²¹⁸ Although the directors are therefore not the servants or agents of the shareholders, it may be that a major shareholder, or a group of shareholders who have effective voting powers, will be able to influence the decisions and may even go further and be seen to dictate decisions to the directors.²¹⁹ Often to illustrate this, reference is made to the case of *Unit Construction Co v Bullock*.²²⁰

This case is said to have upset the proverbial apple cart, the latter being a reference to the complacency with which it was accepted that central management and control would be where the board of directors met.²²¹ In this case, three corporations were incorporated in Kenya, their directors resided in Kenya and held their board meetings in Kenya, and the business was carried out in Kenya. However the parent corporation of the three corporations was found to effectively control the corporations by its board of directors in England.²²² Consequently the residence was determined to be where the central management and control was located, which was with the parent company resident in England. The court was faced with the difficulty that -

“... if we allow the appeal, of accepting that each of them has residence in two different countries without passing upon the validity of the alleged residence in Africa or indeed knowing what are supposed to be the determining circumstances that bring it about. I do not think that satisfactory. This case ought not to be regarded as in any sense an authority on the problems of double residence for companies. It deals only with what is a different point, whether assuming that all the acts which constitute central management and control of the subsidiaries' affairs take place in England, an English residence arises despite the fact that the persons who performed those acts had no authority under the companies' regulations to do so, nor could the meetings, if any, at which the decisions to act were taken validly be held in England. It is that point which has been argued before us.”

In the lower courts, the view was that "only constitutional, and therefore authorised, management and control are relevant to an inquiry as to the residence of a company." In the higher court this was found to reduce an inquiry, which has generally been regarded as one of "actual fact" to a mere formal reading of regulations. In particular the court found that the objective of all the prior judicial pronouncements was to repeat that the question where control and management abide

²¹⁸ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.4(a).

²¹⁹ *Unit Construction Co. v Bullock* (1960) AC 351.

²²⁰ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.4(a).

²²¹ McKie, AB "Canadian Tax Commentary: A Question of Residence" 27 *Tax Executive* 1974-1975 at 273.

²²² Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.4(a).

must be treated as one of fact or "actuality." Thus in the present instance –

“control and management in London remain a fact, despite the failure to adapt the companies' articles to the occasion. The articles prescribe what ought to be done, but they cannot create an actual state of control and management in Africa which does not exist in fact. In litigation *inter partes* this sort of situation may perhaps be brought about by the operation of the law of *estoppel*, but here I see no ground for saying, nor has it been argued, that there is any *estoppel* either by words or conduct which blinds the appellants in the face of the Revenue.”

Thus the crucial question was whether a principle ought to be applied that “evidence of what has happened in fact must be excluded by a rule of law if that which has been done is inconsistent with the regulations of the company.” This the court found would be an incorrect approach, as entities could be equipped with the most comprehensive set of documents, establishing management to be located in a specific tax jurisdiction and should the true facts then deviate therefrom, it would merely be deemed as unconstitutional and not be taken into account. To this court concluded –

“But I cannot think that such considerations are sufficient to introduce an important qualification upon this accepted test by which you try to ascertain what are the real facts about the seat of management and control and to put in its place what seems to be the merely formal device of studying a set of written regulations. I do not believe that this would conduce to the health of revenue administration.”

McKie describes that these local directors were “mere puppets” and this case provided revenue authorities with a new weaponry, the “puppet test” to challenge international operations in tax havens in particular.²²³ A distinction must however be made between where the “board of directors of a corporation is exercising an independent discretion, albeit influenced by a shareholder, or other outsider, or whether the board has actually surrendered its discretion.”²²⁴ Succinctly put it is “control that determines the jurisdiction of residence; influence does not.”²²⁵ This may often be a question of degree which is complicated to determine on the facts.

In the Thibodeau-case, the court was not prepared to apply this test for determining residence for corporations to trusts, stating that the judicial formula cannot apply to trustees as trustees can not delegate any of their authority to co-trustees. Whilst the absoluteness of this rejection was long questioned by academic writers, the correctness of this finding was to be addressed in the recent Supreme Court case of *Fundy Settlement v Canada*,²²⁶ discussed next.

²²³ McKie, AB “Canadian Tax Commentary: A Question of Residence” 27 *Tax Executive* 1974-1975 at 273.

²²⁴ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.4(a).

²²⁵ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 704.

²²⁶ 2012 SCC 14, Judgment delivered on 12 April 2012.

8 3 2 6 Fundy Settlement v Canada

Said to be a “new landmark” in Canadian tax law,²²⁷ this case is regarded to be have been the “most widely anticipated trust tax case in over three decades” and would “forever change the way... the residency of a trust for tax purposes” is viewed.²²⁸

The case had progressively made it way up through the hierarchical court structure, but on each occasion did so without success for appellant, being the St Michael Trust Corporation, the sole trustee of two trusts, the Fundy Settlement and the Summersby Settlement. As trustee, it had appealed against assessments issued to the trusts by the Canadian Revenue authorities, first to the Tax Court where it was reported as *Garron Family Trust v. The Queen*,²²⁹ then against the dismissal of its appeals to the Federal Court of Appeal, reported as the *St. Michael Trust Corp. v. Canada*,²³⁰ and eventually to the Supreme Court of Appeal, (now reported as the *Fundy Settlement v Canada*) where it met a similar dismal fate.

The two trusts had been established by an unrelated individual who was resident in St Vincent in the Carribean, an island close to Barbados.²³¹ St. Michael Trust Corporation (referred to as St Michael herein after), the sole trustee of each trust, was a corporation resident in Barbados.²³² The two trusts were separately for the benefit of a family each, all such beneficiaries resident in Canada.²³³ A protector for the trusts had been appointed, who was a resident of St Vincent. The transaction that gave rise to the assessment was the disposal of shares in a Canadian company by the trusts, giving rise to considerable capital gains.²³⁴ As the shares were taxable Canadian

²²⁷ Cestnick, T “Offshore trusts can still fall within Canada’s tax net” Published 18 April 2012 in The Globe and Mail. Available online at <http://www.theglobeandmail.com/globe-investor/personal-finance/offshore-trusts-can-still-fall-within-canadas-tax-net/article4100963/?service=mobile>, last accessed on 07/05/2013.

²²⁸ STEP Inside Editorial Board “Mind and Management – Courts get Garron Right” Editorial, *STEP Inside (Canada)* May 2012 Vol 11 at 2.

²²⁹ 2009 TCC 450.

²³⁰ 2010 FCA 309.

²³¹ Par 1. The Fundy Settlement (the Garron Trust) had as beneficiaries, Mr Garron, his spouse, their children and issue, and any trust established for the benefit of them. The Summersby Settlement (the Dunin Trust) had Mr Dunin, his spouse, children and issue, and any trust established for the benefit of any of them as beneficiaries. The Settlor was reported to be a longtime friend of Mr Garron.

²³² Par 1. It was incorporated in Barbados. At the time its shares were held by the Barbados partners of the accounting firm, Price Waterhouse which later merged with Coopers & Lybrand to become PricewaterhouseCoopers. St Michael’s sole business activity was the administration of trusts (par 27 of the Federal Appeal Court case).

²³³ Par 1.

²³⁴ Par 2. An extensive overview of the facts were given in the Federal Court (par 15 -50) and the

property, withholding tax in respect of the gain was calculated and duly remitted to Minister of National Revenue of Canada.²³⁵ To be expected, it may be noted that Barbados does not tax capital gains realized by its residents.²³⁶

On application to the authorities to return the withheld amount, St Michael relied on an exemption from capital gains tax under the tax treaty between Canada and Barbados.²³⁷ In terms thereof, tax would only be payable in the country where the seller was resident. St Michael claimed that it was resident in Barbados, and thus as the trusts' trustee, the trusts were resident in Barbados.²³⁸ Consequently there was no basis to withhold the tax as Canada was not the country where the seller (trusts) was resident. In this it met with a difference of opinion from the Minister of National Revenue which regarded the trusts to be resident in Canada and the withheld tax indeed to be payable.²³⁹ A treaty had been entered into between Barbados and Canada. In terms of the treaty's provisions, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to taxation therein by reason of his domicile, residence, place of management or other criterion of similar nature."²⁴⁰ The trusts would be resident of Canada, if under the laws of Canada, they were liable to taxation by reason of, *inter alia*, their residence.

Thus the crucial issue was the residence of the trusts, and how same had to be determined. Again a difference in opinion was expressed. St Michael argued that the residence of the trusts must be alluded on the basis of the "residence of its trustee" (Barbados), whilst the Minister argued that the "central management and control test" must be applied and regarded that to be in Canada.²⁴¹ This

particular nature of the transaction, as well as the in the Tax Court. The capital gains that were realized was over \$450 million for the two trusts.

²³⁵ This was done in terms of S116 of the Act which provides for reporting procedures to facilitate the collection of non-resident tax of disposals of taxable Canadian property.

²³⁶ Ernst & Young "What determines where a trust resides? 2009 Issue No 27

²³⁷ *Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital*, incorporated into Canadian law by the *Canada-Barbados Income Tax Agreement Act, 1980*

²³⁸ Par 3 of the case. Par 4 of Article XIV of the Tax Treaty allows a "person" (specifically including a trust) who meets the treaty definition of "resident of Barbados" but not the treaty definition of "resident of Canada" an exemption from Canadian income tax on any capital gain realized on the disposition of shares of a corporation.

²³⁹ Par 4.

²⁴⁰ In terms of Par 1 of Article IV Par 3 directs that should a person (other than an individual) be resident of both Contracting States, then the competent authorities shall by mutual agreement endeavour to settle the question and determine the mode of application to the person. However in the tax Court it was found that no agreement by the competent authorities of Canada and Barbados to engage the residence tie-breaker provision had been made. As the Minister had however not put this in issue, the court was not willing to decide the appeal on whether the trust was resident in Barbados.

²⁴¹ Par 6.

latter view was endorsed in the Tax Court, where it was found that on the facts, whilst St Michael as trustee was resident in Barbados, the central management and control of the trusts were carried out by the principal beneficiaries in Canada.

Two further alternative arguments were made by the Minister. Firstly, that the trusts should be deemed residents of Canada in terms of the provisions for taxing of non-resident trusts as set out in Section 94.²⁴² Thus, in the event they were found to be non-resident in terms of the common law, then these provisions should deem the trusts to be resident and thus Canadian residents for purposes of the treaty exemption. Alternatively, it argued for an anti-avoidance provision to be invoked so that the benefit should be denied on the basis, that it frustrated the relevant parts of the treaty.²⁴³ Ultimately it was not necessary for the court to make a finding on either of these arguments.²⁴⁴

The Supreme Court of Appeal provided a singularly, unanimous (as well as anonymous as it was written by “the Court”) judgement.²⁴⁵ It commenced its judgment by referring to the principles underlying the residence basis for imposing income tax in Canada, namely that it is to ensure that

²⁴² Par 18. The SCA did not find it necessary to make a finding. The Federal Court found that the deeming provisions result in the non-resident trust to be a person resident in Canada but not for all purposes but only for purposes relevant to Canadian source income and foreign accrual property income. Thus treaty exemption would trump the applicable provision. If therefore the central management and control test is not applied and the trust consequently in common law held not to be resident but deemed to be resident in terms of this section, the trust would have been able to avail themselves of the exemption from Canadian capital gain tax. This is so because the applicable section does not render the trusts fully “liable to tax” in Canada for purposes of the treaty as it creates a less comprehensive tax base than normal residents. Consequently they would have not been resident of Canada for treaty purposes and able to utilize the exemption as Barbados residents. See Pars 73-88 of the Federal Court of Appeal’s judgment.

²⁴³ S 245(2). Again in the lower courts the issue was decided. There it was found that the issue turns on whether the series of transactions that resulted in the trust becoming entitled to the treaty exemption in the face of the deeming provision (s94) is an abuse or misuse of the tax treaty. If residence is to be found on the basis of the residence of the corporate trustee, then the trust have not avoided the provision. If then residence then the trust cannot misuse or abuse the tax treaty by claiming the exemption which Canada had explicitly negotiated to be available for Barbados Treaty Residents.

²⁴⁴ Par 19. It determined residence according to the common law principles.

²⁴⁵ The panel consisted of seven judges. Siegal notes that this makes this decision quite unique as particularly such ‘per curiam’ decisions are few and are usually reserved to indicate unity in important and controversial cases. Whilst he states that there is nothing controversial about this routine tax appeal, it is a strong signal from the court to be progressively show be more unified on tax matters. Siegal, B “SCC Pulls Back the Curtain on Trust Residence” Published 27 April 2012 online at http://www.martindale.com/trusts-estates-law/article_1502924.htm and accessed last on 07/05/2013. Also of similar view, Spiro, D “A Triumph of Functionalism over Formalism: SCC holds that the test for determination of residence of a trust is “central management and control” Published on 12 April 2012 at <http://www.canadiantaxlitigation.com/tag/st-michael-trust-corp> – last accessed on 07/05/2013.

“a person who enjoys the legal, political and economic benefits of associating with Canada will pay their appropriate share for the costs of this association.”²⁴⁶ Generally, residence is a question of fact. In the Federal Appeal Court this was also stated with the added text, that it requires a consideration of a number of factors that would either point to, or away from, an economic or social link between the person and a particular country.²⁴⁷

In relation to the residency of a trust, it was concluded by the court that there was a dearth of judicial authority.²⁴⁸ In relation to companies, the test for residency is where its central management and control abides,²⁴⁹ a test which has been adopted in Canada and is well-established.²⁵⁰ Generally central management and control will be exercised where its board of directors exercise their responsibilities, but where the circumstances are that the central management and control is exercised by a shareholder, then the corporation will be found to be resident where the shareholder resides.²⁵¹ In the Federal Appeal Court this was explained as follows

“...the residence of a corporation is determined primarily by finding the location of the corporation’s central management and control, which is a question of fact. The relevant factors include the legal indicia of the place where the corporation’s management and control should be exercised (as disclosed, for example, by the corporation’s governing law and constituting documents). Where a corporation is actually managed and controlled by its directors in the manner contemplated by its governing law, the residence of a corporation usually will be determined as the place where the corporate directors exercise their management and control responsibilities. ... However, that may not be the result if the facts disclose that the corporation is not in fact managed and controlled as its governing law requires. In that regard it is relevant to consider the nature of the decision making authority actually exercised by the directors. If significant management decisions are in fact taken by a person who is not a director, the place where that person resides or operates may be determined to be the residence of the corporation. Thus, for example, if it is established that management and control is exercised in fact by a shareholder operating out of another country, the corporation may be found to be resident where the shareholder resides.”

St Michael had argued that that the residence of the trust must be the residence of the trustee, and did so based on two fundamental propositions:

- (a) The first proposition being that a trust is not a “person” such as a corporation is²⁵² and thus

²⁴⁶ Par 7.

²⁴⁷ Par 53 of the Federal Appeal Court Case.

²⁴⁸ Par 8.

²⁴⁹ Reference was made to the *De Beers Consolidated Mines Ltd-case*.

²⁵⁰ Par 8. So too had the Federal Appeal Court found that there is “very little jurisprudence” in relation to the determination of the residence of a trust for tax purpose.

²⁵¹ Par 9 and in support of this contention quoted *Unit Construction Co. v. Bullock*, [1960] A.C. 351 (H.L.)

²⁵² A trust is regarded as a “legal relationship” but without a separate legal personality.

the central management and control test is not applicable to the trusts.²⁵³ The court dismissed this argument finding that although a trust is not a person at common law, it is deemed to be an individual under the Act, and thus the fact that it does not have an independent legal existence is irrelevant for the Act's purposes.²⁵⁴

- (b) The second fundamental proposition it raised related to the wording of the Act which reads that “a reference to a trust... shall unless the context otherwise requires, be read to include a reference to the trustee having ownership or control of the trust property”, which in its view, linked a trust to its trustee for all attributes, including residence.²⁵⁵ The court found that St Michael did not produce any provision linking the trust and trustee specifically for purposes of determining residence, and the link that it asserted is not a principle of general application to trusts for *all* purposes. The linkage found in the wording had been said in the Federal Court, to have as its objective the resolution of practical problems of tax administration that would necessarily arise when it was determined that the trust may be taxed, despite it not having legal personality.²⁵⁶ However there is nothing in the context of the particular section that would suggest a legal rule, that the residence of a trust must be the residence of its trustee. On the contrary the next subsection separates the trust from the trustee in respect of the trust property and it is the trust who is subject to the basic charging provision, not the trustee.²⁵⁷

Having dispensed with the above arguments, the court found many similarities between a trust and a corporation that would justify the application of the central management and control test for determining the residence of a trust.²⁵⁸ The Tax Court had found the essential function of each to be the management of property.²⁵⁹ The similarities identified by the Supreme Court are duplicated below:²⁶⁰

- 1) Both hold assets that are required to be managed;
- 2) Both involve the acquisition and disposition of assets;
- 3) Both may require the management of a business;

²⁵³ Par 10.

²⁵⁴ Par 10 – quoting Section 104(2) of the Income Tax Act. The explanation provided by the Federal Court of Appeal is more clear – a trust is not a person but for income tax purposes a trust is treated as though it were a person. Consistent with this implicit statutory is the recognition that the residence of a trust is not always determined by the residence of its trustee – at Par 63.

²⁵⁵ Par 11 – quoting Section 104(1).

²⁵⁶ Par 11. Federal Court of Appeal at par 64.

²⁵⁷ Par 13.

²⁵⁸ Par 14.

²⁵⁹ Tax Court at par 159.

²⁶⁰ Par 14

- 4) Both require banking and financial arrangements;
- 5) Both may require the instruction or advice of lawyers, accountants and other advisors; and
- 6) Both may distribute income, corporations by way of dividends and trusts by distributions.

A second justification was that a similar test for trusts and companies promoted the important principles of consistency, predictability and fairness in the application of tax law.²⁶¹ A third justification was that if a totally different test for trust is to be applied there must be good reasons and no such reasons were provided.²⁶² Thus the court was justified to apply the central management and control test.

Upon application of the test that the “central management and control” of the trust will be where “its real business is carried on”²⁶³ to the facts of the case, this had been found by the Tax Court to be in Canada where the principal beneficiaries exercised it.²⁶⁴ The corporate trustee, St Michael had a circumscribed role – to provide administrative services and little or no responsibility beyond that.²⁶⁵ Therefore the trusts must be found to be resident in Canada. The court made a clear warning on the possible interpretation of its judgment by stating that this case however does not imply that the residence of a trust can never be the residence of the trustee - where the central management and control of the trust is carried out by the trustee and the duties are performed by him where he is resident, then the resident of the trustee will be the residence of the trust.²⁶⁶

Comments on the Case

For the many professional advisors the significance of the case lies therein that it has purportedly established a fresh approach to determine the trust’s residence for tax purposes, namely that it is now determined according to central management and control and that the actions of others, who may not necessarily the trustees, may be taken into account.²⁶⁷ In so doing it is seen to have considerable implications for tax planning arrangements involving trusts where reliance was placed on the historical concept of the residence of the trust ie solely on the location of the residence of the trustee, and

²⁶¹ Par 16.

²⁶² See Par 161 of the Tax Court where the Judge explains that the development of a test of trust residence has been left by Parliament to the courts. Thus if the courts were to develop a totally different test of residence than they have for corporations, good reasons must be advanced.

²⁶³ De Beers-case at p458.

²⁶⁴ Par 1.

²⁶⁵ Par 15.

²⁶⁶ Par 15.

²⁶⁷ Anon, “Canadian Non-Resident Trust Rules: New Draft Legislation” published 03/12/12, available at <http://www.stikeman.com/cps/rde/xchg/se-en/hs.xsl/17070.htm> – last accessed on 07/05/2013.

oblivious to where the actual control and management of the trust is carried out.²⁶⁸

A further consequence of this case is that in each matter now the “central management and control” must be established, necessitating that each and every arrangement must be reviewed, and that it must be determined who is making the major decisions, the extent to which beneficiaries’ “advices and suggestions” can be seen as directions to the trustees, where those decisions are made, and how those decisions are documented and executed.²⁶⁹ This is seen by some as an impediment to utilize the trust vehicle in international and provincial tax planning.²⁷⁰ This may be the impact of the case on a practical level, but on a more academic level, the following issues arise:

a) Conflict with the *Thibodeau*-case

Three points may be made in this regard. The first that comes to mind is the relationship between this case and the precedent purportedly established by the *Thibodeau*-case. Generally the latter had been taken to establish that the residence of a trust is determined by the *residence of its trustee*, or where the majority reside, where the trust instrument allows the majority to act for the

²⁶⁸ International Law Office “Central Management and Control Determines Trust Residence” Newsletter (Offshore Services – Canada) published on 8 October 2009; Anon “Supreme Court confirms Central Management and Control Test for Trust Residency” Tax News Flash of Aird & Berlis LLP available at <http://www.airdberlis.com/Templates/News/NewsDetail.aspx?NewsID=474&page=54&search=Supreme%7cCourt%7cconfirms%7cCentral%7cManagement%7cand%7cControl%7cTest%7cfor%7cTrust%7cResidency> – last accessed 07/05/2013. Cestnick, T “Offshore trusts can still fall within Canada’s tax net” Published 18 April 2012 in The Globe and Mail. Available online at <http://www.theglobeandmail.com/globe-investor/personal-finance/offshore-trusts-can-still-fall-within-canadas-tax-net/article4100963/?service=mobile>, last accessed on 07/05/2013. KPMG, “Supreme Court Confirms “Management and Control” Residency Test for Trusts” TaxNewsFlash Canada. Available online at <http://www.kpmg.com/ca/en/issuesandinsights/articlespublications/tnf/pages/tnfc1217.htm> - last accessed 07/05/2013; Ernst & Young “Supreme Court of Canada decides landmark residence case” 2012 Issue No 19 Published on 13 April 2012, available online at [http://www.ey.com/Publication/vwLUAssets/Tax_Alert_2012_No_19/\\$FILE/TaxAlert2012No19.pdf](http://www.ey.com/Publication/vwLUAssets/Tax_Alert_2012_No_19/$FILE/TaxAlert2012No19.pdf) – last accessed 07/05/2013.

²⁶⁹ Siegal, B “SCC Pulls Back the Curtain on Trust Residence” Published 27 April 2012 online at http://www.martindale.com/trusts-estates-law/article_1502924.htm and accessed last on 07/05/2013; Dalton, J “Taxpayers must review trusts after SC ruling” Published 1 May 2012 online at [http://www.internationaltaxreview.com/Article/3018212/Search/Taxpayers-must-review-trusts-after-Canadian-SC-ruling.html?Keywords=Taxpayers+must+review+trusts+after+SC+ruling&OrderType=1&PartialFields=\(CATEGORYIDS%3a10329\)&tabSelected=True&Brand=ITR](http://www.internationaltaxreview.com/Article/3018212/Search/Taxpayers-must-review-trusts-after-Canadian-SC-ruling.html?Keywords=Taxpayers+must+review+trusts+after+SC+ruling&OrderType=1&PartialFields=(CATEGORYIDS%3a10329)&tabSelected=True&Brand=ITR) and accessed last on 07/05/2013. Tax Specialist Group “Residence of Trusts” Published 05/04/2012 at <http://www.taxspecialistgroup.ca/public/taxtips.asp?n=12-10&site=tsg> and accessed on 07/05/2013; Grant Thornton “Supreme Court of Canada addresses the residency of trusts” April 2012 – available online at http://www.grantthornton.ca/resources/insights/articles/Supreme_Court_of_Canada_addresses_residency_of_trusts.pdf - last accessed on 07/05/2013. Itta, M “SCC puts Garron Debate to rest” *STEP Inside (Canada)* May 2012 Vol 11 at 3.

²⁷⁰ Ernst & Young “What determines where a trust resides? 2009 Issue No 27 in relation to the Garron Judgment; Smith, J “Offshore Trusts under attack” *CA Magazine* (January/February 2010) at 32-24.

trust. This was also understood from the Interpretation Bulletin issued by Canadian Revenue authorities, which regarded it to be the general consideration. The test laid down in this case is however one of “central management and control.” Thus it is said that the case is a major departure from the 30 year old entrenched position, which looked to the residence of the trustees.²⁷¹ The Supreme Court however did not even mention the *Thibodeau*-case in its judgment or provided reasons as to why it was not endorsing the precedent such earlier case had purportedly established.²⁷² Useful insight is however provided in the judgment of the (lower) Tax Court which had found that²⁷³ –

“It is clear from the reasons in *Thibodeau* that the judge did not purport to state a general test of trust residence. The decision was intended to be limited to the particular facts of the case. At page 6386: *In this case, [...] a judicial formula applicable to the facts of this case alone must be employed, [...].*”

Thus the *Thibodeau*-case was concluded not to be *general* authority for the proposition that the residence of the trustee must be the decisive factor in determining the residence.²⁷⁴ This the Federal Court similarly affirmed, by stating in general terms that no case had found the residence of the trustee to be an invariable legal test for the residence of the trust.²⁷⁵

A second point in respect of the *Thibodeau*-case, is that in the Federal court it was acknowledged that the *Thibodeau*-case is perceived by some as an absolute rejection of the corporate test for residence for trusts. After all, the central management and control test was expressly argued for by the revenue authorities there but such submissions were rejected.²⁷⁶ However, the Federal court felt that if regard is had to the actual comments of the *Thibodeau*-court as cited in support for the blanket rejection of the central and management test, it is apparent that it was done in a narrower context, namely that of dual residence. The court found that on its interpretation of the *Thibodeau*-case, it was not authority that the residence of a trust can never be determined on the basis of the place where central management and control is exercised and must always be exclusively based on the residence of the trustee.²⁷⁷

²⁷¹ Siegal, B “SCC Pulls Back the Curtain on Trust Residence” Published 27 April 2012 online at http://www.martindale.com/trusts-estates-law/article_1502924.htm and accessed last on 07/05/2013.

²⁷² The *Thibodeau* case was a Federal Trial Court Division case and thus is lower on the hierarchy than the Supreme Court.

²⁷³ Par 137.

²⁷⁴ Par 139.

²⁷⁵ Par 59 of the Federal Appeal Court judgment.

²⁷⁶ Par 60 of the Federal Appeal Court judgment.

²⁷⁷ Par 61 of the Federal Appeal Court judgment.

A last point to be made in respect of the *Thibodeau*-case, relates to the emphases it had seemingly placed on the trustees compliance with their fiduciary obligations, in concluding that the central management and control test cannot be applied to the trust, as they cannot delegate their authority. Thus the concept can not be applied as the fiduciary duties imposed on trustees, would not permit them to take directions from a third party.²⁷⁸ In the present case, it would certainly be doubtful whether the trustees would be meeting their fiduciary obligations to the beneficiaries, if they were but taking directions from the two patriarchs of the families.²⁷⁹ Unfortunately the Supreme Court of Appeal did not discuss this aspect, yet the Tax Court did. The Tax Court regarded such view to be based on the assumption that the trustees will always comply with their fiduciary obligations, which the court found may not always be the case. In support it referred to the case of *Robson Leather Company Ltd v MNR*,²⁸⁰ a Federal Court of Appeal case, which although it did not deal with residence, also dealt with the issue of control. There the assumption was framed in the negative, “it was argued that it could not be assumed that the trustees would not carry out their duties as trustees in accordance with the legal obligations imposed on trustees ... but rather would follow Robson’s instructions merely because he had the power to cause the retirement of either or both...” This argument was rejected by the court and the following extract reflects the reasoning of the lower court it endorsed²⁸¹ –

“In my opinion, however, in deciding the larger issue before me. I must look at the practical and business reality of the operation of the trust. By demanding retirement of trustees, or even the threat of such demand, or the knowledge in the co-trustees that the ultimate power was always in Mr. Robson, I have no doubt that Mr. Robson, for practical and legal purposes, controlled the trust and, therefore, controlled Robson Leather. I add the caveat here, that share control alone, (or absence of it), is not necessarily conclusive; it is a factor to be considered in determining questions of arm's length. With this conclusion I agreeThus, while Robson did not have de jure control of the Appellant, he did have de facto control.”

In the Tax Court’s view it does not make sense to assume that in every case the trustees will comply with their fiduciary obligations, instead the particular facts and circumstances must be considered.²⁸² This brings us to the next point.

b) Importance of factual approach

This case illustrates the importance of *de facto* management and control, as opposed to *de iure*

²⁷⁸ Ernst & Young “What determines where a trust resides? 2009 Issue No 27 in relation to the Garron Judgment.

²⁷⁹ Brodlieb, JM ““St Michael Trust Corp v The Queen – Central Management and Control Test Applies to Trusts” Ontario Bar Association Taxation Law Newsletter Vol 21 No 2 – April 2011 – Available online at http://www.fmlaw.com/upload/en/publications/2011/0411_Brodlieb_Jesse_Michael_Trust_Queen.pdf- last accessed 07/05/2013.

²⁸⁰ 77 DTC 5106. The case was decided shortly before *Thibodeau*.

²⁸¹ P 5112.

²⁸² Par 150.

control and management. Both the Supreme Court and the Federal Court of Appeal accepted that the residence of the trust may correspond with the residence of the trustee, where the trustee carries out the central management and control of the trust, and these duties are performed where the trustee is resident.²⁸³

The Federal Court went one step further and predicted that in “most cases” the residence of the appointed trustee, will be sufficient basis in fact for determining the residence of the trust. Yet this does not constitute a rigid legal test that necessarily ties the residence of a trust to the residence of the trustee. This would not in the lower court’s view be in accordance with the central theme of the jurisprudence on the determination of residence for tax purposes, which is that residence is “fundamentally a question of fact” and hence a “fact driven analysis” approach must be followed.²⁸⁴

c) Role of corporate trustee

The case has also given attention to the role of trustee and their level of activity and independence. The Tax Court had harsh words towards the professional conduct of the corporate trustee in the present case. It regarded its true role as “to execute documents as required, and to provide incidental administrative services”. It was not expected to “have responsibility for decision-making beyond that”, instead of exercising its own discretion as per the trust instrument, it would “default automatically” to the recommendation of the two controlling beneficiaries, and it was they who “made the substantive decisions” regarding the trust. It may be useful to have regard at the facts which the Judge regarded as leading to such conclusion:²⁸⁵

- a) *The powers of the beneficiaries and the role of the protector:* The two controlling beneficiaries, and their spouses had the power in terms of the trust instrument to substitute the protector, who in turn could replace the trustee, if the trustee acted against their wishes.
- b) *Limited role to be played by the trustee:* The corporate trustee had a limited role which had been “understood by all parties at the outset” – for example, it had no decision making role in respect of the sale of the interest in the companies, nor of the investment of the proceeds received on the sale, the making of distributions to beneficiaries, and that such decisions would be made by the two controlling beneficiaries.

²⁸³ Par 15 of the Supreme Court of Appeal judgment & Par 62 of the Federal Court of Appeal Judgment.

²⁸⁴ Par 62 of the Federal Court of Appeal judgment.

²⁸⁵ Par 67 of the Federal Court Judgment.

- c) *Identity of advisers and beneficiaries ability to instruct them:* The investment advisers to the trust were the same as to the beneficiaries which facilitated the latter's direct dealings with them and to directly control the investment activity without the involvement of the corporate trustee; The tax advisers were similarly utilised by both the beneficiaries and the trusts.
- d) *A lack of documentary evidence to establish that the corporate trustee took an active role in managing the trust.* Instead the correspondence and other documents filed, reflected that it had no involvement aside from the execution of documents and in administrative, accounting and tax matters.
- e) *The expertise of the trustee.* The corporate trustee was an arm of an accounting firm. This gave it significant expertise in tax and accounting matters, yet its expertise in the management of trusts assets was questionable.
- f) *Evidence of the beneficiaries* The oral evidence of the two controlling beneficiaries did not advance their case. The court found the one to be particularly disingenuous in his statement that the corporate trustee controlled the trust, which in light of his substantial economic interest in the Trust could not hold water as should the corporate trustee have actually controlled the trust, he would have been greatly interested in what they were doing given his exposure.
- g) *Inference to be drawn from omission to call key parties* Certain key personnel were not called to give evidence – including the lead adviser on the sale, investment advisers, the person in charge when the trust were created, the protector.
- h) *Lack of knowledge of the trustee* Those who were called on behalf of the corporate trustee did not have substantive information about the transactions, the purported due diligence it carried out in any of the relevant transaction – an indication that the role of the corporate trustee was intended to be limited to administrative matters.

The Federal Court did recognise that certain of these factors are common characteristics of ordinary trusts, and would not on their own be sufficient to hold the trust's residence other than in Barbados. It cited several examples. The right to appoint a protector who is empowered to replace the trustee is a general safeguard and does not translate to the beneficiaries having control of the trust.²⁸⁶ Similarly the fact that the beneficiaries and trustees have common advisers, or that they advised the corporate trustee themselves, or even encouraged it to engage in a particular transaction would fall short of vesting control in them.²⁸⁷ Even where the trustee has little investment experience, this may not prove conclusive, as it may have the power to retain others for advice and remain the one who ultimately

²⁸⁶ Par 67 of the Federal Court Judgment.

²⁸⁷ Par 67 of the Federal Court Judgment.

makes the decisions.²⁸⁸

A line must however be drawn between recommendations, even if strongly advanced yet still allowing the trustee to decide freely the exercise of his powers and discretions and thus remain “managing and controlling the trust.”²⁸⁹ and on the opposite side, a situation where beneficiaries are really exercising the powers and discretions under the trust, and hence manages and controls the trust.²⁹⁰ This therefore remains a factual enquiry, necessitating the consideration of all the evidence. The case is said to highlight the importance of trustees ultimately making their own decisions, for which sufficient expertise and the necessary information to do so, should be at hand.²⁹¹ Yet it is also said that in so doing, it added a new level of uncertainty, as it will require “many more cases, before the taxpayers can be sure on which side of the line their particular facts fall.”²⁹²

d) Other Criticisms against the case

Some authors strongly lament the fact that the trust has now been equated with a corporation. Grinhaus explains²⁹³ –

“The most recent authority expounding the test for determining this paradoxical question analogizes a trust, which it presumes is an entity of sorts, to a corporation. This type of analysis loses sight of the basic principles underlying the trust relationship, accepts it as a separate entity in law, and creates problems of enforcement when it comes to assessment for income tax purposes.”

According to him, the process of first analogizing and subsequently equating trusts with corporations began in the *Thibodeau*-case as a result of the weak distinction on which the court relied, with the final nail in the coffin being the more recent *Garron*-case, a case which “ultimately

²⁸⁸ Par 67 of the Federal Court Judgment.

²⁸⁹ Par 68 of the Federal Court Judgment.

²⁹⁰ Par 68 of the Federal Court Judgment.

²⁹¹ Osler, Hoskin & Harcourt LLP “Supreme Court of Canada decides on trust tax residency” Published on 13 April 2012 – available online at <http://www.lexology.com/library/detail.aspx?g=15a2ec65-eda1-429a-b532-8fe4d826119b>; Last accessed on 07/05/2013.

²⁹² Brodlieb, JM ““St Michael Trust Corp v The Queen – Central Management and Control Test Applies to Trusts” Ontario Bar Association Taxation Law Newsletter Vol 21 No 2 – April 2011 – Available online at http://www.fmlaw.com/upload/en/publications/2011/0411_Brodlieb_Jesse_Michael_Trust_Queen.pdf- last accessed 07/05/2013. For example the question may be asked what the result would have been had the trustee been more active in the sale of the assets of the trust - Wong, PA & Wong, S “Central Management and Control Test Determines Residence for Canadian Tax Purposes” Tax Law Bulletin of Borden Ladner Gervais (April 2012) Available at <http://www.lexology.com/library/detail.aspx?g=fedc05a8-6731-4476-998a-f93d37692371> - Last accessed on 07/05/2013.

²⁹³ Grinhaus, A “There’s No Place Like Home” Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

killed the distinction between corporations and trusts in the most fundamental sense: the nature of the ownership of property.”²⁹⁴ Whereas the courts had named as justification the fact that the function of both a trust and corporation is at a basic level, the management of property, Grinhaus is of the view that such a simplistic analogy disregards the fundamental difference between a trust and corporation as a trust does not have the same uses, characteristics or aims.²⁹⁵ When a corporation holds property it holds both legal and beneficial title; in a trust relationship these are divided amongst the trustees and beneficiaries.²⁹⁶ Furthermore he explains²⁹⁷ -

“... a corporation is not merely created for the management of property, but instead for the protection of individuals engaged in risk, for their own personal gain: The very purpose of a corporation is to separate out conduct and pocketbook, to allow some to contribute capital and share in profit, and to allow others to contribute work, generally for a fixed return. On the other hand, a trust is the opposite: it is designed to minimize risk by those who do not stand to gain anything: —[a] trust is an equitable obligation binding a person (called a trustee) to deal with property owned by him ... for the benefit of persons ... anyone of whom may enforce the obligation. Given this distinction, one cannot simply analogize these two vehicles as being for the —management of property, and even if they were, the mode by which this management would occur differs on an axiomatic level.”

Grinhaus also analyses the rationale for adopting the central management and control test for corporations, as based on the *De Beers* case, being that “it is the place where the corporation derives its main benefit – namely the protection of the law for the peaceful administration of a business.”²⁹⁸ Juxtaposed with a trust, the parties that stand to benefit are the beneficiaries and not those who run the business of the trust. This he submits is why the test is inapplicable to trusts which do not operate the way corporations do within the legal system.

²⁹⁴ Grinhaus, A “There’s No Place Like Home” Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

²⁹⁵ Grinhaus, A “There’s No Place Like Home” Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

²⁹⁶ Grinhaus, A “There’s No Place Like Home” Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

²⁹⁷ Three main criticisms are leveled by him at the case. Firstly that the decision was clearly tailored to the specific circumstances of the matter ie where the beneficiaries are really calling the shots and not the trustees. Consequently where the court discarded a thirty year old test is it should have discussed the various differing circumstances which will be caught by the new test - an analysis was not substantially conducted. Secondly the court incorrectly proceeded on the basis that trusts and corporations are analogous in their primary function of managing property as discussed above. Thirdly the assets of a corporation are ascertainable in the name of the corporation, whereas beneficial title vests in the beneficiary of a trust but is controlled by the trustee. Thus the focus is on control as opposed to ownership is inappropriate in the trust context. Grinhaus, A “There’s No Place Like Home” Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

²⁹⁸ Grinhaus, A “There’s No Place Like Home” Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013..

Murdoch similarly finds that not one of the three judgments considered the trustee's legal ownership to be relevant, which is important as in terms of the common law, by virtue of the trustee's legal ownership, a presumption that the trustee has central management and control over the trust, unless the trustee role has been usurped, should have been made by the courts.²⁹⁹ Instead the court by application of the central control and management trust directs the search from who controls the trust property, rather to who manages or supervises the business of the trust – it “wants to know who controls the business and affairs of the relationship that is the trust in the same way that it seeks to know who controls the business and affairs of the legal fiction that is a corporation.”³⁰⁰ Most often with corporations, legislation will state that the directors shall manage or supervise the management of the business and affairs of the corporation, which is then also endorsed in the corporation's articles. In contrast, trust law does not create a person and no similar provisions as to who manages or controls the business of the trust appear. Instead the focus is on the management or control of the trust property, which appears to be an immaterial factor to the central management and control test.³⁰¹ Consequently Murdoch states that

“... there is potential for chaos in that the CMC Test seeks to know who has management and control of a *trust*, that the management and control of *trust property* is irrelevant, that private trust law, preoccupied as it is with the relationship between trustees, beneficiaries and the trust property, will not provide a satisfactory answer, and that Canadian courts in determining the question of central management and control of a trust will start with a blank slate, searching widely for the party with the greatest influence and power over trust affairs, and for the place where such party wields such influence and power.

He concludes that such an approach would undermine the principles of “consistency, predictability and fairness in the application of tax law”, which the courts seek to promote.³⁰²

A further point that he notes is that it is clear that in the application of the central management and control test, any fettering of the discretion or decision-making of the trustees will be a relevant factor.³⁰³ A factor which however was not considered in the cases was split decision-making, where for example the trustee is not empowered to make certain types of decision which power is instead given to other parties eg investment decisions by the investment advisor, the making of distributions by the distribution advisor.³⁰⁴ Where such split decision making does occur, and it is done in more than one jurisdiction he predicts that it will “wreak havoc on attempts to apply the

²⁹⁹ Murdoch, J “Applying the CMC test: Some Guidelines” *STEP Inside (Canada)* May 2012 Vol 11 at 4.

³⁰⁰ Murdoch, J “Applying the CMC test: Some Guidelines” *STEP Inside (Canada)* May 2012 Vol 11 at 4.

³⁰¹ Murdoch, J “Applying the CMC test: Some Guidelines” *STEP Inside (Canada)* May 2012 Vol 11 at 4.

³⁰² Murdoch, J “Applying the CMC test: Some Guidelines” *STEP Inside (Canada)* May 2012 Vol 11 at 4.

³⁰³ Murdoch, J “Applying the CMC test: Some Guidelines” *STEP Inside (Canada)* May 2012 Vol 11 at 4-5.

³⁰⁴ Murdoch, J “Applying the CMC test: Some Guidelines” *STEP Inside (Canada)* May 2012 Vol 11 at 4.

‘central management and control’ test to trust.”³⁰⁵

Ahmed³⁰⁶ also holds the view that the central management and control test is inappropriate for trusts, as it is not a legal entity but a relationship. In particular as part of that relationship, the trustee will have duties and obligations to the beneficiaries, but this is completely disregarded by the focus on control. This approach does not allow the trustee to have a passive role, and yet a settlor may assign any role, including that of a passive role to a particular trustee.³⁰⁷ The trustee’s passivity should not be material as his role is to carry out his obligations to the beneficiaries.³⁰⁸ Furthermore she ask the palpable question, if parliament had wanted residency for trusts to be determined in the same manner as for corporations, then it could have done so long ago after the *Thibodeau*-case.³⁰⁹

It is also interesting to note that in the Tax Court, it was stated that the corporate residence should be applied, but “with such modifications as are appropriate”, which has not been included or expanded upon in the Supreme Court in its application of the central control and management test. Indeed some authors are sceptical about the guidance this case brings, as it provided no framework or detailed test to determine whether the trustees exercise the central management and control of the trust.³¹⁰

Despite these criticism it is agreed that this case has now for the first time established a general test for determining residency for Canadian tax purposes³¹¹ and that in so doing, it has now put to “rest any doubt” regarding the appropriate legal test to determine a trust’s residence, by establishing that the central management and control test is to be applied.³¹²

³⁰⁵ Murdoch, J “Applying the CMC test: Some Guidelines” *STEP Inside (Canada)* May 2012 Vol 11 at 4.

³⁰⁶ Ahmed, F “Tax Residency of a Trust: The Need for a New Test? New Developments in the Residency of a Trust (2010) 29 *Estates, Trusts and Pensions Journal* 219.

³⁰⁷ Ahmed, F “Tax Residency of a Trust: The Need for a New Test? New Developments in the Residency of a Trust (2010) 29 *Estates, Trusts and Pensions Journal* 219.

³⁰⁸ Ahmed, F “Tax Residency of a Trust: The Need for a New Test? New Developments in the Residency of a Trust (2010) 29 *Estates, Trusts and Pensions Journal* 219.

³⁰⁹ Ahmed, F “Tax Residency of a Trust: The Need for a New Test? New Developments in the Residency of a Trust (2010) 29 *Estates, Trusts and Pensions Journal* 219.

³¹⁰ Wong, PA & Wong, S “Central Management and Control Test Determines Residence for Canadian Tax Purposes” *Tax Law Bulletin of Borden Ladner Gervais* (April 2012) Available at <http://www.lexology.com/library/detail.aspx?g=fedc05a8-6731-4476-998a-f93d37692371> - Last accessed on 07/05/2013.

³¹¹ International Law Office “Central Management and Control Determines Trust Residence” *Newsletter (Offshore Services – Canada)* published on 8 October 2009.

³¹² Shafer, J & Kroft E “Supreme Court of Canada Upholds New Test for Residency of Trusts” *Blakes Bulletin Tax* April 2012 – available at http://blakesfiles.com/pub/English/tax/apr_2012/FSC.pdf - last accessed on 07/05/2013.. See also Ma, I declaring that the decision has “put to rest the debate... as

e) Alternative Tests

Against the backdrop of this case and the possibility it presented to develop a new test, alternative tests were also proposed. Grinhaus suggests that the focus should be on determining the location and residency of the taxable properties of the trust and then deeming the trust properties to be resident in the jurisdiction in which the beneficiaries reside.³¹³ He is of the view that this would promote enforcement and accountability of the trusts. If assets are located in a foreign jurisdiction, it necessitates a great deal of circumvention to access those assets, whereas where the assets are situate in Canada, the authorities is said to have "virtually unlimited power and unfettered access to assets."³¹⁴ A problem may arise where assets are located offshore and the beneficiary is resident in Canada.³¹⁵ Yet this can be overcome by the basic fundamental elements of the trust relationship, which requires that where the beneficiary does not have the assets at its disposal to satisfy the tax liability, the trustee is under an obligation to access the trust's assets for the benefit of the beneficiary. Where he does not do so, the beneficiary would have a claim against him for breach of fiduciary duty.³¹⁶ Furthermore there appears to be a sound rationale for looking to the beneficiary:³¹⁷

"Beneficiaries are the ones directly benefitting from the trust property, and it is they who have the right to exercise their beneficial rights to the property. A beneficiary that is resident in Canada benefits from all protections and programs offered by the Canadian government and thus is liable for its fair share of tax. The property and its owner benefit from the protection and laws of the state, and the state can only effectively enforce its collection powers within its jurisdiction against the assets; therefore, it must deem residency where the assets are beneficially held, namely in the jurisdiction in which the beneficiary resides."

The problem with such an approach is that not all beneficiaries will always directly benefit from the trust property. In a discretionary trusts, beneficiaries only receive benefits if and when the trustees in their entire discretion allocate same. Beneficiaries can also not be said to control the trust for should they be able to do so, the fundamental nature of a trust would be offended. As was stated

to the correct test for determining the residence of a trust..." – Itta, M "SCC puts Garron Debate to rest" *STEP Inside (Canada)* May 2012 Vol 11 at 3.

³¹³ Grinhaus, A "There's No Place Like Home" Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

³¹⁴ Grinhaus, A "There's No Place Like Home" Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013..

³¹⁵ Grinhaus, A "There's No Place Like Home" Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

³¹⁶ Grinhaus, A "There's No Place Like Home" Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

³¹⁷ Grinhaus, A "There's No Place Like Home" Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

by Du Plessis, beneficiaries “do not make the key decisions of the trusts.... If a beneficiary can indeed make the key decisions of a trust, the vital issue of separation of ownership and control... becomes a matter of concern.”³¹⁸ Practically, if there are multiple beneficiaries and they are widespread, it will cause havoc with the application of the test as each and every's beneficiary's residence will then have to be investigated, and principles developed whether residence will be attributed based on the majority's residence or where the beneficiaries who benefits the most, are resident.

One author suggests a further alternative test, and that is to apply a test similar to the economic nexus test. The latter was also discussed in the South African context. He explains that this test could be employed by analogy to the choice of law rule, that an obligation is governed by the law of the place with which it has the closest and most real connection.³¹⁹ This test requires that all factors relevant to the trust be considered. The place where it was formed, the location of the trust property, where the control is exercised. An objective inquiry into what place is more substantially connected to the trust would then follow. Yet the author concludes that “this solution presents perhaps more problems than it solves.”³²⁰ Similarly as in the South African context, the problems would be to decide what weight to give to the various factors.³²¹ Such an added complication seems unnecessary, if the place where the control in relation to the trust is accepted as a major factor, in determining the place with the most substantial connection.³²² It also appears to be uncalled for to introduce a new test, when the corporate residence test is as applicable and is already familiar to professionals in the legal field.³²³

Having now reviewed the approach of Canada to trust residence in a domestic context, reflecting on its historical development from a focus on the residence of trustees to the more recent movement to apply the central management and control test, we turn next to its interaction in a international context to see what guidance can be obtained from their approach.

8 3 3 Residence in a tax treaty context

In so doing, disappointment awaits as Saunders warns that there is very little guidance on what would

³¹⁸ Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) *SA Merc LJ* at 341.

³¹⁹ Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 101.

³²⁰ Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 101.

³²¹ Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 101.

³²² Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 101.

³²³ Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 101.

be considered residence for a trust for tax treaty purposes.³²⁴ A trust is considered to be an entity capable of having residence under a tax treaty.³²⁵ Yet most often where an entity is regarded as resident of both contracting states, Canadian treaties will provide that the “competent authorities of the states shall by mutual agreement endeavour to settle the question and to determine the mode of application of the Convention to such person.”³²⁶ Consequently it is difficult to extract useful rules and guidelines for general application from such an approach, as much will depend on the particular facts of the situation and the negotiations of the two contracting states, which is not necessarily readily available “Place of Effective Management”, which is the default tie-breaker in the OECD Model Convention is also not generally the primary tie-breaker in Canada. It prefers instead to attribute residence on the basis of nationality, with the place of effective management as an alternative.³²⁷

Recently there has been one case considering the treaty residence of a trust, again involving a Barbados Trust and capital gains arising from a sale of shares held in a Canadian private company.³²⁸ In this case, it was held that residence in the treaty required that physical criteria associated with an actual residence be displayed. Although it also allowed “criterion of similar nature”, the court found that this would denote other aspects of physical presence and not more esoteric concepts such as deemed residence.³²⁹ A finding of dual residence is consequently based on actual physical factors.³³⁰ It had been prima facie been accepted that the trust was resident in Barbados.³³¹ On the facts before the court, it found that there were no such factors linking the Barbados Trust to Canada.³³² This case therefore gives but limited guidance.

³²⁴ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 689.

³²⁵ Avery Jones states it “reasonably clear” that it will be treated as a person capable of having resident. He further raises an interesting question: in that Canada deems a trust statutorily to be an individual does it then invoke the natural person tie-breaker or would the tie-breaker for persons other than individuals apply. He finds that it could be contended that a trustee in his capacity as such does not have a permanent home, vital centre of interests or nationality especially in the case of corporate trustees, therefore that the tie-breaker for non-natural persons must be applicable. Avery Jones Avery Jones, JF “The Treatment of Trusts under the OECD Model Convention (Part2)” 1989 BTR(3) at 65.

³²⁶ Saunders, R *International Tax Systems and Planning Techniques* (2010) at 689.

³²⁷ Brooks K in *Residence of Companies under Tax Treaties and EC Law* (2009) at 436.

³²⁸ *Morris v Canada (National Revenue)* 2009 FC 434.

³²⁹ Par 37.

³³⁰ Par 38.

³³¹ Par 37. This was based on the fact that the trust was settled under the laws of Barbados, its trustees were residents of Barbados, it held a business office in Barbados, filed tax returns in Barbados and its accountants were located in Barbados.

³³² Par 38.

8 3 4 Conclusion

The difficulties in ascribing residence to a trust in the Canadian context were appropriately formulated by O'Brien:³³³

“...a trust is an obligation, a legal relationship between persons and things (the trust property) but it is not a legal entity in itself. It is, therefore extremely difficult to apply the concept of residence to it. None of the previously quoted definitions or tests of residence appear to be applicable to a trust. It cannot be said to dwell in a place, to be habitually present, like a company it does not eat, sleep, consume and entertain. Unlike a company, a trust does not necessarily keep house and do business. The two concepts of a residence and trust are foreign to each other and were not devised with each other in mind.”

As was discussed above, similar to South Africa, the Canadian Income Tax Act does not provide clarity. It neither contains a statutory definition nor formula to assist with this difficulty. Its provisions were historically however interpreted to denote that residence may be alluded on the basis of where the trustee who has ownership or control reside.³³⁴ Where there is only one trustee, or multiple trustees *and* they are all resident in Canada, this ‘test’ poses no difficulty. Conversely, if the sole trustee or all trustees are resident outside Canada, it appears to be straightforward. The difficulties arise when there are multiple trustees and not all are resident in the same jurisdiction.³³⁵ This coupled with the underlying trust law principles give rise to conflict. So for example does trust law dictate that all trustees jointly own the trust property. If ownership is the basis for residence, then where one or more trustees are not resident, the test can not be applied as residence can not be ascertained.³³⁶ Similarly, if regard is had to the “control” aspect and there is only one trustee, the interpretation is workable, but where there are two equally controlling trustees to the trust, then difficulties arise.³³⁷ Further problems that may arise was also discussed above, namely the possibility that the control may not in fact be exercised by the trustee or trustees, but by another party. To this may be added the fallacy in assuming that the control would always be exercised by the trustee, or this party at their “residence” when it could equally well be exercised at other places.³³⁸ Based on these intrinsic problems, it may therefore be agreed with the court’s conclusions in both the *Thibodeau*-and the *Fundy Settlement* cases, that the Act does not really give guidance.

³³³ O'Brien, M L “Residence of a Trust 33-34 Canadian Current Tax (1978) at 313.

³³⁴ Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.5.

³³⁵ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 93.

³³⁶ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 93.

³³⁷ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 95.

³³⁸ Flannigan, RDM “Trust Obligations and Residence” 7 Est & Tr Q (1985-1986) at 95.

The *Thibodeau*-case was held to be the first on this issue and a “landmark decision.”³³⁹ The residence test that may be extrapolated from the *Thibodeau*-case as well as the CRA’s Interpretation Bulletin could be set out as comprising four levels,³⁴⁰ - not necessarily applicable as a hierarchy, but rather as to where the facts of the case most fit:

- *Residence of the Managing Trustee* – The residence of the trust will be where the trustee who has management and control of the trust, resides.³⁴¹ For ease of reference, one could term that trustee to be the Managing Trustee. To determine who the trustee is who has management and control regard could be had to the factors identified in the interpretation bulletin.³⁴²
- *Residence of the Preponderance of the Managing Trustees* – Where a trustee has two or more managing trustees, and they reside in the same jurisdiction, the trust will be accordingly resident, but in the event that they reside in different jurisdictions, then either the dominant trustee³⁴³ must be identified and the trusts’ residence will follow his residence, alternatively if there is no dominant trustee, then where the majority of managing trustees, reside, will be the place where the trust resides.³⁴⁴
- *Location of assets* – if the residence can not be determined through application of the above, then the trust’s residence may be determined by taking into account where its assets are located or the where the legal rights in respect of such assets are enforceable³⁴⁵
- *Residence of Some other person*- should the facts show that the substantial portion of the management and control is exercised by some other person other than the trustee, the residence of such person may be considered to be the determining factor.³⁴⁶

The *Thibodeau*-case was regarded as endorsement for the residence of the trust to be determined where the majority of the trustees reside,³⁴⁷ this was a “longstanding position” and also the “established position” of the Canadian Revenue Agency.³⁴⁸ The case is further thought to be authority

³³⁹ Bernstein, J & Worndl “ Resident Trust and No Trust” Canadian Tax Highlights (Vol 17, No 10) October 2009 - accessed online at http://www.ctf.ca/ctfweb/Documents/PDF/Cdn_Tax_Highlights/2009CTH10.pdf. Last accessed on 07/05/2013.

³⁴⁰ In particular see Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 177.

³⁴¹ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 177. Par 1 of the Interpretation Bulletin IT-447.

³⁴² Par 2 of the Interpretation Bulletin IT-447. Should a trust have only one trustee and this trustee reside outside Canada, it is to be concluded then that the trust resides outside Canada, subject of course that the deeming provisions may render it resident for certain tax purposes. Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 177.

See S94 of the Act. Canadian Encyclopedic Digest *Income Tax* 4th ed (Sept 2007) title by Hogg, PW, Magee, JE & Li, J at Par 3.5

³⁴³ See Par 3 of the Interpretation Bulletin IT-447, described as the person who “clearly exercises a more substantial portion of the management and control than the others”

³⁴⁴ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 177-178.

³⁴⁵ Par 4 of the Interpretation Bulletin IT-447. Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 178.

³⁴⁶ Par 5 of the Interpretation Bulletin IT-447.

³⁴⁷ Rochweg describes it as the “general rule of thumb” Rochweg, M “Tax Effective Cross-Border Will Planning” Presentation delivered on 27-28 February 2012. Accessed online at http://www.millerthomson.com/assets/files/article_attachments2/M-Rochweg_Tax-Effective-Cross-Border-Will-Planning-Feb-27-2012.pdf – last accessed 07/05/2013. Ernst & Young “What determines where a trust resides” 2009 Issue No 27.

³⁴⁸ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 347. Mirza, A “Garron: Determining Residence of Trusts” –Available online at <http://www.thecourt.ca/>

for two further principles, namely that the test for determining residence for companies could not be applied to trusts, and that a trust can not have dual residency.³⁴⁹

The solidity of the principles the *Thibodeau*-case is deemed to established, has to a certain extent been shaken by the recent *Fundy Settlement* –case. It is said to have lain down “what appears to be a new test for determining the tax residency of a trust.”³⁵⁰ A test which is viewed as “somewhat radical and a change in law.”³⁵¹ The test it is said to have introduced is that a trust will be resident in the place where “its real business is carried on”, which is where “the central management and control of the trust abides.”³⁵² In so doing the “judge made test of residence” that has been established for companies will now also be applicable to trusts. This in light of the *Thibodeau*-case appears to be a dramatic shift.

The controversy as to whether it is a shift from the viewpoint expressed in *Thibodeau* and is in fact a “new test”, has been remarked upon above. For those who argue that the earlier case rejected the application of the corporate rules in a narrower context of dual residency, it is not regarded as that new. For them, management and control was implicit to the fact that the court in *Thibodeau*-case had looked to majority decision-making as a key factor in determining residence. Reference can also be made to the fact that “management and control” was a concept already utilised in the Interpretation Bulletin issued by the Canadian revenue authorities and therefore those who interact with trusts, would have been sensitive to it.³⁵³ Moreover, although the case does establish that “central management and control” is now to be used as the key determinant, the Supreme Court also reinforced the notion that the place where the trustee resides will determine residency, should such trustee exercise the central management and control of the trust, and does so at his place of residence.³⁵⁴ Yet as one author concluded, “whether the test is new, or not, ...[it] leads the law on

[2009/09/28/ garron-determining-residence-of-trusts](http://www.ibfd.com/2009/09/28/garron-determining-residence-of-trusts). Last accessed on 07/05/2013.

³⁴⁹ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 178. Brown, C *Canada - Trusts, Topical Analyses IBFD* available at www.ibfd.com.

³⁵⁰ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 179.

³⁵¹ Murdoch, J “Applying the CMC test: Some Guidelines” *STEP Inside (Canada)* May 2012 Vol 11 at 5, in relation to the tax court judgment which first laid down the test.

³⁵² Anon “The Supreme Court of Canada upholds the application of the Central Management and Control Test for determining the Residence of a Trust for Canadian Income Tax Purposes” *WeirFoulds Estates & Trust Newsletter*. Est. L. Nws. 2012-04. Available online at Westlaw International – last accessed on 14/06/2012.

³⁵³ The Tax Group “Canada: Supreme Court of Canada Renders Decision on Trust Residency” Published on 25 May 2012 at <http://www.mondaq.com/canada/x/179004/Capital+Gains+Tax/Supreme+Court+of+Canada+renders+decision+on+trust+residency> – Last accessed on 07/05/2013.

³⁵⁴ Wong, PA & Wong, S “Central Management and Control Test Determines Residence for Canadian Tax Purposes” *Tax Law Bulletin of Borden Ladner Gervais* (April 2012) Available at <http://www.lexology.com/library/detail.aspx?g=fedc05a8-6731-4476-998a-f93d37692371> - Last accessed on 07/05/2013.

point to a consideration of broader factors and a sharper focus on trustee conduct.”³⁵⁵ Indeed it is clear that a much more factual and realistic approach is followed.

The benefits of this test as opposed to the test of residence based on the residence of the trustee, is said to be that the residence of the controllers would be irrelevant, as the focus is on where their control is exercised.³⁵⁶ Thus the assumption that the trustee would always exercise the control as his place of residence as opposed to any other place eg office, routinely scheduled meeting place, *en route* would no longer be relevant. It would also look to who is actually exercising the management and control as opposed to assuming that it is done by the trustees. The test’s further benefits lies therein that it is already familiar and established having been applied for many years in the corporate context, and thus guidance may be sought from that sphere whilst on a practical level, tax practitioners would be familiar with the concept. As it promotes a holistic factual enquiry, it appears to be in line with the objective of the residency concept in law, which is to determine whether or not the nexus between an individual/ entity and a jurisdiction is sufficiently strong so that legal consequences should follow.³⁵⁷

On the downside as it is a more factual enquiry and requires a case-by-case approach, it detracts from the simplicity required for tax administration purposes, and could undermine enforcement. It is also unpredictable in its application, thus affecting legal certainty in this context. There also appears to be an inherent tension between the tax test and the principles of trust law. Whereas at present it may be regarded as but an anomalous situation, only time will tell whether it is irreconcilable. This difficulty can perhaps be attributed to an underlying characteristic of the interchange of these two subjects as described by Frostiak et al³⁵⁸ -

“At the end of the day authors concerned with both trusts and tax remain faced with the conceptual nature of the trust law, slowly developing over the decades, and the ultimate pragmatism and constant change that is tax law.”

On this note we now turn to the second jurisdiction selected for an more in-depth investigation , that of the United Kingdom to ascertain not only how they have dealt with the interplay between trust law and tax law, but also in particular how they have addressed the issue of the residence of the trust for tax purposes.

³⁵⁵ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at 180.

³⁵⁶ Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 99.

³⁵⁷ Brooks K in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 14.1

³⁵⁸ Frostiak, LH, Poyser, J & Chow G *Taxation of Trusts and Estates A Practitioner’s Guide 2010* at vii.

8 4 United Kingdom

8 4 1 Background to the UK's tax system

The United Kingdom is widely regarded and accepted to be the country of origin of the trust.³⁵⁹ As the discussion in Chapter 2 regarding the historical foundations of the trust revealed, the ancestry of the trust stretches far back into the Middle Ages, when it was initially utilised by knights departing on the Crusades to safeguard their lands during their prolonged period of absence.³⁶⁰ The subsequent development of the trust from century to century thereafter is described as the “greatest and most distinctive achievement by Englishmen in the field of the jurisprudence.”³⁶¹ Even more lyrically its presence in English society has been equated to that of a guardian angel—

“One admirer described it as the guardian angel of the Anglo Saxon, accompanying him undisturbed from cradle to grave, it is present at his school as at his sport associations, it follows him in the mornings to his office, evenings to his club, on Sundays it awaits him at his pew or at the committee of the political party of his preference, it supports him in his old age to his last day and even from the grave it unfurls its protecting wings over his grandchildren. If one were to ask the Anglo-Saxon what a trust is meant for, one most likely will get the reply, “For everything, well... almost!”³⁶²

The aforesaid quote clearly illustrates the pervasiveness of the trust in English society. Yet also of notable presence in that society is taxes, similarly having its origins in the Middle Ages.³⁶³

The first Income Tax was introduced in 1798, and apart from a short reprieve between 1816 and 1842, has remained in force, being annually provided for by Parliament at the commencement of the tax year.³⁶⁴ This yearly re-enactment is necessary as the tax is in theory a temporary tax - Tiley explains that –

“This doctrine of the annual tax is a relic from the days when Parliament wanted to make sure that the King would summon a Parliament each year, a perpetual source of income would make a calling of the Parliament less necessary.”³⁶⁵

³⁵⁹ Olivier et al *Trust Law and Practice* (November 2011) at 1-15. Also Haynton DJ *The Law of Trusts* (1993) at 1.

³⁶⁰ See chapter 2 2 2 1 above. Also Hayton, D J Hayton & Marshall commentary and Cases on *The Law of Trusts and Equitable Remedies* 11th Ed (2001) at 11.

³⁶¹ Prof F Maitland " *The Unincorporated Body*" in *Collected Papers* (1911) 271

³⁶² Olivier *Trust Law and Practice* (1990) in the Preface – written by L Ign Coertze.

³⁶³ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 115.

³⁶⁴ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 115. Capital gains tax was introduced in 1965.

³⁶⁵ Ault, HJ & Arnold, BJ *Comparative Income Taxation: A Structural Analysis* 2nd ed (2004) at 115; Morse, G & Williams, DW *Davies: Principles of tax law* 5th Ed (2004) at 26.

When income tax was introduced more than two centuries ago, no provisions were made for the taxation of trusts, although trusts were at that time a familiar concept in law.³⁶⁶ Unfortunately the view is that this has still not been remedied in this day and time. In the words of Hardy -

“The income tax liabilities of trusts have never been properly and comprehensively dealt with by legislation... Consequently, the courts have developed principles with regard to the taxation of trust income on a case by case basis.”³⁶⁷

The UK, similar to South African and Canada, applies residence based taxation.³⁶⁸ It regards the trustees (as opposed to the trust per se) to be a separate taxable entity, distinct from the persons who are individually the trustees.³⁶⁹ Thus a resident trust will be taxable on its worldwide income and capital gains, whilst a non-resident trust would only be taxable on its UK income.³⁷⁰ Specifically then in relation to the residence of trusts, this is an appropriate time to have regard to what the UK legislature and judiciary have developed in relation to trusts, even if developed in an arbitrary fashion. As was done in the discussion regarding Canada, a chronological approach is followed.

8 4 2 Determining the fiscal residence of a trust in the UK tax context

8 4 2 1 Historical overview

Despite the trust’s strong historical association with the UK, the UK’s taxation laws until recently provided but little proof of such relationship. So for example there was to begin with no statutory definition in respect of the residence of a trust for tax purposes, and when a definition was eventually introduced, it was only in respect of capital gains tax, and not for income tax purposes.

³⁶⁶ Hardy, A United Kingdom - Trusts, Topical Analyses IBFD available at www.ibfd.com- last accessed 11/07/2012.

³⁶⁷ Hardy, A United Kingdom - Trusts, Topical Analyses IBFD available at www.ibfd.com- last accessed 11/07/2012.

³⁶⁸ Finney, M Personal Tax Planning: Principles and Practice 2011/2012 at 391 and 421. A resident trust is liable to tax on its worldwide income on the “arising” basis and thus it is not required for the income to be remitted to the UK per se. The trust itself is regarded as distinct and separate from its settlor or its beneficiaries.

Finney, M “Trust and Trust Residence” available at <http://www.taxationweb.co.uk/tax-articles/general/trusts-and-trust-residence.html> - last accessed on 07/05/2013. He states that the trust is regarded as a separate taxable entity prior to explaining that that it is the trustees and not per se the trust who are so liable for the income tax and capital gains tax, and they are treated as a single person distinct from the persons who are in fact the trustees. Essentially they are deemed to be a single person and it is the this deemed person to which residence can be attributed.

³⁷⁰ Anon “Tolley’s Tax Training” at 1.9 – available at <http://www.tolleytaxtutor.co.uk/taxtutor/files/public/personal-tax/uk-trusts-and-estates/lectures/1d01.pdf> - last accessed on 07/05/2013. Gains arising from certain disposals may be attributed to the UK resident settlor or beneficiaries.

The statutory definition that was so introduced for capital gains tax purposes remained in place until its recent amendment the past decade.³⁷¹ It provided that a trust would be regarded as resident in the UK, unless all the trustees or a majority of the trustees were neither resident nor ordinarily resident in the UK *and* the general administration of the trust was ordinarily carried on outside the UK.³⁷² Thus it created a presumption of residence which could be rebutted should the two stated conditions both be met:

- all/the majority of trustees were not resident *and*
- the general administration was ordinarily carried outside the UK.³⁷³

The administration of a trust would be regarded as being carried on outside the UK, if the majority of the trustees were not resident in the UK,³⁷⁴ or by taking the following factors into account: assets held abroad, bank accounts maintained abroad, decisions taken abroad, and correspondence (especially if carried on with revenue) initiated abroad.³⁷⁵

An exception to this deeming provision was made in relation to professional trustees, who would be deemed to be resident outside the UK, if the whole of the settled property consisted out of property that originated from someone who at that time was neither domiciled, resident nor ordinarily resident in the UK. Thus even should the professional trustee be in fact resident in the UK and carry on the administration of the trust in the UK, if the settlor of such property to the trust was not resident, the exemption would prevail. A professional trustee was defined as a person who carries out a business consisting of the management of trusts and acts as trustee of a trust in the course of its business.³⁷⁶ The underlying motif to the exemption was to prevent the discouragement of appointing UK resident professional trustees.³⁷⁷ The view of the revenue's authorities was that it would accept that members of the legal and accountancy professions can be 'professional trustees', whilst others cannot. For example a stockbroker who was the trustee of over 40 trusts, was regarded not be a professional trustee.³⁷⁸ These provisions were in practice

³⁷¹ Amended with effect 6 April 2007 when the definition for both income tax and capital gains tax was streamlined.

³⁷² Capital Gains Tax Act 1979, S52(2).

³⁷³ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 56.

³⁷⁴ Finney, M *Personal Tax Planning: Principles and Practice* 2011/2012 at 388.

³⁷⁵ Anon "The UK as a Trust Tax haven" 7 October 1987, Law Gazette – available at <http://www.lawgazette.co.uk/news/the-uk-a-trust-tax-haven>, last accessed 07/05/2013.

³⁷⁶ S52(2).

³⁷⁷ Jones, JFA "The Taxation of Foreign Trusts in the United Kingdom" 1987 *Int'L Bus. LJ* 219 (1987) at 428.

³⁷⁸ Anon "The UK as a Trust Tax haven" 7 October 1987, Law Gazette – available at <http://www.lawgazette.co.uk/news/the-uk-a-trust-tax-haven>, last accessed 07/05/2013.

referred to as the professional trustee “let-out” rules.³⁷⁹ Such rules were regarded as important in attracting international trust business to the UK³⁸⁰, thus providing financial benefits to the UK economy and allowing non-residents the opportunity to utilise leading UK trust professionals.³⁸¹

Unlike the position for capital gains tax purposes discussed above, in respect of the residence of a trust for income tax purposes, there was no statutory definition or guiding provisions. Although at common law, the general view was long held that the position in relation to income tax would be the same as that for capital gains, ie the trust would be resident in the UK unless all or a majority of the trustees were non-resident and the general administration of the trust was carried on elsewhere, this was rejected in 1987 in the case of *Dawson v Inland Revenue Commissioners*.³⁸² Said to have “exploded” this view, we now turn to this apparently radical case.³⁸³

8 4 2 2 *Dawson v Inland Revenue Commissioners* [1987] STC 114

In this case the court was faced with a “short, but difficult and important question”,³⁸⁴ namely whether, where only one of three trustees of a trust was resident in the UK, the majority being non-residents, such trustee can be held liable for tax on the income of the trust arising from trust investments situated outside the UK.³⁸⁵ The special commissioner who was first assigned the case answered affirmatively, but in the subsequent court processes, from the lower Chancery Court³⁸⁶ to the Court Of Appeal³⁸⁷ and last to the House of Lords³⁸⁸, the question was answered in the negative.

The facts can be briefly summarized: Mr Dawson, an UK resident was a co-trustee of three trusts established by a Mr Cotton for the benefit of his family and relatives. Mr Cotton subsequently

³⁷⁹ Finney, M Personal Tax Planning: Principles and Practice Chapter 17 at 388.

³⁸⁰ McKie, S “ Trustee Residence: Bring Back King Log” 2008 PCB (2) 72 at 73.

³⁸¹ Ingham, J UK Taxation of Trusts and the Trust Modernisation Proposal – available at http://www.il-trust-in-italia.it/Formazione/Congressi/Congresso%202005/ingham_judith.pdf, last accessed 07/05/2013.

³⁸² [1987] STC 114.

³⁸³ Anon “The UK as a Trust Tax haven” 7 October 1987, Law Gazette – available at <http://www.lawgazette.co.uk/news/the-uk-a-trust-tax-haven> , last accessed 07/05/2013.

³⁸⁴ Judge Vinelott in the Chancery Division, *Dawson v ICR* [1987] 1 W.L.R. 716.

³⁸⁵ In the House of Lords it was stated that this issue has not been considered in any previous reported case. There it was phrased as follows : “the issue...is whether, where one of a number of trustees of a settlement resides in the United Kingdom but the other or other reside abroad, the one who resides in the United Kingdom is liable for income tax upon income of the settlement which arise from assets situated outside the United Kingdom.”

³⁸⁶ [1987] 1 W.L.R. 716.

³⁸⁷ [1988] 1 W.L.R. 930;

³⁸⁸ [1990] 1 A.C. 1; [1989] 2 W.L.R. 858;

emigrated from the UK to Switzerland, where he became permanently resident with his family. All three trustees of the trusts were initially resident in the UK, but two later retired and were replaced by non-resident trustees, with only Mr Dawson remaining as trustee and resident in the UK, until he too retired as trustee. The trusts were discretionary trusts and consequently no beneficiary had a vested right to the income. The greater part of the trust's assets were held outside the UK, the income arose outside the UK, no income was remitted to the UK, the principal beneficiaries were non-residents and all distributions to the beneficiaries were decided at meetings of the trustees held in Switzerland.³⁸⁹ The case concerned income that was accumulated in the trusts for the tax years just prior to Mr Dawson's retirement, when he was the only UK resident trustee of the trustee complement, and which the UK revenue authorities sought to tax him on all of the income of the trust.

The tax legislation at the time did not contain any specific provisions in respect of the levying of income tax on income accruing to persons as trustees. Consequently regard had to be had to certain general provisions of the Act which regulated the charging of taxes.³⁹⁰ These provided as follows:

"Section 108, Schedule D

1. Tax under this schedule shall be charged in respect of —(a) the annual profits or gains arising or accruing —(i) to any person residing in the United Kingdom from any kind of property whatever, whether situate in the United Kingdom or elsewhere, and ... (iii) to any person, whether a British subject or not, although not resident in the United Kingdom, from any property whatever in the United Kingdom ..."

It is particularly the first subparagraph that establishes a residence based jurisdiction, resulting therein that profits or gains arising or accruing to a *resident* must be taxed. This section must be read with Section 114 which identified the persons chargeable to income tax under Schedule D:

"...income tax under Schedule D shall be charged on and paid by the persons receiving or entitled to the income in respect of which the tax is directed by the Income Tax Acts to be charged."

On the reading of these two sections then together, the pertinent issue is whether the income was income which accrued to the trustee (Section 108) *and* which he received or to which he was entitled (section 114).

³⁸⁹ In particular the trust settlement provided that the trustee was not entitled to transact any trustee business whilst in the United Kingdom.

³⁹⁰ Income and Corporation Taxes Act, 1970.

In the Court of Appeal, the court first had regard to the income and the entitlement thereto in a trust setting. As the relevant income was trust income and the entitlement of trustees to trust property is jointly (*not* jointly and severally), the income accrues not to the trustee alone, but to him *jointly* with his co-trustees.³⁹¹ The court further found that the relevant reference to “person” in section 108 could furthermore be read to include the plural “persons”, based on the Interpretation Act.³⁹²

As such, the court therefore concluded that no difficulty arises in respect of income, which accrues to the trustees when all the trustees are resident: it accrues to all three and all three will be jointly assessable to tax. But where the income accrues to persons jointly, of whom one, or more than one, is non-resident, it is no longer easy. The revenue authorities argued that in such a case, the provisions would be satisfied if *any* of the persons were resident. Mr Dawson as trustee disagreed, contending that the provisions are not satisfied, unless *all* the persons were resident.

In the court’s view neither contention produced a “wholly satisfactory result” and regardless of whichever contention is correct, both may lead to surprising and unattractive consequences. For example should a trust with all elements foreign (the settlor, the proper law, the beneficiaries, location of the trust property all be foreign) have but one trustee, that becomes resident in the UK, that trustee will, on the revenue authorities’ contention, then be regarded as chargeable to tax on all income. Yet Mr Dawson’s contention also results in an anomalous situation, where for example a trust with all elements English, from settlor to trust property, appoints an additional trustee who is non-resident, then none of the trust’s income would be chargeable in the UK.

In light of these problems, the court stated that it would be tempting to opt for more robust interpretation, for example by applying the provisions of the capital gains tax act by analogy,³⁹³ or to have regard to the provisions concerning partnerships.³⁹⁴ Yet the court found that to do so would go far beyond the legitimate boundaries of construction of these provisions. Thus, unlike in a capital gains tax situation, it could not look to the residence of the majority of the trustees, as this was not provided for in terms of the specific applicable legislative sections. It had only the alternatives advanced by the parties. The court concluded that in its view the trustee’s construction is

³⁹¹ None of the trustees are therefore entitled to any particular share or fraction of the income.

³⁹² Interpretation Act, 1978.

³⁹³ Thus to proceed on the basis that the trustees are regarded as resident in the UK unless the general administration is ordinarily carried on abroad, and the trustees, or a majority of them are not resident or ordinarily resident.

³⁹⁴ In such an instance, the residence of the trustees would be taken to be the country where the general administration of the trust is ordinarily carried on.

preferred, finding that the qualification of the provision “residing in the United Kingdom” stated in the levying section, is one which, when the income accrues to one person, applies to that person, and when it accrues to persons jointly, to all those persons. Consequently they must all possess the attribute of “residing in the United Kingdom.”

Three footnotes were made by the Court of Appeal to its judgment. Firstly, it must be noted in the present case no beneficiary had an absolute vested interest to the income. Should this have been otherwise and a beneficiary had a vested interest, then the question may arise as to whether there was any income at all “accruing” to the trustees. Secondly, also particular to the case, none of the trustees had a beneficial interest in the trust fund and all were independent. The court declined to express a view as to whether the position would be different should the trustee have such an interest. Thirdly and in closing, it commented that to some it may appear that the construction that the court has adopted in this case has now left the door wide open for “wholesale tax avoidance”, but to those a warning was issued that there are avoidance provisions which may avail the revenue authorities.

The House of Lords unanimously agreed with the Court of Appeal. In their judgement they too concluded that there is no justification for taxing the resident trustee alone on all the income, as the income does not accrue to him personally. He has no right of control over the income, only a right and duty to secure in conjunction with his co-trustees that is applied in accordance with the trust deed. The income could therefore not be said to have arisen or accrued to him personally. His interest was too limited. The court also made reference to the anomalies that may result, yet concluded that the issue cannot be resolved by a balancing of the anomalies. Whilst an argument could be made that it would be advantageous to base the tax liability for income tax purposes upon the centre of administration of the trust and the place of residence of the majority of the trustees (similar to the capital gains tax situation), the court concluded that Parliament had not chosen to do so as yet.

As there was no legislative definition for determining the residence of a trust for income tax purpose, this case established the test judicially as being that a trust would only be resident should all its trustees be resident. As such it overturned the general practice at that time based on the assumption that the test for income tax would be the same as that for capital gains tax, and appeared to set a simplistic, but potentially easily manipulative test. It could therefore be expected that the case would not pass without criticism.

One such critic, Francis³⁹⁵ agreed with the court's approach that the first question is whether there is a person to which income has accrued and that "person" based on the statutory interpretation rules may be construed as "persons." The term "persons" may then in her view be taken to refer to the trustees as a distinct entity (as opposed to individuals), although such an "entity" would generally not be awarded legal recognition.³⁹⁶ It would be this "entity" that would take actual receipt and control of the income and thus could be concluded as having the income accrued to it. In reaching this conclusion it would not be necessary to examine the individual circumstances of the trustees, as the next question would be to determine this entity's residence.³⁹⁷ It is here that the court then looks to the residence of the individual trustees and should one be non-resident, deems the trust to be not resident.³⁹⁸ In her view, it is implicit to the court's approach to do so, that the concept of the trust as separate entity is ignored as the focus is on the individual trustees. This approach she finds difficult to accept and summarizes her criticism in three points.

Firstly when determining the question whether income accrues to the trust, it is necessary to treat the trust body as a distinct entity. It is therefore strange that on the second question, whether the trust is resident, the trust body is simply ignored and the individual circumstances of the particular trustees are regarded as conclusive to determine the residence. No authority or explanation for this difference in approach is given by the court. Secondly, should one look to the individual trustees, then all the complex and difficult tax rules to determine the residence of an individual becomes applicable. A third reason advanced by her relates to the moral justification for using residence a criterion for determining tax liability, namely that "it is a reflection of the measure of connection one has with a country generally."³⁹⁹ Consequently when seeking to tax the trust, its residence must be established according to the country with which it has its *strongest* connection. This she argues cannot solely be based on the residence of the individual trustees. Instead she offers her own approach, arguing that residence should follow the country with which the trust has its "closest and most real connection", which would therefore require that the control and management of the trust feature centrally. Such a test would be analogous to the test applied to determine whether a company is resident, that of "central management and control."⁴⁰⁰ As both a company and a trust is a "body of persons", there appears to be a logical justification for the application of similar tests. In the application of such a test, it would be essential that the trust be analysed as an entity distinct

³⁹⁵ Francis, C "Residence of Trustees" 1988 BTR 462.

³⁹⁶ At 463.

³⁹⁷ At 463.

³⁹⁸ At 463.

³⁹⁹ At 464.

⁴⁰⁰ At 464-465.

from its trustees. To treat it as a separate entity, notwithstanding the fact that it is not a legal entity, is also supported by the rules of private international law used to determine the proper law of a trust.

A further author, Avery-Jones also supports such an interpretation.⁴⁰¹ His view is that the court should have interpreted the word “person” as including a “body of persons, corporate or incorporate.”⁴⁰² In relation to trustees, the residence of such a body could then be determined in a similar fashion as the way in which the residence of a corporation is determined. Now the finding of the court had the effect that in all cases where the trustees had mixed residence, they would be treated as non-resident, an insensible approach and one which in his view, made “change inevitable.”⁴⁰³

Such change came in the form of statutory rules introduced shortly after the judgement. As Ettinger notes following this case, the “UK government wasted no time in amending its legislation.”⁴⁰⁴

8 4 2 3 The position after Dawson and before 2007

Indeed applicable from the start of the tax year immediately following the case of *Dawson*, a new statutory test for the residence of a trust for income purposes was introduced.⁴⁰⁵ According to this test in cases of “mixed residence”, that is where at least one trustee is not resident in the UK and at least one is resident, then depending on whether the settlor was resident in the UK⁴⁰⁶ at the time that the settlement was effected⁴⁰⁷ (*the condition*). The trustees would be deemed resident accordingly. Thus where this condition is satisfied and the settlor was resident in the UK at the relevant time, then the non-resident trustees would be regarded as resident in the UK, and all

⁴⁰¹ Avery Jones, JF “Residence of Trustees” 1988 BTR 359.

⁴⁰² Avery Jones, JF “Residence of Trustees” 1988 BTR 359.

⁴⁰³ Avery Jones, JF “Dawson Reversed ” 1989 BTR 249 at 249.

⁴⁰⁴ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 75.

⁴⁰⁵ Finance Act, 1989 – S6 provided that it would be applicable for the year 1989-90 and subsequent years of assessment. Thus the legislation did not operate retrospectively. It came into operation on 6 April 1989. A brief time period was allowed whereby these deeming provisions would not be applicable should none of the trustees be resident in the UK. According to Ettinger the purpose was to allow time for removing UK resident trustees without making all the trustees resident.

⁴⁰⁶ S2 stated the condition as being that the settlor, or in the event that there is more than one, any one of them is (i) resident or (ii) ordinarily resident or (iii) domiciled in the UK at the relevant time.

⁴⁰⁷ The relevant time was according to S3 in the case of a settlement arising under a testamentary disposition of the settlor or on his intestacy, the time of the settlor’s death, and in the case of any other settlement, the time or, where there is more than one, each of the times when the settlor provided the funds directly or indirectly for the purposes of the settlement.

trustees would thus be “resident.”⁴⁰⁸ In the event that the condition is not met and the settlor was not resident, the trustees resident in the UK would be regarded as not resident in the UK. The term settlor was defined for purposes of this section as including any person who has provided or undertaken to provide funds directly or indirectly for purposes of the trust.⁴⁰⁹

According to Avery Jones the legislature had only two options. Firstly, to either give the trustees as a body a residence, or secondly to institute deeming provisions whereby the non-resident trustees would be regarded as resident and vice versa so that mixed residence cases would not exist any more.⁴¹⁰ The former, in his view would have been preferable and would not have required a legislative change as an approach to interpret the word “person” as a “body of persons” based on the Interpretation Act, and then ascertaining the single residence of the body, could have been endorsed.⁴¹¹ As is evident from the statutory test discussed above, the UK legislature preferred the latter, and thus the individual residence of the trustees as opposed to a collective approach to the residence of the trust, remain important for income tax purposes.

This was unlike the position for capital gains tax purposes at the time, which expressly directed that the trustees be treated as a single and continuing body of persons distinct from the persons who may be trustees from time to time.⁴¹² It would be this “body” that would be regarded as resident in the UK, unless the general administration was ordinarily carried on outside the UK and majority of the trustees were non-resident. When the legislation relating to capital gains tax was consolidated in the Taxation of Chargeable Gains Act of 1992, the provision for trusts were verbatim retained and the approach to treat the trustees collectively, as a body thus remained for capital gains purposes.⁴¹³

Thus different tests to determine residence were applied for income tax purposes and capital gains purposes. Potentially this could have the effect that the same trust could be resident for the one and regarded as non-resident for purposes of the other. An example illustrates this point: a trust is established by a settlor resident in the UK at the time of the settlement, it has three trustees, two of whom are non-resident and one resident in the UK, and all meetings and administration of the trust is conducted outside the UK. For purposes of the income tax act, it would be resident. It has a

⁴⁰⁸ S1.

⁴⁰⁹ S6.

⁴¹⁰ Avery Jones, JF “Dawson Reversed ” 1989 BTR 249 at 249.

⁴¹¹ Avery Jones, JF “Dawson Reversed ” 1989 BTR 249 at 250. See also his further article “Bodies of Persons” 1991 BTR 453 -465.

⁴¹² Capital Gains Tax Act, 1979 – S 52(1).

⁴¹³ Taxation of Chargeable Gains Act, 1992 – S 69(1).

resident as well as non-resident trustees, thus regard is had to the settlor who was an UK resident at the relevant time and hence the trust is resident. For capital gains tax purposes it would not be resident as the majority of trustees reside outside the UK and the general administration of the trust is conducted outside the UK.

The different tests and discrepancies that resulted were described as an “unsystematic and problematic” position⁴¹⁴, “complex” with rules developed in a “piecemeal fashion”⁴¹⁵ and as not “perfect or free from anomaly.”⁴¹⁶ Consequently in 2003 the then Chancellor of the UK announced that the income tax and capital gains tax system for trusts⁴¹⁷ would be modernised and simplified and amongst others, the residence test for trusts would be reviewed. The process was projected to be completed by 2005,⁴¹⁸ but would only in 2007 culminate in a single residence test for both income and capital gains tax purposes.⁴¹⁹ As one author remarked, “it was perhaps predictable that the radical changes in trust taxation proposed in the original consultation document, needed more thought than the government at first envisaged.”⁴²⁰ It is to this modernisation process we now turn.

8 4 2 4 The modernisation of the tax system for trusts

The starting premise to the modernisation of the tax system was summarized as follows:⁴²¹

“The Government recognises the important role trusts play in society. As far as possible it wants a tax system for trusts that does not provide artificial incentives to set up a trust but, equally, avoids artificial obstacles to using trusts where they would bring significant non-tax benefits. The Government does not want a system that enables people to use trusts to avoid tax but, equally, as far as possible it does not want the tax system to penalise beneficiaries where a trust is imposed upon them by statute, such as the laws of intestacy. Neither does it want to penalise beneficiaries where a trust exists to protect the vulnerable, such as a disabled

⁴¹⁴ Schwarz, J Booth and Schwarz: *Residence, Domicile and UK Taxation* (2010) 14th ed at 119.

⁴¹⁵ HMRC “Modernising the Tax System for Trusts: Consultation” 11/12/2003 available at http://www.step.org/pdf/disdoc_mod_trusts.pdf?link=contentMiddle -last accessed on 07/05/2013.

⁴¹⁶ McKie, S “Trustee Residence: Bring Back King Log” 2008 PCB (2) 72 at 72.

⁴¹⁷ The focus of these modernisation proposals were on family and personal types of trusts, not on offshore trusts, unit trusts, venture capital trusts or other specialised vehicles that whilst they are called trusts have their own separate taxing system or are taxed as companies.

⁴¹⁸ HMRC “Modernising the Tax System for Trusts: Consultation” 11/12/2003 available at http://www.step.org/pdf/disdoc_mod_trusts.pdf?link=contentMiddle -last accessed on 07/05/2013.

⁴¹⁹ Chancellor G Brown in the Pre- Budget Report delivered on 10 December 2003 – available at <http://webarchive.nationalarchives.gov.uk/20091222074811/http://www.hmrc.gov.uk/pbr2003/index.htm> – last accessed on 07/05/2013.

⁴²⁰ Sowler, R “Half Time for Trusts” *Tax Adviser* May 2005 at 13.

⁴²¹ HMRC “Discussion Paper” *Definitions and Tests* 17 December 2003 – available at http://collection.europarchive.org/tna/20061009092805/http://hmrc.gov.uk/pbr2003/disdoc_definitions_trusts.pdf – last accessed on 07/05/2013.

person. Administration and compliance costs should be kept as low as possible.”

It was further stated that the government did not wish to change the current legislation simply for the sake of change, but instead wished to build onto what is in force as opposed to start from nothing.⁴²² The overall objectives of this modernization process, was to reduce the compliance burden and to endorse measures that were fair, support the competitiveness of the UK economy, and are clear and easy to operate.⁴²³

To do so a process was followed by whereby following the 2003 pre-budget report and subsequently released overview document, four discussion papers were published.⁴²⁴ One of these focused on the streamlining of the main definitions used in the taxation of UK resident trusts and dealt with amongst others, the issue of the two tests for residence for income tax and capital gains tax purposes, proposing a single residence test for trusts. This, it was hoped would help make the tax system easier to navigate for trustees and beneficiaries, and avoid confusion.

In the Discussion Paper⁴²⁵, the two tests were first analysed. In relation to the test for income tax purposes it was recorded that the rules were that where all the trustees are resident in the UK, the trust would be resident and conversely, where all the trustees were non-resident, the trust would be non-resident.⁴²⁶ In the case of mixed residence of the trustees, the focus shifted to the settlor and his residence at the time of the settlement of the funds including later additions.⁴²⁷ In particular in relation to the capital gains tax test, it was noted that the trustees of the trust are treated as a single and continuing body of persons, separate from the persons who may from time to time be the trustees.⁴²⁸ This was regarded as an useful concept in that it allows the individual trustees to come and go, but the body to remain the same for tax purposes, and further prevents problems over who exactly to assess and to hold responsible for the tax.⁴²⁹ It was further noted that the

⁴²² HMRC “ Modernising the Tax System for Trusts: Overview of the Proposals” http://collection.europarchive.org/tna/20061009092805/http://hrc.gov.uk/pbr2003/disdoc_overview_trusts.pdf – last accessed on 07/05/2013.

⁴²³ HMRC “ Modernising the Tax System for Trusts: Overview of the Proposals” http://collection.europarchive.org/tna/20061009092805/http://hrc.gov.uk/pbr2003/disdoc_overview_trusts.pdf – last accessed on 07/05/2013.

⁴²⁴ The four papers were respectively: Income Tax Issues, Capital Gains Tax Issues, Definitions and Tests, and Overview of Trusts.”

⁴²⁵ HMRC “ Discussion Paper” Definitions and Tests” 17 December 2003 – available at http://collection.europarchive.org/tna/20061009092805/http://hrc.gov.uk/pbr2003/disdoc_definitions_trusts.pdf – last accessed on 07/05/2013. Paragraphs 51 – 67.

⁴²⁶ Par 52-53.

⁴²⁷ Par 52-53.

⁴²⁸ Par 55.

⁴²⁹ Par 56.

statutory test contained special rules for professional trustees, which had as its purpose the encouraged utilisation of UK professional trustees and lawyers.⁴³⁰ However, it was also noted that the rule was said to be restrictive and resulted at times in the wrong result. It was therefore proposed that the professional trustees be permitted an election to be treated as either UK resident or not.⁴³¹ It was lastly noted that in the application of the test it was looked to where the “general administration of the trust” was carried out. This it was held is where the trustees carry out their general duties as trustees and whilst all circumstances pertaining to the trust may be taken into account for purposes of determining its place of effective management, this “general administration” is not the same as “place of effective management” as used in double taxation agreements.⁴³²

It was concluded that generally the difference tests appeared in practice to result in but minimal problems.⁴³³ However it was still felt that that the differences between the tests were not helpful and could be utilized for tax avoidance opportunities.⁴³⁴ Consequently a single test appeared sensible. This test could take one of three forms: either be an endorsement of the income tax test, or secondly the capital gains test, or be a completely new test such as for example based on “effective management” or “control and management.”⁴³⁵ In the further discussion a further two proposals were slipped in. Firstly, that the trust be treated as UK resident should it have a UK resident trustee regardless of the status of the settlor, which in light of circumstances where the settlor is a company or his status unknown, appears to simplify the enquiry process.⁴³⁶ In the revenue’s view it also appeared fair that tax liability should flow from having an UK trustee as by having such a trustee, the trust enjoys the benefit of access to the UK legal system and undoubted trust expertise.⁴³⁷ On the other hand, a second suggestion would be to regard the trust as UK resident should it have an UK settlor, regardless of the residence status of its trustees.⁴³⁸ This it noted was the position in the Canada and apart from possible compliance problems, requested the views of the trust industry on such a test.⁴³⁹

⁴³⁰ Par 58.

⁴³¹ Par 58.

⁴³² Par 59.

⁴³³ Par 60.

⁴³⁴ Par 60.

⁴³⁵ Par 61. It was stated further in the discussion that the test of effective management and control is one which is known in the context of double taxation agreements.

⁴³⁶ Par 62.

⁴³⁷ Par 62.

⁴³⁸ Par 66.

⁴³⁹ Par 66. The compliance problems it foresee would be where all the trustees were in fact non-resident and thus outside the ambit of its “grasp” ie jurisdiction.

The initial feedback on the discussion paper was that a common residence test for income tax and capital gains tax purposes was endorsed by all role-players and interested parties, but as to which test should be applied, there was no consensus.⁴⁴⁰ In relation to the proposal to base a test on the place of effective management and control of the trust, it was found that this enjoyed only limited support and the arguments against its introduction was that the test did not have the same relevance to trusts as to companies due to their different legal institutions and may lead to uncertainty.⁴⁴¹ Nor was the further proposals to base residence solely on the status of the settlor, or on the presence of one UK trustee supported.⁴⁴² The proposed election for professional trustees was however supported and was regarded as a promising incentive to bring trust business to the UK.⁴⁴³

The 2004 consultation paper that preceded the draft legislation essentially reiterated the aforesaid alternatives for the residence test as well as the findings made thus far.⁴⁴⁴ It stated that the main benefit in harmonizing such a test would be to improve consistency.⁴⁴⁵ The two more radical options proposed - treating *all* trusts with an UK resident trustee, or UK resident settlor, as resident – were criticized based on the discouraging effect it would have on the UK trust sector and practically, issues of enforcement as well as the unintended consequence of catching temporarily UK resident but not domiciled settlors within its net.⁴⁴⁶ Now it was firmly stated that these options would not be pursued.

Thus the choice would be between the income tax test which offers greater certainty or the capital gains test which allows more flexibility.⁴⁴⁷ The revenue authorities supported the income tax test as it provided greater clarity and simplicity.⁴⁴⁸ In relation to the special dispensation allowed under the capital gains tax regime for professional trustees, it was felt that it was unnecessary to extend this to the income tax test and consequently it was stated that this would not be pursued.⁴⁴⁹ A

⁴⁴⁰ HMRC “Summary of Responses to the Discussion paper issued on 17 December 2003” available at <http://collection.europarchive.org/tna/20061009092805/http://hmrc.gov.uk/trusts/summaryofresponses.pdf> - last accessed on 07/05/2013. Par 46.

⁴⁴¹ Par 49.

⁴⁴² Par 50 – 51 - regarded as unpopular and not workable tests.

⁴⁴³ Par 52.

⁴⁴⁴ HMRC “Modernising the Tax System for Trusts: a Consultation Document” August 2004 – <http://webarchive.nationalarchives.gov.uk/20080814090418/http://hmrc.gov.uk/trusts/trusts-modernisation.pdf>. -last accessed on 07/05/2013.

⁴⁴⁵ Par 4.22.

⁴⁴⁶ Par 4.24.

⁴⁴⁷ Par 4.32.

⁴⁴⁸ Par 4.33.

⁴⁴⁹ Par 4.34. The reason given was that “as most professional trustees in the UK have agreements with

transitional period for trustees to realign their residence status would be allowed.⁴⁵⁰

The response to the consultation paper⁴⁵¹ was essentially twofold. Firstly some criticized the utilisation of the income tax test arguing that the capital gains tax test is preferable as the former requires knowledge of the settlor's residence and domicile at the time the trust property was settled, which would not necessarily be a known or documented fact.⁴⁵² The greater response that was received however related to the professional trustee dispensation that would no longer be allowed. A general outcry followed that it would be most damaging to the UK's trust industry, and would advance other jurisdictions' interests.⁴⁵³ In particular it was emphasized that the UK is a global provider of trustee and related services, which provides employment for UK citizens, creates wealth in the UK economy and provides tax revenues from such UK-source profits, all of which was seemingly disregarded by the Revenue authorities.⁴⁵⁴ Following this, the revenue authorities referred the issue to Department of Trade and Industry for investigation where it was confirmed that such a dispensation would constitute state aid and would be unlawful in terms of the European Union's completion laws.⁴⁵⁵ This was greatly disappointing to the trust industry and as one author remarked wryly remarked, "Mr Brown (the then chancellor) had achieved the remarkable result of driving trust business away from the country, which had invented the trust concept and had given it to the world"⁴⁵⁶

In 2006, the Finance Act was published containing the new statutory residence test for income and

professional firms in other countries and can make arrangements so that trusts established by nonresident settlors are taxed in a non-UK jurisdiction."

⁴⁵⁰ Par 4.35.

⁴⁵¹ HMRC "Summary of Responses to the Consultation Document issued on 13 August 2004", available at <http://collection.europarchive.org/tna/20061009092805/http://hmrc.gov.uk/trusts/feedback-trusts-modernisation.pdf> - last accessed on 07/05/2013.

⁴⁵² Par 29. The Chartered Institute of Taxation in their submissions (Modernising Trust : CIOT further comments) 17 July 2005, argued that a prudent settlor would understandably not choose UK resident trustees as it may expose the trusts to capital gains tax at 40% and the additional necessity of having a non-resident trustee would also serve as deterring factor. They also pointed out that other jurisdictions such as Ireland and New Zealand specifically have legislation exempting local professional trustees should there be no other connections and similar provisions would assist the UK professionals to compete on an "even playing field." Also the Society for Trusts and Estate Practitioners UK Technical Committee "Reply to IR Consultation On Trust Modernisation" pointed out that it would not be good practice to only appoint a non-resident trustee for tax purposes, creating unnecessary administrative burdens and costs, and further contradicts the effort of the OECD to ensure that trust funds are dealt with in well regulated onshore jurisdictions.

⁴⁵³ Par 30. Riches, J & Kermally, L "Modernising the Tax System for Trust – Draft Legislation issued" (2006) PCB at 166.

⁴⁵⁴ McKie, S "Trustee Residence: Bring Back King Log" 2008 PCB (2) 72 at 72.

⁴⁵⁵ Regulatory Impact Assessment for Trust Modernisation – Available at <http://www.hmrc.gov.uk/ria/ria-trust-modernisation.pdf>- last accessed on 07/05/2013. Par 15.19.

⁴⁵⁶ McKie, S "Trustee Residence: Bring Back King Log" 2008 PCB (2) 72 at 76.

capital gains tax purposes.⁴⁵⁷ This test would be effective from 6 April 2007 in respect of any trust created whenever.⁴⁵⁸ Thereby for the first time the same test for residence would be applicable for both income tax and capital gains tax.⁴⁵⁹ The test as was postulated in the discussion papers was premised on the former income tax rules. The concept of a collective personality as was found in the capital gains tax rules was however brought forward to this test and the trustees of a settlement are now expressly required to be treated together as if they were a single person, thus distinct from the persons who are the trustees from time to time.⁴⁶⁰ It is then this deemed person which is regarded as resident or not should the further conditions be met.⁴⁶¹

The test so formulated can best explained by making a distinction between a situation where all the trustees are resident in the UK or all outside the UK (“single residence”), as opposed to a situation where one or more of the trustees are resident, whilst one or more are non-residents, thus an instance of “mixed residence.” In the first instance, that of single residence, the test is described as “straightforward.”⁴⁶² The trustees, or rather the deemed person, would be regarded as resident when all of them are resident with the opposite applicable should they all not be resident.⁴⁶³ This is so regardless of whether the settlor is a resident.

In instances of mixed residence, the settlor’s residence becomes conclusive. For this test to be applicable there must be at least one trustee resident and one non-resident,⁴⁶⁴ and if so, regard is then had to the residence or not of the settlor⁴⁶⁵ at the relevant time.⁴⁶⁶ Should the settlor be

⁴⁵⁷ S474 – 476 of the ITA, 2007 (previously s68 E of the ICTA) and S69(1) and (2) of the TCGA , 1992 as was contained in Schedule 13 for Income Tax and Schedule 12(1) for capital gains in the Finance Act, 2006.

⁴⁵⁸ Published a year in advance it was felt that this would allow trustees sufficient time to arrange their affairs to avoid any unintentional change of residence when the new common test would come into effect. Anon “Stop Press – Modernising the Tax System for Trusts: Draft Legislation issued” Published 30 January 2006 – available at <http://www.withersworldwide.com/news-publications/stop-press-budget-22-march-2006-personal-tax-highlights> .Last accessed on 07/05/2013.

Also Smith, J “The Residence of Trusts – New Rules and Tips?” 2007 PCB (2) 116-120; Schwarz, J Booth and Schwarz: Residence, Domicile and UK Taxation (2010) 14th ed at 119.

⁴⁶⁰ S 474 (1) of the ITA, 2007 and S 69(1) of the TCGA,1992 both provide that the trustees of a settlement shall together be treated as if they were a single person, distinct from the persons who are trustees of the settlement from time to time.

⁴⁶¹ S475(1) of the ITA, 2007 and S 69(2) of the TCGA,1992.

⁴⁶² Schwarz, J Booth and Schwarz: Residence, Domicile and UK Taxation (2010) 14th ed at 120.

⁴⁶³ S475(4) of the ITA, 2007 and S 69(2A) of the TCGA,1992.

⁴⁶⁴ S475(5) of the ITA, 2007 and S 69(2B)(a) -(b) of the TCGA,1992.

⁴⁶⁵ Resident, ordinarily resident or domiciled – S 476 of the ITA and S69 (2B)(c) of the TCGA,1992.

⁴⁶⁶ The relevant time in relation to the settlor is (a) where the trust was created on the settlor’s death (by will, intestacy or otherwise) the time immediately before his death and (b) in any other case, the time when he made the settlement. – S476 (1)-(4) of the ITA, 2007 and S69(2C) of the TCGA,1992.

resident then the deemed person would be resident, with the converse true should he not be resident. This is so regardless of whether the majority of trustees are resident, or where the general administration of the trust is carried out, which were previously the determining factors for the capital gains test. Thus whilst the residence of the trustees is important in instances where there is mixed residence, it does not matter how many trustees are resident and how many are not as their respective residences does not determine the deemed person's residence, but rather that of the settlor.⁴⁶⁷

When so much is therefore dependent on the individual residence of the trustees, any changes thereto, whether voluntarily or accidentally can be profound. As one author⁴⁶⁸ warns-

“Great care will be needed in future so that the residence status of a trust is not accidentally changed by a trustee either establishing residence in or ceasing to reside in the UK, or indeed through the death of a trustee.”

For natural persons as trustees the relevant residence applicable to natural trustees would be applicable, whilst in relation to companies who act as trustees, the relevant residence rules applicable to corporate would be applicable.

For professional trustees despite their protestations, the let-out historically applicable in the context of capital gains tax was abolished.⁴⁶⁹ In relation to professional trustees, and specifically non-resident companies, the following section for both income tax and capital gains tax was introduced –

If at a time a person (“T”) who is a trustee of the settlement acts as trustee in the course of a business which T carries on in the United Kingdom through a branch, agency or permanent establishment there, then for the purposes of subsections (4) and (5) assume that T is UK resident at that time.⁴⁷⁰

Thus in terms of this section, a trustee will be treated as resident in the UK, when the trustee acts as a trustee in the course of a business which he carries on through a “branch agency or permanent establishment” in the UK. Should such a trustee be a sole trustee, the trust will be regarded as a UK

When the settlor meets this conditions, the trustees will ceased to be resident when the settlor ceases to be treated as a settlor in relation to the settlement – S 476 of the ITA, 2007.

⁴⁶⁷ Schwarz, J Booth and Schwarz: Residence, Domicile and UK Taxation (2010) 14th ed at 120.

⁴⁶⁸ Rawlinson & Hunter “Briefing” February 2007” –available at <http://www.rawlinson-hunter.com/News/Archives-Last> accessed on 07/05/2013. also Hutton, M “Tax Trap: The Potentially Disastrous Trustee Retirement” 2009 PCB 261-262.

⁴⁶⁹ Finney, M Personal Tax Planning: Principles and Practice 2011/2012 at 389. – it was regarded to constitute state aid under the EU competition laws.

⁴⁷⁰ S475 (6) of the ITA, 2007. The equivalent for TCGA,1992, is S69(2D).

resident trust. As the section is a deeming provision some refer to it as the “professional trustee deemed residence rule.”⁴⁷¹

Booth & Schwarz explain that the terms “branch or agency” relates to an UK representative’s liability in respect of a trade carried on by non-resident *individuals* in the UK, whilst the term “permanent establishment”⁴⁷² is the equivalent expression in relation to non-resident *companies*.⁴⁷³ This distinction is accepted by the revenue authorities in a Guidance Paper issued by the HMRC.⁴⁷⁴ The importance hereof lies therein that an overseas trust company need only be concerned for tax purposes should it carry on business through a permanent establishment in the UK and not if it only has a branch or agency.

The approach HMRC follows is to essentially ask three questions. Firstly, whether the trustee is carrying on a business in the UK.⁴⁷⁵ The “business” to which reference is made is however not the business of the particular trust, but instead that of providing professional trustee services for a fee. In other words, is the person who is the trustee carrying out business activities as a professional or businessman in the UK, and not as a trustee of a particular trust? If the answer is affirmative, the next question is whether the business is conducted through a branch, agent or permanent establishment in the UK.⁴⁷⁶ Again “business” does not denote the activities of the particular trust, but instead whether the trustee is carrying on the activities through which it substantially derives its worldwide profits (professional services for a fee) through a branch, agent or permanent establishment.

Should both the aforesaid questions be answered positively, then only is regard is had to the activity of the trustee for that particular trust. The third question is therefore whether the trustee is

⁴⁷¹ McKie, S “Blind Guides: the Professional Trustee Deemed Residence Rule – a critique of HMRC’s Guidance” 2009 PCB 400.

⁴⁷² Although no reference is made to the statutory definition in the Guide for “permanent establishment”, such a definition is to be found for purposes of determining whether a company has a permanent establishment in a country – s 148 of the Finance Act, 2003. Instead the Guide refers to the Commentary on the OECD’s Model Tax treaty and its article 5, which is however different from the statutory definition and must be noted is not directly part of UK Law. McKie, S “Blind Guides: the Professional Trustee Deemed Residence Rule – a critique of HMRC’s Guidance” 2009 PCB 402.

⁴⁷³ Schwarz, J Booth and Schwarz: *Residence, Domicile and UK Taxation* (2010) 14th ed at 122.

⁴⁷⁴ HMRC “Trustee Residence Guidance” (Version 1 July 2009) states at par 5 that it accepts that “branch and agency” tests apply to non-corporate trustees whilst the “permanent establishment” test applies to corporate trustees. The Guidance was issued specifically to provide HMRC’s view on the application of the residence tests in relation to overseas trust companies, owned by UK-based groups.

⁴⁷⁵ HMRC “Trustee Residence Guidance” (Version 1 July 2009) - Par 8A at 4.

⁴⁷⁶ Par 8B.

carrying on the activity of being a trustee of that particular trust in the course of its business through the branch, agent or permanent establishment?⁴⁷⁷ This last question imposes a case by case approach and it may be that a corporate trustee may be a trustee in relation to one trust through a permanent establishment, but in relation to another trust on the circumstances not be so regarded.

A trustee would further be regarded as “carrying on the function of being a trustee” should it perform the core activities of a trustees, and not merely those auxiliary or preparatory activities.⁴⁷⁸ This is based on the Commentary to the OECD Tax Model Convention.⁴⁷⁹ In the revenue authorities’ view the following activities are regarded as core activities of a trustee:

- the general administration of the trusts,
- the over-arching investment strategy,
- monitoring the performance of those investments, and
- decisions on how trust income will be dealt with and whether distributions should be made.⁴⁸⁰

This is in contrast to auxiliary or preparatory activities which would for example be information gathering meetings, meeting with independent agents or with beneficiaries although a case-by-case approach would need to be followed.⁴⁸¹ To decide whether the conduct and management of a particular trust is carried on in the course of the business of the trustee through the permanent establishment, the focus would be on where the core activities are *physically* carried out.⁴⁸² Yet the nature as well as significance of the activities and meetings would also be important factors, and in particular their frequency.⁴⁸³ An example is cited by the HMRC where there is substantial administrative work being carried on the UK through such meetings so that these meetings become a major element of the trustee’s activities in relation to the trust and are no longer preparatory or

⁴⁷⁷ Par 8C.

⁴⁷⁸ Par 9.

⁴⁷⁹ Commentary on the OECD Tax Model Convention of January 2003, Article 5 which defines “permanent establishment.”

⁴⁸⁰ Par 10 with 10.1 – 10.4.

⁴⁸¹ Par 11. This is criticised by McKie who argues that gathering relevant information about the circumstances of the beneficiaries, having meetings regarding the performances of the duties of independent agents, or with lawyers, investment managers, land agents for information purposes are important parts of the duties of trustees and would be inevitable acts by a professional trustee during the course of his business of providing professional trustee services. McKie, S “Blind Guides: the Professional Trustee Deemed Residence Rule – a critique of HMRC’s Guidance” 2009 PCB 405.

⁴⁸² Par 12.

⁴⁸³ Par 12.

auxillary.⁴⁸⁴ The rest of the guidance consists out of practical examples. Whilst the rule and the subsequently published Guidance has been severely criticized, until repeal or amendment, they remain in force.⁴⁸⁵

8 4 2 5 Conclusion

It is clear from the above discussion that in English tax law, the residence of the individual trustees to the trust, have traditionally been and still is, a paramount factor in determining the residence of the trust. This occurrence is perhaps due to the fact that in English trust law, the trust is regarded as a relationship as opposed to a person. Thus, whilst in English tax law, the trust is now regarded as a separate taxable entity, in keeping with the aforesaid trust principle, to determine the residence of the trust, it is essentially the residence of this relationship that must be ascertained, and thus regard is had to the trustees, the pivotal roleplayers in this relationship. As Schwarz explains –

“Residence, on the other hand, is a personal attribute – a quality which a person attracts to himself by virtue of the strength of his association with a particular place or country. The liability to tax in relation to trusts is by reference to the persons concerned as a result. In the case of the trustees, their personal residence will thus determine their fiscal affiliation as the representative owners of the trust property.”⁴⁸⁶

In South Africa, this focus on the residence of the trustee was historically present in the case of *Estate Nathan*, but with the changeover from a source to residence based system of taxation, it became but a relic, as the focus was now on the trust as a person for tax purposes and through the statutory definition of residence, on its place of establishment or place of effective management to determine its residence. The discussion of the position in Canada also revealed that historically, reference would be had to the individual trustees and their residence, with the residence of the majority of the trustees being conclusive. Yet the recent developments in Canadian jurisprudence in favour of a test of central management and control of the trust indicate a clear move away from the historical focus. Whilst neither South Africa nor Canada had a specific programme to develop

⁴⁸⁴ Par 12.

⁴⁸⁵ See for example McKie, S “ Trustee Residence: Bring Back King Log” 2008 PCB (2) 72 and his further article “Trustee Residence: A Permanent Fog” Tax Adviser December 2009 at 19 – he states that the Guidance is imprecise and misleading in places, and overall, will not assist in retrieving trust business which has been lost to the UK due to the uncertainty regarding this rule. See also the Guidance Note agreed to by HMRC and the Institute of Chartered Accountants in England & Wales(ICAEW), the Chartered Institution of Taxation (CIOT) and the Society of Trust and Estate Practitioners (STEP) which had all expressed their concern that the new rules lack certainty and clarity, does not provide consistent treatment for all trusts and would discourage settlors and trustees from utilizing UK professionals and investing in the UK. Available at http://www.step.org/news/press_releases/2010/trustee_residence_guidance.aspx. Last accessed 07/05/2013.

⁴⁸⁶ Schwarz, J Booth and Schwarz: Residence, Domicile and UK Taxation (2010) 14th ed at 119.

their trust tax law, through these statutory and judicial pronouncements, the law in relation to the residence of trusts for tax purposes have been developed and modernised.

Yet in the UK, where specifically a trust modernisation programme was followed, the historical position was essentially retained. The new test introduced in 2007 requires that the residence status of the trustees first be ascertained, and only where this does not result in a clear result, that the residence of the settlor be applied as tie-breaker with the trust's residence following his at the time of the settlement. The benefit of such a test appears to lie in its simplicity of application and that is a familiar to all role-players having been the entrenched test for income tax purposes for many years. Yet its simplicity means it is also easy to manipulate. Nor does it look beyond the mere offices of the trustees, to their real activities, to the trust's substance and the actual management of the trust.⁴⁸⁷ It is disappointing that when presented with an opportunity to evolve their trust tax laws, the recorded documents give no evidence of any real debate as to the matter, no intellectual arguments as to the tax policies, the moral justifications for residence and the test to be applied in a trust context. Instead it may be inferred from the discussions papers that the objective to have one residence test was so dominant, that the focus would only be on deciding which of the two tests currently in force would be better to use in future.

So for example when preliminary testing the waters as to whether a place of effective management test to found residence could be utilised, the subsequently published feedback received was very brief and cryptic, and would unfortunately not assist in formulating an interpretation of the concept. However for purposes of treaty purposes in the UK this concept of place of effective management is a tie breaker, and specifically in the context of trusts have also been the subject of court cases. It would therefore be useful and insightful to have regard to how this term have been interpreted in such a context.

8 4 3 Residence in a tax treaty context - Place of Effective Management

As a trust (or rather its trustees) is in UK tax law, regarded as a separate taxable entity and capable of having a residence, circumstances may arise where the trust may be regarded by the UK as resident, whilst another country may also regard it as having residence within its jurisdiction.⁴⁸⁸ This would therefore be an instance of dual residence and to resolve the potential double taxation that

⁴⁸⁷ Apart when determining the permanent establishment for the non-resident professional trustee deemed residence rule.

⁴⁸⁸ Schwarz, J Booth and Schwarz: *Residence, Domicile and UK Taxation* (2010) 14th ed at 123.

may occur, recourse would be made to the double taxation agreement between the governments of the two countries, should there be one. In the UK these agreements are essentially premised on the OECD Model Tax Convention, which in instances of dual residence aims to resolve this by application of the tie-breaker provision.⁴⁸⁹ This has as central determinant the concept, “place of effective management”:

“4(3) Where by reason of the provisions of paragraph 1 a person other than a individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.”

In the UK, the application of this concept of “place of effective management” has specifically in the context of trusts, been considered on two occasions, which cases were discussed in the previous chapter dealing with tax treaties.⁴⁹⁰ The second criteria of South Africa’s fiscal residence test is that of “place of effective management” and a consideration of these cases provided insight as to the interpretation and application of the term.

8 5 Conclusion

Russo states that “At the very least, a tax system must define when a person is a resident in its territory for tax purposes...”⁴⁹¹ In this chapter, the definitions (or approaches) formulated by various jurisdictions to determine when a trust will be resident, has been considered.

Firstly the different approaches in countries regarded as civil law, common law and low tax jurisdictions were considered by reviewing specific countries as examples. From such a discussion it was clear that countries follow divergent approaches. Some attribute residence similarly to South Africa on both a legal and factual seat (such as Italy), others on a mere formal connection (the low tax jurisdictions come to mind), or develop their own unique test, such as Belgium and the United States. Whilst there may not have been uniformity, the diversity did reflect that various factors in relation to the trust, could be identified (be it the governing law of the trust, the place of residence of its trustee, the main place of its activities or management or assets, etc), with each state selecting those factors it viewed as decisive in establishing tax residence for the trust. This each state is entitled to do, as Fichardt & Delegat explained – “As each state is sovereign it is entitled to determine its own tax regime, it is no surprise that definitions of tax residence in domestic

⁴⁸⁹ Schwarz, J Booth and Schwarz: *Residence, Domicile and UK Taxation* (2010) 14th ed at 123.

⁴⁹⁰ See par 7 5 1 and 7 5 2.

⁴⁹¹ Russo R (ed) *Fundamentals of International Tax Planning* (2007) at 5.

legislation differ from state to state. So too does the interpretation attributed by those definitions by tax authorities”.⁴⁹²

An in-depth study of Canada and the United Kingdom then followed. In comparison to South Africa, Canada similarly has no statutory defined residence test particular to trusts. Also similar to South Africa, a trust has been expressly deemed for purposes of the Act to be an “individual,” thus capable of having a residence and being a taxable entity. Although South Africa has at least defined “residence” in its legislation (although not specifically with reference to trusts), the Canadian legislator has not done so, leaving it to the judiciary to develop such meaning through court cases.

Historically such judicially developed test looked to the residence of the trustee.⁴⁹³ A commission tasked to review the tax system also included the residence of trusts in its report,⁴⁹⁴ recommending that this basis of attributing residence for the trust on the basis of residence of the trustees, be retained and that a statutory definition be formulated. In addition to the historical basis, it also proposed residence to be attributed where the trustees, the majority or controlling group of the trustees, reside within Canada, or where the trust carries on substantially all of its business, or lastly and interestingly, should substantially all of its assets be located in Canada. Although these recommendations could be regarded as pragmatic and innovative, they were not adopted. Instead, the residence of the trustees as basis for the residence of the trust, was subsequently endorsed in the case of *Thibodeau Family Trust v the Queen*,⁴⁹⁵ which for many years was the only case on this important issue.

Canada’s Revenue Authorities also endeavored to assist in the formulation of an approach by issuing an Interpretation Bulletin specifically on the topic of the residence of a trust.⁴⁹⁶ Whilst South African revenue authorities have issued an Interpretation Note and Discussion Paper, they did so in relation to only one aspect of the test for residence and focused only one entity, companies. Canada’s Interpretation Bulletin emphasized the factual nature of the enquiry. It also re-affirmed the general consideration that the residence of the trust will follow the residence of the trustee who, importantly it added, manages or controls the trust assets. In the guidelines it was indicated that where this was unclear, other factors such as the location where the legal rights are

⁴⁹² Fichardt, L & Delechat, A “Residence Revisited” September 2010 (1) Business Tax & Company Law Quarterly at 3.

⁴⁹³ See the discussion at 7 3 2 1.

⁴⁹⁴ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 87.

⁴⁹⁵ [1978] FCJ No 607 also cited as 78 DTC 6376 sub nom *Dill v The Queen*.

⁴⁹⁶ Income Tax Interpretation Bulletin IT-447: Residence of a Trust or Estate Issued by the Canada Revenue Agency, date 30 May 1980. Modified 1995-01-01.

enforceable and the location of the trust assets, will be considered and where an abnormal situation is present, in that a substantial portion of the control and management rest with another person, then such person/s' residence will be important. Fundamentally therefore to the Canadian approach, the residence of the trustee remained important. However the more recent of judicial cases⁴⁹⁷ indicate a shift in perspective with trust's tax residence being interpreted by analogy, to the test applied for companies, that of central management and control.

These more recent cases being the sequential cases leading up to and including the Supreme Court of Appeal case, *Fundy Settlement v Canada*.⁴⁹⁸ It was in the latter that the approach to determine the trust's residence on the basis of central management and control was established. The case also indicated that role-players other than the trustees may be considered as to their impact on where the actual management and control of the trust is situated. The case lastly reaffirmed that the test for residence requires a factual approach. South Africa applies the test of place of effective management, and in addition to this *de facto* standard, a further *de iure* standard, the place of formation and establishment. The various criticisms against the approach of "central management and control", as well as the proposals for alternative tests to determine the residence of the trusts, were also considered.

Then the position in the UK was considered. In the UK, a statutory test has been set which could be perceived to be quite progressive as neither South Africa nor Canada has done so. However on deeper inspection such view would appear to be questionable as the historical basis of the residence of the trustees remains the predominant test.⁴⁹⁹ Traditionally different approaches were followed to determine the trust's residence for income tax purposes on the one hand, and capital gains tax purposes on the other hand. Following a trust modernisation programme, a single test for both income tax and capital gains was introduced. The test however retained the approach of attributing the residence of the trust on the basis of the residence of the trustees.⁵⁰⁰ This test directed that in instances of a "single residence", where all the trustees are resident in the UK, or all are resident outside the UK, the trust would be resident where the trustees were all resident. In instances of "mixed residence", ie where at least one trustee is resident and one non-resident, the settlor's residence is conclusive and the trust's residence will follow the settlor's residence at the

⁴⁹⁷ *Garron Family Trust v. The Queen*, 2009 TCC 450 *St. Michael Trust Corp. v. Canada* 2010 FCA 309.

⁴⁹⁸ 2012 SCC 14, Judgment delivered on 12 April 2012.

⁴⁹⁹ See the discussion at 7 4 2 1 as well as the case of *Dawson v Inland Revenue Commissioners* [1987] STC 114.

⁵⁰⁰ See the discussion at 7 4 2 4 wherein the different processes for the modernisation system was discussed.

time of the settlement.⁵⁰¹

It was noted that this is a formal approach⁵⁰² and stands in contrast to Canada and South Africa who apply a more factual and substance-based approach. Whilst the approach has the benefit of simplicity and familiarity, there are also the risk of purposeful manipulation on the one end, and on the other end, the inadvertent disastrous consequences which may result upon the sudden death or relocation of a trustee and the impact it will have on the residence test. It was lastly also regretted that during the trust modernisation programme, alternatives such as the “place of effective management” were raised, but not comprehensively considered, thus detracting from the usefulness of the exercise for our purposes.

The discussion in this chapter has showcased the many varied tests that may be utilised by countries to determine a trust’s residence for tax purposes. The discussion has also reflected certain advantages as well as disadvantages of the tests so applied. The differences to the test South Africa applies to determine the residence of the trust, has been considered. Yet the determination of whether such tests are more appropriate and effective is not discussed here as such an examination will be conducted in the next chapter. We now turn to the penultimate chapter of the study where the various test for residence are critically analyzed.

⁵⁰¹ S 474 (1) of the ITA, 2007 and S 69(1) of the TCGA,1992 as well as S475(1) of the ITA, 2007 and S 69(2) of the TCGA, 1992.

⁵⁰² Apart when determining the permanent establishment for the non-resident professional trustee deemed residence rule.

CHAPTER NINE:**ANALYSIS OF THE VARIOUS TESTS FOR “RESIDENCE” OF A TRUST****9 1 Introduction**

Norr comments that “within its own legal and fiscal framework a country is free to adopt whatever rules of tax jurisdiction it chooses.”¹ This quote aptly illustrates the right each state has to determine its tax rules, including thus the basis upon which it will exert its rights to tax entities such as trusts. That countries do adopt their own rules - which are not necessarily the same, similar or even in line with other countries - was evident from the previous discussions where South Africa’s residence test for the trust was traversed, followed by a review of the tests in various other jurisdictions, including in particular Canada and the United Kingdom.

From such discussions it became apparent that countries utilize a variety of tests to determine the residence of a trust. In order to analyze these tests and determine which is more appropriate and effective, it is firstly necessary to review the taxation basis of “residence” for its underlying justification, as this forms an implicit measure of the effectiveness of any residence test for a trust. Secondly then to determine the further measures by which the tests are to be assessed, and lastly to conclude by conducting such an assessment of the various tests.

9 2 Residence as taxation basis

Already in the introductory chapter of this study it was noted that “residence” resorts under the fiscal jurisdiction whereby a state authority levies taxes.² Fiscal jurisdiction refers to the right and power of a state to impose taxes.³ This right is regarded as a fundamental aspect of a state’s sovereignty.⁴ In theory a state can attempt to exert these rights and powers as wide as possible by promulgating tax laws as broad and encompassing as possible. This would accord with the primary purpose of a tax system which is to raise revenue to fund public expenditure. As Weber-Fas⁵ explains,

¹ Norr "Jurisdiction to Tax and International Income" 17 Tax L Rev (1962) at 431.

² See Chapter 1 at par 1 1.

³ Danzinger E *International Income Tax The South African Perspective* (1991) at 13; Tillinghast D *Tax Aspects of International Transactions* (1978) at 1.

⁴ Cappelen, A W “The Moral Rationale for International Fiscal Law” at 98.

⁵ Weber-Fas, R “Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law “ 5 Harvard Journal on Legislation (1967-1968) at 175.

“In order to meet its fiscal needs and to advance its social, economic and political goals, the modern nation-state asserts the right to take its tithe of the wealth present and the economic gain produced within the ambit of its powers. While such national fiscal claims may not always be as modest as they should be, and are not always in line with those of other nations... there exist no rules of international customary law which limit the extent of any country’s tax jurisdiction to the confines of its territory.”

Yet practically, requirements of efficiency and enforceability as well as fairness would act to counter such a far-reaching grasp. Of these considerations, Danziger singles “effectiveness” out as the reason why states will only levy taxes upon tax subjects and objects to the extent that there is a link or connection which justifies the taxing.⁶

As was stated in previous chapters, there are in general two possible connecting factors that serve as justification – source and residence.⁷ “Source” is described as the connecting factor which arises when the activities that yield the income are connected to the country, whilst “residence” is the connecting factor when the person who receives the income (or to whom it accrues) is connected to the particular country.⁸ Which factor a state will choose is according to Tillinghast a “policy decision like any other – a purely mortal determination,” with each state influenced by what it considers fair and appropriate to impose its taxes on persons and entities.⁹

The principles underlying each of these bases of taxation were established in *Kergeulen Sealing and Whaling Co Ltd v CIR*.¹⁰ In that case it was explained that when source is used as connecting factor, the link is present in that the activities that generate the income takes place within the jurisdiction and that the justification for the state to levy taxes, lies in the fact that it is entitled to a share of the wealth which is produced by its natural resources or activities of its inhabitants.¹¹ Alternatively residence may be used as basis for taxation and be justified on the grounds that the resident taxpayer may be expected to pay a tax as contribution towards the cost of the government, which grants it privileges and protection.

⁶ Danziger E *International Income Tax The South African Perspective* (1991) at 5; Rohatgi, R *Basic International Taxation Vol 1 : Principles* at 14.

⁷ See the introductory chapter as well as Chapter 5. Cappelen, A W “The Moral Rationale for International Fiscal Law” at 98 distinguishes the connections as either personal or economic. Personal connections are for example, citizenship and residence, which allows for full unlimited tax liability, whilst economic connections by reason of the location of the economic activities or assets give rise to limited tax liability as only the income arising from same within the state’s borders can be taxed.

⁸ Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 9; Arnold BJ & McIntyre MJ *International Tax Primer* 2002) at 15.

⁹ Tillinghast D *Tax Aspects of International Transactions* (1978) at 4.

¹⁰ 1939 AD 487 at 507.

¹¹ At 507.

Thus when applying a residence based test it is important to be mindful of this underlying justification as this forms the rationale in applying the test.¹² In other words, when applying a test based on source, the focus is on the income and where it was generated as justification, whilst when applying a test based on residence, the focus should be on the taxpayer, here - the trust. Rohatgi affirms this by explaining that when residence is used, taxation rights arise due to the “personal attachment” of the persons, whilst when “source” is used, there is an “economic attachment.”¹³

For a practical application as to how this underlying justification may inform the application of the residence test, reference can be made to the e *Robinson v COT*¹⁴ which was discussed in Chapter 5. It would be recalled that there the court resorted to the underlying basis to devise a solution where the facts were inconclusive stating that,

“It is said that in determining the meaning of the word ‘residence’ regard must be had to the object of the Act and the context in which the word appears. These tests are not easy to apply in the present case....But where a person has been living all this time in the country and has had the benefit of its government for himself, his property and business, there seems no *a priori* reason for exempting him from taxation.”¹⁵

Thus the “privilege, protection and shelters”- theme by which residence based taxation is identified, may be used in the final instance to serve as justification for the imposition of taxes. So too, when measuring the appropriateness of any test for residence should the question be posed as to whether it is in accordance with this rationale and furthers this justification basis.

More recently in the 2013 Budget Speech, the South African Minister of Finance again emphasized the importance of this justification in our tax system, by stating that “we also owe it to our taxpayers to ensure they are not carrying the burden of those who benefit from our country’s infrastructure and resources without paying their fair share of the costs.”¹⁶

A further two principles can be said to flow from this distinction between classifying persons as resident or not resident–

¹² At 507.

¹³ Rohatgi, R *Basic International Taxation Vol 1 : Principles* at 14.

¹⁴ 1917 TPD 542

¹⁵ At par 546. Hattingh J in *Residence of Companies under Tax Treaties and EC Law* (2009) at par 19.4.5.2.

¹⁶ 2013 Budget Speech is available at <http://www.treasury.gov.za/documents/national%20budget/2013/speech/speech.pdf> . Last accessed on 01/05/2013.

- The first being that taxpayers with a sufficiently close nexus to the jurisdiction, should be subjected to tax on their worldwide income, whilst
- Taxpayers without such close connections should only be liable for tax on income that originates from or is connected with the jurisdiction.¹⁷

These principles therefore demonstrate that the residence test should ensure that sufficient connections between the trust and the jurisdiction which seeks to levy the tax, is present.

A last aspect should also be noted. Fiscal jurisdiction does not only involve the right to tax, but also the right to collect those taxes. The latter denotes the enforcement of the legislation whereby the taxes are levied.¹⁸ Whilst “fiscal jurisdiction” thus refers to both the right to legislate and the right to enforcement, an important distinction must be made. On the one hand, a state cannot enforce what it cannot legislate, but on the other hand, a state can in theory legislate what it is unable to enforce.¹⁹ The latter would however yield an unfeasible if not an impossible situation. Where a state endeavours to do this, it will be halted by practical issues - as Rohatgi explains²⁰-

“International law only permits the enforcement by a country of its tax laws within its legislative jurisdiction. It forbids executive or administrative acts and enquiries by foreign tax authorities without the consent of the host country. For example a State cannot send officials to gather tax evidence, examine books, value any property or interview witnesses... Generally one State does not normally enforce the tax laws of another State, as a matter of sovereignty.

Thus, as Spengel & Schäfer state “ the tax system has to be enforceable in practice and thus has to have the capacity to achieve its basic objectives”.²¹ This brings one to the realisation which Ettinger encapsulates by saying - “there would be little point in having rules which result in a tax liability in situations where there are no assets nor funds flowing or accessible to residents within the particular country”²² In a source-based system, the income is derived within the country’s borders and enforcement by collecting the tax *at the source* within the country’s borders is therefore not

¹⁷ Tillinghast, DR “A Matter of Definition: ‘Foreign’ and ‘Domestic’ Taxpayers 2 Intl Tax & Bus Law (1984) at 239.

¹⁸ Danziger explains that jurisdiction is the power of a state to make rules of law, to adjudicate on the application of those rules, and to enforce the rules which it has made. Danziger E *International Income Tax The South African Perspective* (1991) at 3.

¹⁹ Rohatgi, R *Basic International Taxation Vol 1 : Principles* at 14.

²⁰ Rohatgi, R *Basic International Taxation Vol 1 : Principles* at 21.

²¹ Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 13.

²² Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 105

problematic.²³ In a residence-based system, income may be earned by the taxpayer worldwide and thus enforcement becomes more complicated. Yet complexity does not necessarily translate into impossibility. As “residents” are regarded as having sufficient connections to the jurisdiction which seeks to levy the tax, it may still be extracted – whether from the fact that most of the resident’s assets are located within the jurisdiction, or whether control over such assets is vested with persons situated in the jurisdiction, such taxes could still be enforced via these avenues, regardless of the fact that the income was earned far outside the borders of that particular jurisdiction. It does however again emphasise that the connections between the taxpayer and the country which seeks to levy the tax, should be substantial. Thus the criteria upon which the residence test is based should embody this.

To summarize - the underlying justification to a residence based taxation gives rise to the following important considerations in assessing the various tests for residence:

1. firstly whether the test is based upon and furthers the justification that the trust should pay taxes for the protection and privileges it receives,
2. that such justification would be more apparent when the trust has sufficiently close connections to the jurisdictions, and if not, such justification would be impeded and the trust should be regarded as non-resident with only its local income taxed,
3. lastly, that in analyzing a test, the possible enforcement and collection of the tax liability should be kept in mind.

9 3 Determining the measures

Residence, where applied as a basis for taxation, forms part of the country's overall tax system and is the key determinant as to whether such tax system would be applicable or not. As such it should therefore enhance the objectives the tax system seeks to serve. Generally these tax objectives are summarized to be the following:

1. The first objective is to generate funds to finance government expenditure. This is often described as the primary purpose or the “chief objective of taxation.”²⁴ Indeed as the American Supreme Court Judge, Oliver Wendell Holmes famously remarked, “taxes are

²³ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 94.

²⁴ Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 2.

the price we pay for a civilized society.”²⁵ As Tillinghast explains in simple terms –

“A nation incurs costs in providing governmental services. Taxes pay for these; and governments accordingly levy tax on those who benefit – or, more accurately, who fall in a class which may fairly be presumed to benefit – from the services provided, or some of them.”²⁶

To therefore ensure that a country receives the fair share of revenue, it needs to develop rules aimed at protecting its tax base.²⁷ However as Ettinger notes, it is trite that in the pursuit of this goal, other considerations such as fairness and efficiency would act as restraints.²⁸

2. Secondly to assist in the reallocation and redistribution of sources. Williams explains that tax removes income or wealth from the private sector, which can then be reallocated in the form of goods, services and benefits to persons or group of persons or any other recipients identified by government.²⁹
3. Thirdly, to provide government with a further instrument for the management of economy. Again this relates to fact that taxes removes wealth from the private sector. Thus by increasing taxes behaviour which is seen to be economically undesirable, is discouraged. The converse is also then true - by lowering taxes, activities that are economically desirable are promoted in that the wealth that is retained can be applied towards such activities, such as investing in new plant and equipment, or employing more people.³⁰

Reflecting on the aforesaid, it is the first objective that has the most significance for the residence test, in that it implicitly indicates that the test for residence should therefore be geared toward raising as much funds as possible and its rules should be formulated to offer the greatest protection of the tax base.

²⁵ *Compania General de Tabacos de Filipinas v Collector of Internal Revenue* 275 US 87 (1927) at 100.

²⁶ Tillinghast D *Tax Aspects of International Transactions* (1978) at 2. See also Harris, P & Oliver, D *International Commercial Tax* (2010) at 8 where they explain that it is foundation of the relationship between community members that they are to share the funding of the government – the government levies taxes as a compulsory contribution to raise funds, and at some level therefore, should there be no taxes there would be no government.

²⁷ Arnold BJ & McIntyre MJ *International Tax Primer* 2002) at 5.

²⁸ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 94.

²⁹ Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 2.

³⁰ Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 2.

Related to these objectives, are the desired characteristics the tax system should exhibit. As early as three centuries ago, Adam Smith identified at least four of these maxims which should be present in every nation's tax system:

1. The first such characteristic is said to be equity or fairness. This is stated to take two forms – horizontal equity – that persons in the same economic circumstances should be treated similarly whilst vertical equity denotes that “the subject of every state ought to contribute, as nearly as possible, in proportion by their respective abilities, that is in proportion to the revenue which they respectively enjoy under the protection of the state.”³¹ Thus tax liability should increase in accordance with the taxpayer's ability to pay. Williams expresses it succinctly - “the burden of tax ought to fall on those with the broadest shoulders.”³²
2. A second characteristic relates thereto, namely of efficiency. Efficiency in the sense that the tax is not excessively felt and thereby causes resentment amongst taxpayers (termed political efficiency) – or as Smith phrased it “every tax ought to ... take out and to keep out of the pockets of the people as little as possible.”³³ Alternatively it is utilised in the sense that it does not require a too high costs to administer and collect it (administrative efficiency).³⁴ In the Katz Commission this aspect was elaborated and it was concluded that a system which cannot be administered effectively, regardless of how effective it should be in theory, would only result in low collection levels and an eventual self-defeating disrespect for the law.³⁵
3. Neutrality is regarded as the third characteristic. In a tax system, neutrality denotes that the tax does not have an impact on economic behaviour, or as stated in the Margo Commission Report - “that people should not be influenced by the tax system to choose one course of action rather than another solely or predominantly because their tax position is better under one of the options.”³⁶ Spengel & Schäfer describes its meaning - “in a world

³¹ Smith, A *An Inquiry into the Nature and causes of the Wealth of Nations* (1776) Book V Chapter II.

³² Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 3.

³³ Smith mentions that discourages entrepreneurial spirit and elicits tax evasion. Smith, A *An Inquiry into the Nature and causes of the Wealth of Nations* (1776) Book V Chapter II.

³⁴ Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 3.

³⁵ Katz Commission “Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa” (7 March 1997) available at www.polity.org.za/polity/govdocs/commissions/katz-5.html - last accessed on 05/05/2013.

³⁶ Margo Commission Report “Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa” (1986) Chaired by Hon J Margo.

without taxes decisions should be made in the same way as in a world where taxes exist.”³⁷ Ettinger explains that the neutrality will be achieved when the tax system does not affect personal or investment decisions, which is regarded as desirable as it promotes the most efficient allocation of resources.³⁸

4. The fourth characteristic is certainty, requiring that any measure of arbitrariness as to the time, manner, and quantity of payment of the tax should be eradicated, and that such aspects should be “clear and plain to the contributor, and to every other person.”³⁹ So too in the Meade Report⁴⁰ it was stated that a “good tax system should be coherent, simple and straightforward” and that the person in the street should be able to comprehend clearly the nature of the taxpayer’s liability. This necessitates that the rules relating to tax be certain, clear and easy to understand by all alike. Williams identifies two factors which may undermine such certainty – firstly, that the language used to formulate the rules may be technical and abstruse, and secondly, that subjective criteria may be applied to determine tax liability.⁴¹ He identifies that such uncertainty amongst taxpayers as to whether they are liable for tax or would be liable for tax if they acted in a certain manner, yields undesirable consequences: firstly that they do not act fearing such tax liability, thus suppressing economic growth, or act with resulting disputes between the taxpayer and the tax authorities, which occasions a waste of time and resources to resolve the dispute.⁴² Adam Smith lists further consequences of such uncertainty in relation to the tax collector, surmising that it places too much power in fiscus’ hands, whereby its officials can either aggravate the tax or extort such increased taxes or other benefits for themselves by merely invoking fear of such aggravation.⁴³
5. To this a further virtue may be added, namely ease of compliance –that the tax should be payable at such time and in the manner which is the most convenient to the taxpayer.

³⁷ Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 6.

³⁸ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 94. Rohatgi, R *Basic International Taxation Vol 1 : Principles* at 23 .

³⁹ Smith, A *An Inquiry into the Nature and causes of the Wealth of Nations* (1776) Book V Chapter II.

⁴⁰ The Meade Committee “Structure and Reform of Direct Taxation: Report of a Committee” chaired by Prof J E Meade (1978)

⁴¹ Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 3.

⁴² Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 3.

⁴³ Smith, A *An Inquiry into the Nature and causes of the Wealth of Nations* (1776) Book V Chapter II. Also apt is his statement that “the uncertainty of taxation encourages the insolence, and favors the corruption” of the fiscus.

Compliance also necessitates that the tax laws be easy to understand to the taxpayer, which in turn facilitates enforcement by the tax collector.⁴⁴ Thus as the Margo Report concluded “simplicity requires that a tax should be easily assessed, collected and administered in order to minimise the costs of tax to both the taxpayer and the fiscus.”⁴⁵

6. Flexibility of the tax system is also important. Williams mentions one example in this regard – that the rates of tax should be adaptable as the economy fluctuates⁴⁶ A further example can be added here, namely that as we shift from a proverbial “bricks and mortar” world to an era of electronics and digital mediums with its enhanced mobility and communication, the tax system, and especially its rules of residence should be able to keep pace with such developments.

These characteristics are regarded to be interrelated and in a certain sense dependent on each other. For example, a tax system which is certain, would lend itself to one that is efficient and has low costs of compliance.⁴⁷ Yet these characteristics are also at times adversaries of each other. For example, a flexible tax system which accommodates changes, leads to uncertainty, or as further example, in achieving fair and equitable rules, it may be necessary to legislate complex relief measures, which in turn detracts from the simplicity of the rules and may lead to high costs to administer, thus affecting efficiency.⁴⁸ This inherent conflict was recognised by SARS in the Discussion Paper where it was stated “in general, the goals of a residency test are to ensure certainty and predictability on the one hand and to prevent manipulation on the other. Unfortunately there is considerable tension between these two goals.”⁴⁹ Thus a compromise may be necessary.

That these objectives and characteristics occupy a central place in the consideration of a tax system was also illustrated practically when South Africa changed over from a source based to a residence based tax system. Then as important considerations it was noted that the changeover would bring about a significantly broadened tax bases and limit the opportunities for tax arbitrage.⁵⁰ Also that it would simplify the administration of taxes, as the South African fiscus need no longer examine every

⁴⁴ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 94.

⁴⁵ Margo Commission Report “Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa” (1986) Chaired by Hon J Margo.

⁴⁶ Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 4.

⁴⁷ Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 4.

⁴⁸ Williams, RC *Income Tax and Capital Gains Tax in South Africa* (3rd Ed) (2001) at 4.

⁴⁹ SARS “Discussion Paper on Interpretation Note 6” September 2011 at 3.

⁵⁰ Available at www.treasury.gov.za/documents%20budget/default.aspx - last accessed on 05/05/2013, at 19.

transaction to determine the location of the source of its income, but rather need only investigate the residence of the person/entity.⁵¹

In conclusion then, when the test for residence is assessed, we should be mindful of these characteristics and how the relevant test assists in enhancing the prominence of these features in the tax system. An optimal test for residence would therefore be one that utilize criteria which 1) justifies the tax liability based on the protection and privileges the taxable entity receives 2) requires sufficiently close connections to the jurisdiction 3) is enforceable 4) is aimed at maximising revenue and protecting the tax base and 5) aims to promote the characteristics of a good tax system, namely equity, neutrality, efficiency, ease of compliance, flexibility and certainty. Consequently these form the measures by which the test should be assessed.

9 4 Analysis of the various tests

9 4 1 Confirm the relevant taxable entity

An approach is formulated by Ettinger to firstly determine who or what the taxable entity in question is.⁵² We regard this approach as useful and are of the view that it should serve as a preparatory step to the analysis of such tests. In other words before such tests can be applied, it should be confirmed whom the taxable entity is and that this is indeed trust itself, and not for example the trustees. That the trust will always be the taxable entity can not be assumed. With individuals and companies, they are accepted in law to be persons and thus capable of having rights and incurring obligations, and thus taxed on their own.⁵³ However as a trust is neither a natural or legal person, but an institution *sui generis*, it does not always follow that in all countries it will always be regarded as person and thus a taxable entity. In certain instances the trustees may be regarded as the taxable entity.

Historically it appears that there was uncertainty and legal perplexity, as to who in a trust setting the taxable entity is. However, in the countries under review, this has been clarified by legislation specifically addressing such ambiguity. The discussions of the various countries have revealed that:

⁵¹ Goosen, C “International Tax Planning: The concept of Place of Effective Management” research dissertation submitted to the University of Cape Town on 15 February 2006 at 5.

⁵² Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 90.

⁵³ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 90.

- In South Africa, the Income Tax Act was specifically amended in 1991 to include a “trust” in the definition of a “person,”⁵⁴ and hence the trust itself may constitute a taxable entity.⁵⁵
- Canada expressly deems a trust for purposes of the Act to be an “individual”⁵⁶ in respect of the trust property and it is accepted that it may constitute a taxable entity. Ettinger notes that this is also implicit to the court’s consideration of the residence of the trust in the *Thibodeau*-case, and that the residence of the trustees was but a way to determine the trust’s residence.⁵⁷ To this one may add the recent *Fundy Settlement*- cases, as again the trust was the focal point.
- The UK has also statutorily addressed this aspect. It deems the trustees of a settlement to be a single person, distinct from the persons who are trustees of the trust,⁵⁸ and this collective person may then be regarded as resident or not. Thus here the taxable entity is this separate person comprising the trustees.

It is so that in other countries such as the USA, Australia and Italy, specific statutory rules for determining the residence of a trust have been promulgated and they too perceive the trust to be the taxable entity, but in other countries the position may differ and it may be that the trust does not constitute a taxable entity, thus rendering the test for residence inapplicable. Once it has been established that the test is applicable to the trust as distinguishable entity, then the focus is on the various connecting factors between the *trust* and the particular country.⁵⁹

Possible connecting factors are identified by Danziger - “the country under whose laws the trust was established, the country in which the founder of the trust, the trustee and their beneficiaries or any of them were resident, the country in which the trust is administered and the country in which the trust assets are situated.”⁶⁰ These connecting factors generally form the basis upon which countries then formulate their residence test. The various tests that so arises are:

⁵⁴ S (1) (d) of the Taxation Laws Amendment Act 129 of 1991.

⁵⁵ See the discussion in Chapter 4 where it was noted that a counter argument could be made that it is the trust fund *per se*, and not the trust as institution which is the taxable entity based on the definition of a trust. Such an argument was rejected based on the further reasons provided at par 4 2 2.

⁵⁶ S 104(2).

⁵⁷ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 93.

⁵⁸ S 474 (1) of the ITA, 2007 and S 69(1) of the TCGA, 1992 both provide that the trustees of a settlement shall together be treated as if they were a single person, distinct from the persons who are trustees of the settlement from time to time.

⁵⁹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 94.

⁶⁰ Danziger E *International Income Tax The South African Perspective* (1991) at 50.

- The country under whose laws the trust was established (the so-called purely legal test)
- Place of central management and control or place of effective management (so-called purely factual tests)
- Residence of the beneficiaries
- Residence of the settlor
- Residence of the trustees
- Location of the assets
- Strongest economic nexus
- Combination approach

Each of these tests are discussed below and critically analyzed.

9 4 2 Assessment of the various test for residence

9 4 2 1 Purely legal tests

An example where such a purely legal test is applied is in Belgium, where to determine the residence of the trust, regard is had to the governing law of the trust as specified in the trust deed by the settlor. In reviewing this test, it appears that it promotes certainty and ease of administration as it will be relatively simple to ascertain and is understandable to all. It also accords with the underlying justification in that the country whose laws will govern the trust, is the country whose laws the trust will be utilizing to ensure its recognition and legal standing, to regulate its affairs, allows it to engage into transaction and to enforce its rights, and thus it seems fair to pay tax in exchange for such benefits.

The downside to such an approach is that it may be selected arbitrarily, as the settlor may initially determine this at whim and thus undermine the maximization of revenue as taxpayers can then choose whether to be resident and taxable, or not. It may also be difficult to enforce as there may be no other or substantial connections between the trust and the country whose laws are chosen. However Tillinghast postulates that the solution would be to have regard to the conflict of laws rule in such an instance. Thus where the governing law is specified, this will mostly be adhered to. However in instances where there are little or no connections between the trust (its parties and assets) to the country, such choice of law recordal will not be given effect to and the conflict of laws

rule will prevail⁶¹ Whilst this may then lead to uncertainty and complexity in the application of such rules, he is of the opinion that such cases would be exceptional.⁶² Furthermore, based on the passive nature of the trust, he finds that such a test is far more appropriate –

“There need be no apology for referring here to the trust’s stated governing law. The definition of the rights of the beneficiaries and duties of the trustees is central to the trust concept, and, although the choice of law is originally relatively free, the legal relations of the entity assume a greater importance than its economic dynamics when its function is one of relative passivity.”⁶³

This type of approach resorts under which may be termed as “formal criteria”, the umbrella name that may be given to the group of criteria, which look to the governing law, or legal (or statutory) seat, or registration in public register, or incorporation.⁶⁴ These are thought to be based on the concession theory by which an entity owes all its rights, powers and benefits to state which created it.⁶⁵

If regard is had to the connections this test requires, it would appear it is only one connection and a very formal one at that. Thus it is to be agreed with Weber-Fas who state that this basis appears questionable- why accord so much weight to a mechanical and formal connection, the act of legal creation, and endow it with such far-reaching tax consequences, when such connection may in time prove to be the only connection between the entity and the country.⁶⁶ It also impacts on neutrality as due to the ease of creating an entity in or outside a particular’s country jurisdiction, the decision-making of taxpayers are indeed affected as those who wish to place the entity and its financial important activities outside the grasp of the fiscus, can do so easily by establishing it outside such country.⁶⁷

South Africa also applies as one of these criterions for its test for residence, a purely legal test, namely to have regard to the place where the entity was “incorporated, established or formed.” It was mentioned that there is some ambiguity in the legislation as it is not exactly clear whether it

⁶¹ Tillinghast, DR “A Matter of Definition: ‘Foreign’ and ‘Domestic’ Taxpayers 2 Intl Tax & Bus Law (1984) at 270.

⁶² Tillinghast, DR “A Matter of Definition: ‘Foreign’ and ‘Domestic’ Taxpayers 2 Intl Tax & Bus Law (1984) at 270.

⁶³ Tillinghast, DR “A Matter of Definition: ‘Foreign’ and ‘Domestic’ Taxpayers 2 Intl Tax & Bus Law (1984) at 270.

⁶⁴ Russo R (ed) *Fundamentals of International Tax Planning* (2007) at 6.

⁶⁵ Weber-Fas, R “Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law “ 5 Harvard Journal on Legislation (1967-1968) at 228.

⁶⁶ Weber-Fas, R “Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law “ 5 Harvard Journal on Legislation (1967-1968) at 227.

⁶⁷ Weber-Fas, R “Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law “ 5 Harvard Journal on Legislation (1967-1968) at 228.

denotes an entity established in South Africa (ie at a place), or established in accordance with the laws of South Africa, though the latter appears to be preferable. If so, then the criterion would also accord with the underlying justification in the sense that the country in terms of which its formation is recognised, which allows it to enter into transaction from which it may derive income, is also the country to which it will be pay taxes. When this criterion was discussed in Chapter 5, the further benefits of the test were also identified – simplicity, certainty, ease of administration and compliance, all characteristics of an optimal tax system. It is similar to the “place of incorporation” test applied to companies and thus places trusts on equal footing. Yet it was found that on its own it would not function optimally. It is arbitrary and can be easily manipulated, more so in the electronic age, which allows for the formation of an entity electronically and thus without any real presence.

If regard is had to the *Oceanic Trust Co. Ltd (NO) v C: SARS*⁶⁸ a practical example can be found. It would be recalled that the relevant trust was a Mauritian registered offshore trust, thus its place of establishment was Mauritius. In terms of its trust deed, the proper law of the trust was specified to be Mauritius, and Mauritian laws were stipulated to govern the trust’s construction, effects and administration with its trustees obliged to maintain their principal place of business and conduct their affairs from premises in Mauritius.⁶⁹ Thus in applying this test, one would easily conclude that the trust is resident in Mauritius. However this would deny the real situation, in that there were evidence suggesting that far more substantial connections bound the trust to South Africa. Its assets were in South Africa, its principal business were conducted here and it appears that key management decisions in relation to its affairs were taken in South Africa. Thus if the underlying justification of a residence based test is applied, it appears that the country whose infrastructure and facilities the trust used and enjoyed to a greater extent was not the country where it was established in accordance with such country’s laws, but instead another country, in this scenario, South Africa.

This then demonstrates that a purely legal test may at times fail to satisfy the underlying justification to the residence test. It also illustrates the main deficiency in utilising this test, that it is a too a formal test, incorporating but a weak connecting factor and opening the door for the unscrupulous to use it to create a formal facade and achieve residence status with ease. As it lacks the ability to look to the economic reality and is devoid of substantial connecting factors, it is ineffective as an independent sole criterion for tax residence.

⁶⁸ *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127.

⁶⁹ Par 3.

9 4 2 2 Purely factual tests – “Place of Central Management and Control” or “Place of Effective Management”

The tests of “place of central management and control” and “place of effective management” are factual in nature and therein lays both an advantage and disadvantage. The advantage being its flexibility, whilst the disadvantage being the ensuing uncertainty. It will not necessarily be clear where the trust is effectively managed, or has its place of central management and control. Nor is it definite that this will always remain at the same place, as those who exercise such management and control may cause it to alternate whether such change be planned or inadvertently. This will necessitate investigation, thus requiring increased compliance costs. Moreover as it is fluid, it will require that such investigations be done periodically as at any point in time, it may differ.⁷⁰ As these tests are dependent on the specific facts of the matter, there will also be a lack of consistency as each matter calls for a decision based on the peculiarities of its facts.

An aspect that must be remembered is that these tests originate from a corporate setting where there are frequent activities, in most instances a physical structure and employees, and managerial levels and meetings. A trust is often as Tillinghast describes it “a typically passive investment vehicle formed by one individual for the benefit of others.”⁷¹ Consequently a test which focuses on the factual presence of activities and decisions, is very difficult to apply when there are none or very little.

An optimal characteristic the test does feature is its ability to promote enforcement. As Ettinger explains, control is a key feature of this test, which in turn facilitates enforcement as those who control the trust and its assets would be identified and accessible to the authorities.⁷² Also as it requires an holistic view to determine residence, far more connecting factors will be taken into account as opposed to other tests where the focus is only on a specific party.

As both these tests focus on where decisions necessary for the entity’s functioning are made, the advent of the electronic age and the use of information and communications technology pose severe problems to its application. Spengel and Schäfer point out three practical concerns. Firstly, enhanced mobility makes it possible for the role-players to meet on a ongoing rotational basis, thus

⁷⁰ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 118.

⁷¹ Tillinghast, DR “A Matter of Definition: ‘Foreign’ and ‘Domestic’ Taxpayers 2 Intl Tax & Bus Law (1984) at 269.

⁷² Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 118.

resulting in a mobile place of management, secondly, it permits those who make the decision to be residing and attending to their duties in multiple jurisdiction and allows them to communicate via electronic means -be it e-mail, electronic group discussion applications or video conferencing, thus making the necessity of a central meeting place as well as the requirement for physical presence, obsolete and confounding the location of only one most significant place of management.⁷³ Thirdly, it allows for decisions to be made, whilst the incumbents are on the move and such place need not have any correlation to where the entity's main activities are.⁷⁴ It is therefore difficult to apply the test and yield a result that is certain and predictable. Furthermore the inherent flexibility of the concept is now further fuelled by the mobility and lack of physical presence, as this allows it to be manipulated as the role-players can now with ease move to chosen locations and be regarded as performing their decision making functions at certain chosen places, so as to manipulate the place of management.⁷⁵ For example the trustees can be flown to a remote destination to make crucial decisions for the trust, with such destination having no other connection to the trust, than merely being a convenient meeting place. This becomes even more difficult when various destinations are chosen periodically. Thus it is this new era of mobility and technology that poses the most severe threats to the application of the tests. It makes it "difficult -if not impossible- to point to one constant physical location",⁷⁶ constituting the place of management, and thus undermines the usefulness of the test. In a future predicted to only increase with the prevalence of technology in every facet of life, it raises concerns about these tests' viability in the long-run as such problems will only proliferate.⁷⁷

Both South Africa and Canada apply such a factual test to determine residence. The difference between these two tests is not always apparent. It has been previously explained that in a corporate context central management and control traditionally refers to the highest level of management as exercised by the board of directors, whereas with the place of effective

⁷³ Spengel, C & Schäfer "ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation" Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 21.

⁷⁴ Spengel, C & Schäfer "ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation" Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 21.

⁷⁵ It must be pointed out that a "move" in residence will mostly result in tax consequences for the entity and therefore such manipulation is not so appealing at a later juncture in the duration of the entity. Spengel, C & Schäfer "ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation" Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 20.

⁷⁶ Spengel, C & Schäfer "ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation" Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 22.

⁷⁷ To address such problems it has been suggested that the test be refined to as to have weights assigned to the importance of functions performed within each country, as well as determining the residence of those who in the final analysis "call the shots." Davis, DM "Residence based taxation: Is it up to the e-commerce challenge" 2002 Acta Juridica at 164.

management, the emphasis is on effective and real management and thus lower levels of management may also be taken into account.⁷⁸ Yet in a trust setting such distinction is not apparent. Case law also appears to indicate that the judicial bench is somewhat sceptic about whether there is any difference between the two concepts. For example in the case of *Wood v Holden*,⁷⁹ the Special Commissioners stated that the term “place of effective management” is very similar to “central management and control” and that it was difficult to make a distinction. Whilst in the *Smallwood*-case this view was rejected, with the court finding that the purposes which the particular concept is to serve, influences it and yields the difference. Thus the “place of central management and control” decides whether an entity is resident or not and is a one-country test, whilst the “place of effective management” is concerned with what happens in both states to resolve dual residence.⁸⁰ However this was stated in a treaty context where the domestic test was place of central management and control, and the tie-breaker, place of effective management. Thus it is difficult where both these tests are applied in a domestic context to found jurisdiction, to argue for any distinction between the two concepts.

Whilst in Canada the test of place of central management and control functions as the sole test for residence, in South Africa, place of effective management, is one of two criteria upon which residence can be attributed. As these factual tests’ greatest drawback appears to be efficiency and certainty, it is preferable to follow South Africa’s approach, where it is utilised as an alternate together with a test regarded as specifically achieving these two attributes of certainty and efficiency, namely the test of formation.

9 4 2 3 Residence of the beneficiaries

Tillinghast has harsh critique for a test based on the residence of the beneficiaries, stating as follows:

“A rule which makes the question turn on the status of the beneficiaries can be rejected out of hand as unworkable, there are simply too many trusts which have multiple beneficiaries in differing and changeable states of life and too many discretionary powers held by too many trustees.”⁸¹

⁷⁸ Russo R (ed) *Fundamentals of International Tax Planning* (2007) at 6.

⁷⁹ 2006 EWCA Civ 26 (Court of Appeal); 2005 EWHC 547 (High Court); 2003 Case no SPC00422 (Special Commissioners).

⁸⁰ Par 111.

⁸¹ Tillinghast, DR “A Matter of Definition: ‘Foreign’ and ‘Domestic’ Taxpayers 2 Intl Tax & Bus Law (1984) at 269.

However such criticism is justified.⁸² In South Africa there is no limit placed on the number or even nature of the beneficiaries, ie whether individuals/group or classes of persons, legal persons and other entities. Consequently a test based on the residence of the beneficiaries could in certain circumstances be a colossal task to ascertain, especially in today's highly mobile world, and where individuals often work, live and travel abroad. Thus it would lead to increase in compliance costs, with the further disadvantage of uncertainty.

As the statement by Tillinghast also points out, the trustees often have discretionary powers and therefore only when and to the extent they exercise such power in a beneficiary's favour, would he/she be regarded as a beneficiary. It is obvious that the exercise of such power may vary from one time period to another, and may in some years not be exercised in anyone in favour. Moreover it would be uncertain as to whose residence would prevail – simply the majority or would the quantum each beneficiary was awarded needed to be taken into account so that it could be ascertained proportionately, and then based on the greatest proportion, residence would be attributed.

It must also be noted that generally income awarded to a beneficiary would be taxed in the beneficiary's hands, and thus the income for which the trust would be liable for would be income accumulated in the trust and not distributed to the beneficiaries. It seems therefore illogical to look to the beneficiaries to determine residence when they do not feature in relation to such income.

A last consideration is one of enforcement, and owing to the fact that the beneficiaries are not the owners of the trust's asset and based on trust law principles, they would also not be able to control the application of such assets as such powers vest in the trustees, it renders an impracticable test.⁸³

9 4 2 4 Residence of the settlor

It is unclear whether such a test would only focus on the settlor at the establishment of the trust, alternatively whether it would bear a wider meaning and include all persons who ever made over assets to the trust. In a testamentary trust, there would generally be speaking only be one settlor

⁸² Grinhaus holds a different view – see the discussion of the Fundy Settlement case and specifically his criticism at par 8 3 2 6. Grinhaus, A “There's No Place Like Home” Published 5 May 2012 on <http://www.himprolaw.com/theres-no-place-like-home.pdf> Last accessed on 07/05/2013.

⁸³ As was remarked by Du Plessis, in a South African context, should the beneficiaries be able to make the key decisions and control the trust, the fundamental premise of a trust, the separation of ownership and control would be at risk. -Du Plessis I “The Residence of a Trust for South African Income Tax Purposes “ 2009 (21) SA Merc LJ at 341.

and thus it appears to be simple task to establish his residence at the time of creation of the trust. Yet as the settlor has died, it means that once the residence of the trust has determined on his residence, it will then remain so resident for ever – this therefore appears to be an “unduly flexible” rule.⁸⁴ Furthermore the settlor’s residence at the time of his death need not necessarily correlate with where the trust’s assets are, where it functions and there may therefore only be this one weak and possibly distant tie to the country.

The certainty the test appears to hold, is also at risk when there is more than one settlor, or where their residences are not straightforward to determine. It may also require that one looks back in time to determine the residence of a settlor at the time the disposition was made, which owing to the passing of time or his death and the lack of documentation as to his residence, may not be an easy task. In an increasingly mobile world, a person’s residence is not necessarily easily ascertained.

An example of a country which applies this criterion is the UK. It would be recalled that in instances of mixed residence of the trustees, the settlor’s residence would be conclusive. To illustrate that this test may however not always yield an inappropriate result, an example may be borrowed from the Canadian case law in demonstration. It would be recalled from the *Fundy Settlement v Canada*,⁸⁵ that the two trusts had been established by an unrelated individual, a resident of St Vincent, an island near Barbados, the latter being the place where the trusts’ sole trustee was resident. Supposing that a further trustee had been appointed, a family member in Canada, resulting in an instance of mixed residence, then regard would be had to the settlor’s residence, which in the present instance would be but a very weak connection as no assets were situated in St Vincent, no control could be exercised by such settlor, and most probably he had long since disappeared from the scene.

Despite this shortcoming, Prebble has criticized the Australian authorities for given too little weight to the settlor’s residence as connecting factor to claim jurisdiction to tax and argues that a distinction should be made between settlors whose “role is wholly formal” (in the sense that they contribute a nominal sum and then vanish) and “true settlors.”⁸⁶ He advocates that the law should take into account true settlors, because the trustees act on their behalf if not in law, and that a tax

⁸⁴ Tillinghast, DR “A Matter of Definition: ‘Foreign’ and ‘Domestic’ Taxpayers 2 Intl Tax & Bus Law (1984) at 239.

⁸⁵ 2012 SCC 14, Judgment delivered on 12 April 2012.

⁸⁶ Prebble, J “Taxation of Trusts with Australian Resident Trustees” at par 10, available at http://www.vuw.ac.nz/~prebble/publications_available/taxtraustsaustrialiabtr.html - last accessed 05/05/2013.

system which does not take cognisance of same, is obliged to employ a formal approach to trust taxation and that such a system would only result in a deficient tax regime.

However it must be noted that even where dispositions are made to the trust by later “settlers”, there are generally rules which provide for the attribution of the income earned on such disposition to such settlers, and residence would therefore arise in the context of the income that could not be so attributed.⁸⁷ Thus again there is an apparent illogicality in determining the residence of a trust in relation to the income accumulated in the trust, based on a settlor’s residence to whom it was already found the income could not be attributed. Ettinger also points out that enforcement could be problematic as the settlor does not have control over the assets nor the income earned by the trust.⁸⁸

9 4 2 5 Residence of the trustees

According to Ettinger the residence of the trustees is a “very strong connecting factor.”⁸⁹ History agrees with this statement, as in all countries considered in-depth in this study, the residence of the trustees featured in the test, whether initially or still to this day. It is possible to explain this phenomena based on the nature of the trust and to note that immediately after the trust has been established, the settlor falls out of picture, with only the trustees remaining, saddled with the duties and obligations to manage the trust fund for benefit of the beneficiaries. Of all the parties to the trust, the trustees are therefore the most likely to influence the residence of the trust. Also as Ettinger explains

“The reason is that the trustee has direct control over the trust property and income earned by the property. The trustee is, therefore, the most direct link to that which makes the determination of residence of a trust necessary in the first place, namely the accumulating of income.”⁹⁰

There are disadvantages to this test, as it becomes complicated when there are more than one trustee and their place of residence differs. Whilst historically this was addressed by looking to the residence of the majority, there may be instances where there is simply no majority of trustees and all trustees have different places of residence. Ettinger submits that this is not necessarily a sound criticism as when the test for domestic residence is applied, it is only necessary to determine

⁸⁷ See Par 4 3 3 of Chapter 4 above.

⁸⁸ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 94.

⁸⁹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 108

⁹⁰ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master’s Dissertation at 108

whether the trust is resident or not, and it need not be established in which foreign jurisdiction it is exactly resident. Consequently should it be found most trustees are non-resident then non-residence would follow.⁹¹

A more valid criticism arises when the trustees are equal in number with half non-resident. In such a situation a deeming rule is mostly invoked. For example in Australia, the rule provides that where there are two or more trustees, should at least one trustee be resident the trustee will be resident.⁹² Similarly in the UK, should at least one trustee be resident and one trustee not be resident, regard will be had to the settlor's residence and based on his residence, the trust will be deemed to be resident.⁹³ Aside from an initial perplexity at the fact that it appears to be but a weak test to justify the trust's residence simply on the basis of one party, other more practical issues arises. In these tests enforcement is an issue as the trustee who is resident within the jurisdiction, is not necessarily empowered to exercise control over the assets – indeed it would appear to be very unusual should he be able to do so.⁹⁴

It could also be regarded as arbitrary and easy to manipulate as one would be able to determine the residence of the trust by simply appointing sufficient non-resident trustees to constitute the majority, thus undermining the ability to maximize revenue, as well as neutrality and horizontal equity.⁹⁵ As trustees also frequently change, whether by resignation or inadvertently, any change in the trustees would weigh in on the scale and may tip it to change in residency, which may have significant tax implications.⁹⁶

Furthermore it also loses sight of the fact that the trustee need not exercise his trustee's functions at his home, but may equally do so anywhere in the world owing to today's enhanced technology and communications mediums, or they may do so at a place centrally agreed, which does not correlate with any one of the trustees' residences.

Thus in reviewing the criteria of an optimal test, this test falls a bit short. In relation to the justification for a residence base test, it is so that the trustees enjoy the protection of the country,

⁹¹ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 114.

⁹² Sec 95(2), Income Tax Assessment Act, 1936.

⁹³ S475(5) of the ITA, 2007 and S 69(2B)(a) -(b) of the TCGA,1992.

⁹⁴ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 115.

⁹⁵ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 115 – 116.

⁹⁶ For example it may give rise to capital gains as such a change in residence would constitute a deemed disposal.

and it could be that in the performance of their duties towards the trust, they utilize the country's infrastructure, however it need not always be true nor does it guarantee that the trust as the actual taxable entity utilizes the infrastructure. In relation to the use of sufficient connecting factors, it only looks to one connecting factor, and is also somewhat uncertain as well as open to manipulation, which undermines the raising of revenue and neutrality.

9 4 2 6 Location of the assets

This was one of the alternatives proposed by Canada's Carter Commission. It is also implicitly applied in Italy where the test requires that the main business of the trust be identified, and where this is for example property holding, where such property is located, will be conclusive. Whilst a test based on the location of the assets would have the benefit of enhancing enforcement and compliance, it has the disadvantage that it is not always certain. Such uncertainty may stem from the fact that assets may be located in various jurisdictions, thus connecting the trust to a multitude of jurisdictions with no measures to determine whether the value of such assets, their nature or other criterion yields the stronger connection. For the revenue authorities it may be difficult to trace where the property is located, thus increasing compliance costs.⁹⁷ The composition of the asset holding may also frequently change, thus making it an uncertain and inconsistent tax base. It may also be that the income which is accumulated and hence taxable, is not the income derived from that particular asset, thus breaking the connection. Enforcement will also be difficult when the assets in the country are insufficient in respect of the worldwide tax liability.

In the South African case of *Nathan's Estate v CIR*,⁹⁸ the court took into account that the trustees were resident in a particular province, and the corpus of the trust, the funds were also administered from such province. Whilst it may then often be that where the assets of trust are located, its administration will also be, this is not necessarily so and even more so in this mobile world where assets can be remotely managed. All-in- all, as this test is therefore one that as it based on only one connecting factor, it does not achieve the optimal features of a residence test.

9 4 2 7 Strongest economic nexus

In relation to the test of "strongest economic nexus," Van der Merwe writes that "it is not a new invention and, depending on the context and meaning attached to it, it may have had its origin in

⁹⁷ Ettinger, LP *The Residence of Trusts for Canadian Income Tax Purposes* Master's Dissertation at 123.

⁹⁸ 1948 (3) SA 866.

the theory of economic allegiance.”⁹⁹ This test features in SARS’ Interpretation Note, where it is listed as the last alternative in resolving a situation where the operations or activities of an entity are conducted from various locations. As remarked in chapter 6, there is uncertainty whether SARS intended it to be a further independent test - which its usual function is to act as a separate rule. Alternatively whether SARS rather wished it to be used as a method to establish the place of effective management and thus act as a deeming provision to do so. It had also been mentioned there that some authors who regard it to be the only other viable test which will be able to withhold the onslaught of the electronic era.¹⁰⁰

The test was also addressed in the discussion of the Canadian test for residence, where it was suggested as an alternative test. This test was stated to be premised on the choice of law rule that an obligation is governed by the law of the place with which it has the closest and most real connection.¹⁰¹ Consequently all factors relevant to the trust should be considered – the place where it was formed, the location of the trust property, where the control is exercised. An objective inquiry into what place is more substantially connected to the trust would then follow. However it is regarded as solution, which may “presents perhaps more problems than it solves.”¹⁰² These problems include deciding what weight to give to the various factors, as well as apparent redundancy of going through such an exercise should it be accepted that the place where the control in relation to the trust is asserted, is the major factor in determining the place with the most substantial connection.¹⁰³

A further place where the test came to the fore was in the proposed revisions of the place of effective management as tie-breaker in the OECD’s discussion paper, and where it was suggested that it substitute the place of effective management as tie-breaker. As the Discussion Paper explains¹⁰⁴ -

“The economic connection to a State may be characterized by the extent that land, labour, capital and enterprise (the factors of production) are used by the company in deriving its profits. Using those characteristics the tie-breaker would serve to determine to which State, the company has its strongest ties and to deem the company to be a resident solely of that State.”

⁹⁹ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 129.

¹⁰⁰ Davis, DM “Residence based taxation: Is it up to the e-commerce challenge” 2002 *Acta Juridica* at 164; Verwey, PM “The Principles of Source and Residence Taxation of Electronic Commerce Transactions in South Africa” (2007) Mini-dissertation submitted to the North-West University at 35.

¹⁰¹ Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 101.

¹⁰² Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 101.

¹⁰³ Flannigan, RDM “Trust Obligations and Residence” 7 *Est & Tr Q* (1985-1986) at 101.

¹⁰⁴ TAG “The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie-Breaker Rule” OECD February 2001 at 11.

In particular the test necessitates that the connections between the entity and the particular country, be reviewed and specifically the extent to which land, labour, capital and enterprise, all factors of production, are used by the entity to yield profits. By looking to such factors, one may surmise that the bases for taxation is no longer residence, but source as it is the latter that looks to the income and whether it is produced by the natural resources or activities of the country's inhabitants. However in the OECD's report it was stated that it would be possible to still justify the test on the residence basis of taxation, by arguing that should a country provide facilities and infrastructure for its resident, thus those who benefit most from it, should contribute to the state's coffers, or simply put –

“So if an entity uses the legal infrastructure, consumes or uses the facilities etc in that State, there is a case that it ought to be treated as a resident. If it does so in more than one State, then a tie-breaker rule based on economic nexus would require a determination (as with individuals) of where its ties/consumption are stronger.¹⁰⁵

So too in the 2003 Discussion Draft¹⁰⁶ under the proposed rules to resolve conflicts of residence, it was stated that

“The preference to the State with which the economic relations are closer is based on the conclusion that, in such cases, the entity should be considered a resident of the Contracting State in which it is making greater use of economic resources as well as the legal, financial, physical and social infrastructures.

The test's strongpoint lies therein that it focuses on the connecting factors, specifically the economic connections, and require residence to be attributed only where these are at their strongest.¹⁰⁷ Thus it furthers the principle that residence should follow where the trust is sufficiently connected. At minimum it ensures that residence would not be located in a jurisdiction where there are no activities by the entity.¹⁰⁸ Its benefit could also be an enhanced enforceability as surely the country with which the strongest economic ties are established, would be able fulfill the tax liability.

In the OECD's Discussion papers, it was felt that the “economic nexus” application could be regarded as analogous to the tie-breaker used for individuals, which focuses is on the “centre of

¹⁰⁵ TAG “The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie-Breaker Rule” OECD February 2001 at 11.

¹⁰⁶ OECD “Discussion Draft - Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention” (27 May 2003) at 5.

¹⁰⁷ The examples mentioned in the draft are: the State in which the entity has most of its employees and assets, carries on most of its activities, derives most of its revenues, has its headquarters, carries on most of its senior management functions or from which State the entity derives its legal status.

¹⁰⁸ Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 31.

vital interest.”¹⁰⁹ Collet endorses this analogy, by advocating that like an individual, one may consider a multinational entity to reside in the place where it has its closest economic, political, cultural and legal links. After all, a general accepted theoretical basis for residence taxation is that residents enjoy the “the benefits of the social, economic, physical and legal infrastructure, which is paid for by tax revenue.”¹¹⁰ Thus, just as individuals are regarded to be residents of the country by reviewing their family and social relations, occupations, political, cultural or other activities, place of business, or place where the individual’s property is administered or where their possessions are held, so too can an entity’s be regarded as resident where it has its strongest economic, political, cultural and legal ties.¹¹¹

The test Collet proposes is that residence is firstly determined by examining the entity’s centre of vital interest. Should that prove indeterminable, residence should be attributed where the entity habitually locates and manages its most significant functions, assets and risks, and should these be spread evenly between states or are not predominantly located in any one of the states, then it will be resident where it is incorporated.¹¹² Yet such an approach is not without problems, as he states that

“... nexus raises major problems of quantification and comparison. How do you measure an entity’s consumption of public good in a particular jurisdiction, let alone undertake meaningful comparisons with competing jurisdictions. This is a daunting task at first sight...”

For this reason, he admits that more work is needed, in particular as to the determination, quantification and comparison of these factors. Yet the test holds several optimal characteristics – “it is difficult to manipulate, administrable, potentially attractive to other tax administrations, and defensible in the face of taxpayer challenges.”¹¹³ It is particularly protective against manipulation as it is unlikely that an entity and in particular its role-players will shift all of its ties to a nominal jurisdiction.

¹⁰⁹ TAG “The Impact of the Communications Revolution on the Application of “Place of Effective Management” as a Tie-Breaker Rule” OECD February 2001 at 11.

The premise for source taxation is that an entity made use of the local infrastructure to derive its income, profits or gains. Collet, M “Developing a New Test for Fiscal Residence for Companies” (2003) University of New South Wales Law Journal (26) 3 at 622.

¹¹¹ Worded differently - Similarly to an individual whose place of residence will through amenities such as its police, courts, hospitals, roads, water, laws make the greatest contribution to the individual’s life, so too will an entity derive the greatest benefit from and be deemed to have the strongest ties, to the places where it utilizes the facilities and legal and economic infrastructure, to the greatest extent.

¹¹² Collet, M “Developing a New Test for Fiscal Residence for Companies” (2003) University of New South Wales Law Journal (26) 3 at 622.

¹¹³ Collet, M “Developing a New Test for Fiscal Residence for Companies” (2003) University of New South Wales Law Journal (26) 3 at 622.

The comments made in the earlier chapters however remain valid, that the test would bring one back to a factual enquiry which would be complicated to undertake. The test requires that that the “strongest” or “closest” economic nexus be located, and thus implicitly requires that there be a weighing of factors to determine where this uppermost or superlative form of residence is located.¹¹⁴ As this may result in uncertainty and complexity, the words of Van der Merwe serves as warning “this ‘test’ will probably be just as difficult to apply in practice as the ‘pure’ test for effective management.¹¹⁵ It may turn into a vast and time-consuming task to complete as first the connections factors must be identified, taking care that these are economic connections. In order to do so it may be necessary to first define same, then such connections must be quantified and lastly, be compared to ascertain which form the strongest economic connections. As no guidance is provided by either the OECD or SARS, and no formula expounded, there is much uncertainty as to the test, thus it will be difficult to apply. As subjective comparisons will be necessary, it also detracts from predictability and efficiency. However it is a sensible approach, one that is familiar as it is applied to individuals, and its greatest attributes appears to be the protection against manipulation and its ability to overcome the challenges of an electronic age.

9 4 2 8 Combination approach

Spengel & Schäfer summarizes the optimal residence test by stating that “the definition of residence has to be efficient and feasible, meaning that it shall ensure legal certainty, practicability and prevent manipulation.¹¹⁶ Each of the aforesaid tests have failed the criteria for an optimal residence test in some respects. Most of the tests are unable to ensure enforcement of the tax liability, have insufficient connecting factors, and is prone to manipulation and uncertainty. Some of them also tend to place the focus on related parties rather than the trust itself. On a scale, the location of assets test appears to be the most ill suited, focusing on only one connecting factor and having no guarantee as to enforcement, whilst the factual test followed by Canada and the South Africa as well as the strongest economic nexus test, are best placed to achieve the optimal features, by ensuring that substantial connecting factors are present.

This may be best illustrated by a practical example. Assume a situation where Mr X was born in the

¹¹⁴ Verwey, PM “The Principles of Source and Residence Taxation of Electronic Commerce Transactions in South Africa” (2007) Mini-dissertation submitted to the North-West University at 35.

¹¹⁵ Van der Merwe BA “The Phrase ‘Place of Effective Management’ Effectively Explained” 2006 (18) *SA Merc LJ* at 130.

¹¹⁶ Spengel, C & Schäfer “ICT and International Corporate Taxation: Tax Attributes and Scope of Taxation” Discussion Paper No. 02-81, Centre for European Economic Research (2003) at 20.

UK, emigrated to South Africa where he became a successful land developer, retires and returns to the UK where he resides for a couple of years before permanently relocating to the French Riviera where he subsequently passed away. He had drawn up and executed his Will in the UK, which Will was a worldwide Will governing his assets in SA (comprising various properties, listed shares and the entire shareholding of the land developing company – these assets collectively totalled the majority of his estate in terms of value), in the UK (various investments, bank accounts and shareholdings, but the total value of these assets were substantially less than the South African portfolio) and in France (a single residence).

Mr X bequeathed the whole of his estate to a testamentary trust, of which his wife and children, and their further descendants were the beneficiaries. The beneficiaries were residents of various countries – his wife in France, most of his children and their family units resided in the UK, whilst one son and his family remained in South Africa. The trustees appointed to the trust were an UK attorney, his son in South Africa and his wife in France. The governing law of the trust was stipulated to be that of the UK and trustees' meeting were to be held in the UK. Such meetings were indeed held in the UK, and it is here that the decisions as to the retention or sale of the shareholdings both in the UK and South Africa would take place, where decisions as to the continued holding of the property development business company would take place, decisions as to the distributions of income, the allowance of the wife to utilize the residence in France and the payment of ancillary costs in respect of the property would be made. All decisions were to be made by majority vote. The bank account of the trust was held in the UK and was operated by the UK trustee who had signatory powers thereon. The books of account would also be prepared in the UK. The son in South Africa would render advice as to the shareholdings in South Africa, would implement the sale and order of any shares, and would due to his location, also be able to report on the land developing company, as well as attend to the leasing and maintenance of the local properties.

Applying firstly the UK residence test for a trust, regard must be had to the trustees and is their residence which would need to be determined. As two of the trustees are UK resident, one resident in France and one in South Africa, this then yields a result of mixed residence. In such a situation the test deems the settlor's residence prior to his death to be conclusive and thus as Mr X was prior to his death, resident in France, the trust's residence follows accordingly. This is despite the fact that the trust has the least connections to France. The assets located in France is in comparison to those held in the UK and South Africa, the most minimal, no administration or management of the

trust takes place in France, and as no control can be exercised solely from France, enforcement is undermined.

If the South African residence test for a trust is applied, the first criterion, whether the trust was established or formed in South Africa would result in a negative answer, as the Will was executed in the UK. However in respect of the second criterion, that of place of effective management, it may be that the answer would be positive. If SARS' view as expressed in their initial Interpretation Note is followed, then the focus would be on where the key management decisions of the trust were implemented. As the predominant bulk of the assets are located in South Africa, the decisions concerning same would be implemented in South Africa, as for example is done by the son who implements the sale and order of shares, the leasing and maintenance of the local properties. If however the proposed refined view of SARS as set out in the Discussion Paper, is followed, the result may be different as the focus would then be on where the key management decisions are made. As these decisions are not made in South Africa, the trust would not be considered to be effectively managed in South Africa, but rather in the UK.

The Canadian residence test following the recent formulation in the *Fundy Settlement* -case applies the concept of central management and control. It has been stated that this concept may in certain instances overlap with the concept of the place of effective management, and may yield a similar result.

If the focus is on the where the real business of the trust is carried on and where the decisions in relation to same was made, then on the facts set out above, this too will be found to be in the UK.

Thus this example has illustrated that both the Canadian and South African test through their factual approach, looks to the economic reality and ties the trust to the location with which it is optimally connected, thus promoting enforcement.

Unfortunately these tests are also plagued with uncertainty and unpredictability. It would have been necessary in the above example to engage in a thorough examination of what the trust's business is, where its assets are situated, what would constitute key management decisions, then to identify who would take such decisions and where were they in actuality taken, necessitating a review of the records of the trust, the minute books and the role of the various parties etc. It is therefore not possible at first blush to state with certainty where such a trust would be resident,

until all such facts have been examined.

It is however possible to combine some of these tests so that they may supplement each other and establish an approach better equipped to attain the objectives of an optimal residence test. This is the approach followed in South Africa. Had the Will been executed in South Africa and the trust was locally formed, it would have been easy to conclude that the trust was resident in South Africa. Only in the event then that the UK would regard it as resident there as well, would it necessitate the tie-breaker between the countries be invoked and assuming that the in terms of the double tax agreement between the UK and South Africa, the tie-breaker is based on 'place of effective management', then only would such a factual investigation have been necessary to determine the exclusive residence of the trust.

In time however it may be that the impact of the technological revolution would result in the fact that the trustees' meetings would no longer be physically held in the UK, and be conducted by electronic means with the trustees present from their various locations via electronic mediums, or that the implementation of such decisions could be done by operators in other jurisdiction. This may plunge the exact location of where the key decisions of the trusts were made or implemented in obscurity. In such an event, the strongest economic nexus test, may then yield the most appropriate results. Such a test would review all the possible connections and attribute residence where such connections are at it is strongest. It may therefore be worthwhile to include it as a further alternative to the two criteria already contained in our residence test.

9 5 Conclusion

It has been said there is "nothing is more fundamental" under a nation's income tax system than determining whether a person is a resident or non-resident. Thus the statutory rules that determine this, should therefore be subjected to critical evaluation.¹¹⁷ In this chapter, such a critical evaluation of the tests have been conducted. Firstly by identifying the objectives such tests seek to achieve, as well as the measures by which they are to be assessed, and concluding by applying such objectives and measures to assess the various tests.

It was found that each of the various tests, were not on their own sufficiently capable of attaining the objectives of an optimal residence test. Therefore the South African approach to combine at

¹¹⁷ Tillinghast, DR "A Matter of Definition: 'Foreign' and 'Domestic' Taxpayers 2 Intl Tax & Bus Law (1984) at 239.

least two of these tests appears to be a solution and offers a better approach than that followed in the UK and Canada. This is stated subject thereto that with the advent of the electronic era, the strongest economic nexus test may in time and with further study and refinement, be a further aid. We therefore turn to the last chapter to conclude the study.

CHAPTER TEN:**CONCLUSIONS AND RECOMMENDATIONS****10 1 Introduction**

We commence this concluding chapter with certainly one of the oldest references to tax -

“Here, show me the coin used for the tax.” When they handed him a Roman coin, he asked, “Whose picture and title are stamped on it?” “Caesar’s,” they replied. “Well, then,” He said, “give to Caesar what belongs to Caesar, and give to God what belongs to God.”¹

If transposed to an international setting with various countries and substituting Caesar with such countries’ fiscal authorities, the above passage illustrates a seemingly easy solution to apply in situations where there is uncertainty as to which country’s fiscal authority the taxes should be paid to. Namely, to simply have regard to the image and description on the money so used. Unfortunately such a test does not present a feasible solution in today’s almost borderless and nearly coinless society.

Instead all countries in the world formulate and establish their own approach as to the basis upon which taxes will be due to their fiscal coffers. Owing to the sovereignty of each state this they are each entitled to do, and countries will generally make a selection between a residence or source basis of taxation,² justifying the former on the grounds that a resident should contribute towards the costs of the government, which provides it with protection and privileges, and the latter on the basis that a country should be able to share in the wealth which originated within its borders, regardless of where the recipient may live.³ South Africa has adopted “residence” as the basis for taxation since 2001. Thus, as also emphasized by the South African Revenue Service, “Residency is therefore one of the most fundamental and important concepts in the Act.”⁴

Consequently in relation to trusts, the tax residence of the trust will be of utmost importance. Unfortunately little attention had been paid to this aspect, leaving it an area of great uncertainty and ambiguity. It has been the aim of this study to ascertain what the ‘residence’ of a trust in South Africa denotes in a tax setting, and we accordingly present our findings below.

¹ The Bible – New Living Translation, Matthew 22:19-21

² Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 1; Danzinger *International Income Tax The South African Perspective* (1991) at 4.

³ *Kergeulen Sealing and Whaling Co Ltd v CIR* 1939 AD 487 at 507.

⁴ SARS “Discussion Paper on Interpretation Note 6” September 2011 at 3.

10 2 Findings in respect of the test for residence of a trust in South Africa

In South Africa the trust is an immensely popular vehicle which is used for a variety of purposes.⁵ It is premised on the ageless trust idea that the trustees hold or administer property separately from their own for the benefit of the beneficiaries or in furtherance of an impersonal objective.⁶ The trust was shown to involve several parties, a founder, trustees and beneficiaries – parties whom could be regarded as essential to its operation, as well as at times certain more dispensable parties, such as protectors, advisers and managers - parties, who in turn, may yield a significant influence over its operation.⁷

Due to its particular historical development in South Africa, a trust is not recognised as a legal person but as an institution *sui generis*.⁸ For tax purposes however, the Income Tax Act has specifically been amended, to include a trust in the definition of a “person.”⁹ Thus for income tax and capital gains tax purposes, a trust is regarded as a “person” and is thus capable of being taxed as a distinguishable taxable entity.¹⁰

The Income Tax Act also contains a definition for the term 'trust' which differs from the definition found in the Trust Property Control Act.¹¹ An analysis of this definition, and comparison of these two statutory provisions, has reflected that the definition in the Income Tax Act is much broader, and whilst it would include entities recognized as trusts in the Trust Property Control Act, such as *inter vivos* and *mortis causa* trusts, discretionary and *bewind* trusts, it is not limited to such trusts. When read together with the definition of a 'trustee,' it acts to establish a wider catchment area, including other entities, whether created in writing or orally, local and foreign. Entities which may not traditionally be perceived as trusts, yet nevertheless be regarded as such for purposes of the Income Tax Act. So too may it include trusts which are not regarded as valid 'trusts' in terms of trust law, who may fall short of the required *essentialia* or offend public policy, yet still constitute a

⁵ See the discussion at par 1 1 1 and 1 1 2 which focused on the widespread application of the trust, and its versatility and functions, respectively.

⁶ The origin of the trust concept, its development and local reception was discussed in Chapter 2 at par 2 2 1 – 2 2 2.

⁷ Chapter 3 focused on the various roleplayers to the trust.

⁸ See the discussion in Chapter 2 which present an historical overview as well as set out the theoretical foundations and legal principles applicable to trusts in South Africa.

⁹ S (1) (d) of the Taxation Laws Amendment Act 129 of 1991.

¹⁰ See the discussion in Chapter 4 where it was noted that a counter argument could be made that it is the trust fund *per se*, and not the trust as institution which is the taxable entity based on the definition of a trust. Such an argument was rejected based on the further reasons provided at par 4 2 2.

¹¹ S1 of the Income Tax Act, 58 of 1962.

'trust fund administered or controlled by a person acting in a fiduciary capacity' and thus constitute a 'trust' as per the definition.¹²

A technical reading of the definition of a 'trust' as contained in the Act, also revealed certain irregularities. For example the definition omits any reference to trusts created by court order, statute or operation of law. The latter is however expressly mentioned when the term 'trustee' is defined and would therefore suggest that such trusts are included in the ambit of the Act's operation. Furthermore, the definition of a 'trust' describes the trust fund as comprising only assets and cash, and omits any reference to liabilities and obligations. This is impractical, but is also out of kilter with our common law understanding of a trust – that a trust is an 'accumulation of assets and liabilities'.¹³ It also appears to be inconsistent with further provisions in the Act itself which envisage the consideration and reckoning of such liabilities.¹⁴ In light of these drafting anomalies, and the resulting uncertainty, it is called upon the legislature to refine the wording so that these discrepancies may be eliminated.

A trust's tax liability is however dependent on whether it is "resident" in South Africa, a term which is defined in the Act.¹⁵ Should it meet this definition and be regarded as "resident" in South Africa, it can potentially be taxed on its worldwide income and capital gains.¹⁶ Conversely, if it is not regarded as being "resident" in South Africa, it may still be taxed should it source income within South Africa, or dispose of its interest in immovable property situate in South Africa, resulting in a capital gains tax liability, and in certain instances, anti-avoidance provisions of the Act may be triggered.¹⁷ Thus determining its residence is of great significance.

The proposed legislative reforms announced in the 2013 Budget Speech were analysed, and whilst these do not appear to propose any changes in respect of the determination of residence of the trust, and are rather aimed at the particular rules by which taxes are levied upon trusts, they do distinguish between resident and non-resident trusts, indicating that this remains a key factor to

¹² See the discussion in Chapter 4 par 4 2 2. It was however noted that the term 'fiduciary capacity' and the manner in which it is interpreted, places a limit on which entities will constitute a 'trust' as defined.

¹³ *Friedman and Others NNO v CIR: In re Phillip Frame Will Trust v CIR* 1991 (2) SA 340 (W).

¹⁴ Du Plessis I (2009) *SA Merc LJ* at 324. She cites trusts with an assessed loss for s 103(2). See also sections 25B (4) –(6) discussed at par 4 3 2.

¹⁵ S 1 of the Income Tax Act, 58 of 1962.

¹⁶ Geach WD & Yeats J *Trusts Law and Practice* (2007) at 234. If it is not regarded as "resident" in South Africa it may still be taxed should it source income from South Africa.

¹⁷ See discussion at Chapter 4. Also Williams B & Mazansky E *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) Chapter 6 at 6.8 available electronically on LexisNexis.

consider.¹⁸

Based on the statutory definition a trust will be resident should it firstly, be regarded as 'established or formed in South Africa,' or in the alternative, have its 'place of effective management in South Africa.'¹⁹ These criteria are not applied conjunctively. It was noted that whilst this statutory definition has in relation to individuals and companies been addressed comprehensively by the South African Revenue Service, legal authors and academic contributors, trusts have been left in the proverbial lurch. Our findings in respect of each of these residency criterions are discussed separately below:

10 2 1 Findings in respect of the criteria “incorporated, established or formed”

We summarize our findings below:

1. The criteria “incorporated, established, or formed”, appears to embody principle that the connecting factor between the country levying the tax and the taxpayer, is the latter's creation which renders it capable of acquiring rights and assuming obligations.²⁰
2. It was firstly noted that “incorporated” is not an appropriate term in a trust setting as no legal personality ensues upon the formation of a trust, and thus regard should only be had to the two further terms, namely "established or formed."²¹ Based on their ordinary and grammatical meaning as per dictionary definitions, these words were concluded to essentially be synonyms for each other, both signifying the creation of a trust.
3. It was also noted that there is some ambiguity as to whether the expression "in South Africa" requires establishment *in terms of the laws of South Africa* or whether it simply requires establishment at any *place in South Africa*, with several arguments to support either view. The former interpretation would limit the application of the test by causing

¹⁸ See the discussion at 4 2 5 3. As stated there the proposals are still shrouded in much uncertainty and speculation.

¹⁹ The definition also contains two proviso's whereby firstly should the trust be regarded as exclusively resident of another country for purposes of a double taxation agreement, it will not be regarded as resident. Secondly, should it comply with the requirements for a foreign investment entity its place of effective management is differently determined which may cause it to be regarded as a non-resident as well.

²⁰ *Mexico Plantagen case* 1931-32. Ann. Dig. (No 135) (German-Mexican claims Commission, January 25, 1930)

²¹ Par 5 4 above; Olivier L & Honiball M *International Tax: A South African Perspective* (2011) at 153. Lewis, A *Silke on International Tax* (Ed. De Koker AP & Brinkler E)(Last updated November 2010) at 17.3.1 available electronically on LexisNexis.

trusts created in accordance with other countries' laws, or which have not been lawfully established in terms of South African laws, to fall outside the ambit of the Act's application. The fact that the related statutory definitions of 'trust' and 'trustee' do not appear to require such restrictions, and the recorded objective of the authorities at the time these provisions were included in the Act, were to throw the tax nets as wide as possible,²² provide support for the second interpretation. However on closer analysis, it is the first interpretation which accords most with the theoretical premise underpinning this basis of taxation, ie that the taxation of the entity is based on the justification that the country will accord protection and privileges to the entity, and this it will most comprehensively do, should the entity be created in terms of its laws. Aside from policy considerations, there are also statutory interpretation rules which support this view.²³ It may therefore be stated that our laws should be used as objective framework against which the creation of the entity should be measured.

4. Therefore whilst the definition of a trust in the Income Tax Act is very wide, when it is read together with the first residence criterion of "formed or established in the Republic," it is tailored so that on this leg, entities created and owing their existence to our laws (statutory or common), is intended – a limitation which is not necessary for the second residence criterion of place of effective management. Here the connecting factor for residence is the tie between the entity and the laws of the country which gives it its existence and acknowledges its rights and obligations.
5. Therefore the latter interpretation is preferred, although it is acknowledged that it is not conclusively supported on the wording of the Act. In light of such uncertainty, it was therefore called upon the legislature to clarify this aspect, which would promote simplicity and predictability, the key features of this test. It would also make it an objective formal standard, which the test is proclaimed to be.

²² Du Plessis I "The Residence of a Trust for South African Income Tax Purposes " 2009 (21) *SA Merc LJ* at 330 fn 64; Anon Comments on representations to the PCOF on the Revenue Laws Amendment Bill, 2000 in par 3.1.

²³ As Du Plessis points out the *noscitur a sociis* rule of interpretation requires that meaning of these words must be ascertained by reference with those associated with it. Consequently as these words are used in the same context as 'incorporated in South Africa' and the latter denotes the obtaining of legal personality through South African law, then these words denote that that trusts must be formed ito South African laws. A further construction rule requires that words used in a statute must also be interpreted to have a specific meaning. Should it be regarded that due to the fact that the definition of a trust is very wide, an entity complying with same would automatically be regarded as formed or established in South Africa, the first criterion would be rendered superfluous and thus offend the construction rule; Du Plessis I "The Residence of a Trust for South African Income Tax Purposes " 2009 (21) *SA Merc LJ* at 330 fn 64.

6. It was also pointed out that in South Africa, trusts in both a wide and narrow sense are recognised in law and to determine whether a trust can be said to be in existence, this distinction will be relevant so as to determine the relevant principles applicable. Unfortunately it is not clear from the Act whether such a distinction should be made, and whether if such a distinction is made and a trust fails in a narrow sense it may still then pass as a trust in the wide sense. The legislature should provide guidance and preferably distinguish and address these two categories separately.
7. Du Plessis' proposition for the criterion to read 'should it be required to be registered and the trustees authorized under the Trust Property Control Act'²⁴ was analysed and commended for simplifying the enquiry process in determining whether a trust has been formed. However its drawbacks include that it would not be appropriate for trusts in the wide sense nor trusts created orally and therefore a distinction should be made so that its inclusion would not cause such trusts to simply fall by the wayside.
8. The focus of the study is on trusts in a narrow sense, and therefore requires that the particular rules and principles relevant to such trusts be investigated. The definition of a trust in the Act further envisages that the person acting in a fiduciary capacity be appointed 'under a deed of trust, agreement or Will of a deceased person.' Therefore the ordinary rules relating to wills and contracts in South Africa would be applicable,²⁵ and necessitated a review to establish their impact on the place and time a trust can be said to have been formed or established.
9. In respect of the establishment or formation of a trust a distinction was made between testamentary trusts and *inter vivos* trusts. A testamentary trust is mostly created in terms of the Will and comes into existence upon the testator's death. There is however uncertainty as to the place *where* it should be regarded as formed with several alternatives raised –the place where the Will was executed in compliance with all the formalities, the place where the Will was drawn up, the place where the testator dies, and the place where the Will is executed and subjected to public authority and becomes operational.²⁶
10. The place where the Will was drawn up as well as the place where the testator dies, were

²⁴ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes " 2009 (21) *SA Merc LJ* at 334.

²⁵ Pace RP & Van der Westhuizen WM *Wills and Trusts* (October 2012) – B8.5 at 44(9)

²⁶ This was discussed in detail at par 5 4 2 1.

found to be impracticable options as well as weak connectors. Thus the two most preferred alternatives are the place where the trust instrument is executed in compliance with all the formalities, and the place where the trust instrument is executed *and* subjected to public authority and becomes operational. The reason for the distinction between the two alternatives arises from the fact that it is not a requirement (*essentia*) in terms of our general law for the trust deed to be lodged with the Master and a trust may come into existence regardless of such lodgement.

11. Whilst the first alternative therefore accords with general trust law, it gives rise to problems in respect of awareness and enforcement. It was noted that this could be cured by the introduction and implementation in South Africa of a central database system as is found in several European countries, but could be countered by an argument that South Africa does not have the infrastructure, administrative capacity and funding, to implement such a system. However in today's electronic era where various governmental departments²⁷ appear to have the technological capacity to collect and retain vast amounts of data, the validity of such an argument wears thin. Yet, even should the Will be executed here and registered in such database, it does not obviate the fact that South Africa may have no substantive interest in its functioning and apart from perhaps initially allowing it, the protection of its laws to confirm its valid formation, it provides no further shelter to it as required by underlying notion to the residence based taxation.
12. It was therefore concluded that the second alternative is to be preferred. It promotes certainty and enforceability, as well as simplifies the enquiry process and puts trust on an equal footing as corporate entities. If regard is had to the definition of a trust for the income tax framework, it requires that a "trust fund consisting of cash or other assets administered or controlled by a person" which may provide implicit endorsement that the relevant time to establish whether a trust has been formed is not to look at the execution of the Will but at the time the administration commences as this definition presupposes the existence of a trust fund and appointment of a trustee which would only be present at this later juncture.
13. This would necessitate that it either be a interpretational read-in to the statutory definition, or that the Act be expressly amended to state that residence on the basis of this criterion of "formed or established" in relation to *mortis causa* trusts will only be

²⁷ The departments to which reference was made and examples given were SARS, the Department of Home Affairs and the Master's office.

attributed to trusts lodged with the Master or the successive applicable authority in South Africa. Whilst it can be criticized as foisting a further limiting requirement onto the definition, in relation to trust *mortis causa* it is a sensible pragmatic approach as they are seldom used for tax avoidance and illegitimate purposes.²⁸ Alternatively if Du Plessis' proposal is carried through and the criterion reads in relation to trusts created in a narrow sense, that it be resident if 'required to be registered in terms of the Trust Property Control Act' then this basis would be accommodated, whether it be a *mortis causa* or *inter vivos* trust, and provides further endorsement for her proposition.

14. It was lastly noted that with the increasing use of electronic mediums, existing formalities for Wills may in future be substantially amended, which would necessitate a similar review of residence of the trust as based thereon.
15. *Inter vivos* trusts differ from testamentary trusts in that they are created by contract and therefore the established rules applicable to the formation of contracts are important in determining the formation or establishment of the trust. Again several places for the establishment of the trust could arise owing to the fact that as a contract it is a bilateral or multilateral act with several contractual parties who need not be located in one venue, and where such a situation may arise, these rules will then be invoked.
16. The traditional rules and their interaction with ECTA,²⁹ which governs electronic communications were discussed, and are not reiterated here except in relation to the deeming rule, which could potentially be problematic. This rule provides that unless parties agree otherwise, the agreement will be concluded at the place where the acceptance of offer was received and deems the latter to be at such person's usual place of business or residence.³⁰ As the latter is stated as alternatives and with no indication as to which place would be decisive, in situations where these places are different, uncertainty will prevail. Du Plessis' proposal for parties to specify a particular place in their trust deed and thus counter this uncertainty is therefore endorsed.³¹
17. Whilst ECTA certainly enhances the environment for the electronic formation of trusts, it was shown that in practice there is but little evidence of trusts being concluded entirely

²⁸ Oguttu AW *Curbing Offshore Tax Avoidance* (LLD-thesis) (November 2007) at 315.

²⁹ Electronic Communications and Transactions Act, 25 of 2002.

³⁰ S 23 of ECTA, Act 25 of 2002.

³¹ Du Plessis I "The Residence of a Trust for South African Income Tax Purposes" 2009 (21) *SA Merc LJ* at 331; Self-regulation was also promoted by the court in *Jafta v Ezemvelo KZN Wildlife* [2008] 10 BLLR 954 (LC) at par 91.

electronically. This was attributed in part to a lack of enthusiasm from the relevant role-players. The Master's recent electronic additions were discussed and although the trust registration process has been electronically enhanced by the provision of forms to be completed electronically and an interactive web-portal, the complete digitalization of the registration system is not provided for as yet.

18. A further contributing factor was shown to be the slow accreditation by the South African Accreditation Authority (SAAA) of service providers in respect of acceptable advanced electronic signature, thus stymieing the Act.³² The recommendations here are therefore directed to the context of ECTA, firstly for its drafters to refine the wording of the deeming provision and for its lobbyists and the SAAA to advance its application by further accreditation and importantly, increasing awareness of electronic contracting.

Overall, the advantage of this test lies in its simplicity and promotion of certainty. It is an objective test which sets standards that may be confirmed without difficulty and costs as opposed to a factual approach. The words of Basu remain apt – it is “bright line rule that is easily understood and furthermore, enjoys the advantages of certainty and requires minimal cost for compliance.”³³ The recommendations made above, seek to enhance these advantages Basu outlines and to ensure that it is an objective formal criteria which may be applied with ease and cost efficiency.

However the test is not without disadvantages – as a purely formal criterion, it can be easily manipulated and more so in an electronic era which enhances communication and contracting without a physical presence. It is also perceived to be but an artificial measure without any real economic substance to it, and can be arbitrarily chosen. On its own it is therefore not an efficient tax net, capturing only those who were created in the country, but allowing those who similarly may make use of the country's infrastructure to escape simply on the basis of their purported foreign establishment.

10 2 2 Findings in respect of the criteria “place of effective management”

In addition to the above *de iure* formal test, South Africa also employs a more factual measure to determine residence- in the form of “place of effective management.” Our findings in respect of this criterion are:

³² Although the Act came into operation in 2002, it was only a decade later in 2012 that the first service provider was accredited.

³³ Basu, *S Global Perspectives on e-commerce taxation law* (2007) at 38.

1. The ordinary grammatical meaning of the term revealed that it requires actual “and not theoretical management – a theme that runs as a golden thread throughout the many considerations and interpretations of this term.
2. In determining the meaning of the term locally, regard was firstly had to our tax authorities’ view. The Interpretation Note³⁴ issued, indicated that for our fiscus the ‘place of effective management’ denotes a lower level of management, with the focus specifically on the *implementation* and *execution* of policy and strategic decisions of the entity. This view poses several difficulties in the context of a trust. Firstly, a lack of different management levels, secondly, established trust law principles governing what may be delegated for implementation and lastly (and more generally) the fact that the expression ‘implementation’ may be difficult to apply in practice, as it is not always clear where the place of implementation is or that there is indeed only one place of implementation.
3. In a trust setting SARS’ viewpoint was explored and it was concluded to mean that the place where the trustees meet or exercise their overriding control is not conclusive, instead that a factual approach is required, thus necessitating a review of the trust deed, its objectives and activities, and that the place of effective management would be where the policy and strategic decision made by the trustees are then executed upon and implemented by either the trustees, a trustee to whom this function is delegated or other functionaries.³⁵
4. To further determine the local meaning, regard was had to the views of local academic and legal authors, but this yielded no consistent results.³⁶ Certain authors appeared to endorse old case law by emphasizing the place of residence of trustees, others favoured a higher level approach, placing value on where the trustees meet and attend to the decision-making. For others the focus was more philosophically on where the fiduciary duties are carried out, whilst others focus on only one such duty, namely where the assets of the trust are administered. A further difference was that some appeared to look only to the trustees, whilst others follow a broader approach and included other functionaries in their review, acknowledging that the trustees may in certain instances act not of their own accord, or that their functions may be usurped by others.

³⁴ Interpretation Note No. 6: Resident: Place of effective management (persons other than natural persons) issued by SARS on 26 March 2002

³⁵ See the discussion at par 6 3.

³⁶ See the discussion at par 6 4.

5. In our opinion, the view of the authors, Olivier & Honiball³⁷ as well as Cohen & Kruger³⁸ who all advocate a more holistic and hands-on approach, placing emphases on the importance of reviewing all the facts and if necessary, looking beyond the trust form and the traditional role of its trustees, is the preferred view.
6. From such commentators, there was also strong criticism against SARS's view.³⁹ In particular it was lamented that SARS' approach was misaligned with the international community, as it focused on implementation and not on the decision making, and was too constrained in their lower level approach. This SARS wishes to address per the recently published Discussion Paper⁴⁰, wherein SARS proposed to refine its approach. The aim of these refinements are to place the primary emphasis on those who "call the shots", thus shifting the focus to those who actually develop or formulate the strategies, make the key decisions and ensure that the strategies and policies are carried out. By so doing, it endeavours to align South Africa with the international viewpoint.
7. The implications of this shift to those who *make* (as opposed to *implement*) key management decisions were discussed. On the other hand, it was felt that this would enhance simplicity of the test as taking into account trust law principles; it is trite that this function may only be exercised by the trustees. This principle has most clearly been articulated - "fundamental *decisions* relating to a trust need to be *taken* by the trustees, the *implementation* of such decisions may be *delegated* to others, although the ultimate responsibility remains with the trustees."⁴¹
8. Unfortunately this does not address the reality that often situations arise where the trustees are peons of others with the real decision-making done by related parties, be it the founder, a dominating co-trustee or beneficiary, professional advisors or investment managers. Consequently a tension arises between the strict principles of trust law and the necessary practical approach required by tax law.⁴²
9. The recommendation was therefore made that in a trust setting, SARS should either retain the implementation approach, which in accordance with trust law principles, would legally allow it to take into account such parties, but the criticisms against implementation as an

³⁷ Honiball & Olivier *The Taxation of Trusts in South Africa* (2009) at 68- 71, and 289-290.

³⁸ Cohen T & Kruger D "Offshore Trusts: Many Dragons wait in Ambush " 2010 (1) (3) *Business Tax & Company Law Quarterly* at 24 – 29.

³⁹ See discussion per 6 3 5.

⁴⁰ SARS "Discussion Paper on Interpretation Note 6" September 2011.

⁴¹ *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) at para 24.

⁴² This tension between trust and tax law was further elaborated in par 6 7.

inadequate measure of the real management of the trust would remain. Alternatively it should develop a separate approach specifically in a trust context to address these situations and issue an interpretation note as it had done for companies. A last option was to retain the proposed refined view of decision-making, but justify the basis upon which the actions of other parties than the trustees may be taken into account and awarded legal recognition. In this regard several alternatives were mentioned, such as the law of agency as well as the substance over form and abuse of the trust form-doctrines, which on their own or in combination may serve as possible justification.

10. Case law on this particular issue is scarce. Until recently there was only one case which addressed this specific issue – *Nathan’s Estate v CIR*,⁴³ which concluded that the place where the trustees resided and from where they thus administered the trust fund was decisive. However the case dealt with provincial taxes and was decided prior to the change-over to a residence based system, thus it is of limited authoritative value.
11. The recent case of the *Oceanic Trust Co. Ltd (NO) v Commissioner, SARS*⁴⁴ thus marked a historical occasion and is therefore welcomed. It provided insight as to how our local judiciary will interpret this term and several valuable lessons may be gleaned from it, despite its limitations.⁴⁵ In our view the case established that the international view of the place of effective management is to be preferred, specifically as there was no reference to the view of the South African's fiscus per their Interpretation Note. Secondly it stresses that the focus should be on where the key management and commercial decisions are substantially made as opposed to implemented. Furthermore, it endorsed the approach set out in the *Smallwood*-case⁴⁶ in that that no definite rule can be given and that holistically all facts and circumstances should be taken into account. Implicitly it also appears to recognise that key management decisions and control aspects may be exercised by parties who are not necessarily the trustees, and that this will have an impact on the determination of the place of effective management.
12. Locally therefore this criterion is useful as it is pragmatic, looks beyond artificial

⁴³ 1948 (3) SA 866.

⁴⁴ Decided on 14 June 2011. (2011) 74 SATC 127.. It is the first case on the “place of effective management” since the introduction of the term.

⁴⁵ The limitations being that it is only a provincial high court case and therefore not binding on other divisions, secondly, it an application for declaratory relief and thirdly the court did not make any conclusions as to the place of effective management of the trust as there were insufficient facts – facts which may only established in the tax court.

⁴⁶ *Re the Trevor Smallwood Trust; Smallwood and another v HMRC* [2010] EWCA Civ 778 (Court of Appeal (Civil Division)).

structures to reality, and is thus more resilient to manipulation. It certainly widens our tax net to also capture those who may not have a formal tie, yet are substantially connected here. Yet it is accompanied with difficult issues of interpretation and may prove complicated to apply in practice. As was also discussed, these issues may be exacerbated in this era of electronic communications, which increasingly makes the place of decision-making extremely difficult to find with certainty.

13. As an alternative in the “strongest economic nexus” test was discussed, which some authors regarding this as the only viable test.⁴⁷ Yet this test too has severe drawbacks – the scale and complexity of the factual investigations it would necessitate being but one such disadvantage, but also on the whole, it would not necessarily be any more clear in its application than the place of effective management-test.
14. In the interpretation of the term “place of effective management” cognisance must however also be taken of the international precedent and interpretation.⁴⁸ Consequently the meaning ascribed to it in the publications of the United Nations⁴⁹ and the OECD,⁵⁰ as well as case law in a treaty context was considered.
15. Again a key finding was that the golden thread as ran through the South African discourse on the meaning of this term, also ran through the international development of this term, with the earliest drafts prepared in the first decades of the last century, already advancing a factual approach.⁵¹
16. Furthermore that there was unfortunately no universal meaning available for the term – even in this international arena, with its participants often attempting to interpret it on the basis of their domestic meaning, thus leading to conflicting views as to its interpretation.⁵²

⁴⁷ Davis, DM “Residence based taxation: Is it up to the e-commerce challenge” 2002 *Acta Juridica* at 164. This test was also discussed in the context of the OECD's proposals at par 7 3 3.

⁴⁸ This is a legislative mandate imposed by the Constitution of South Africa which in S233 requires courts to in their interpretation of legislation give preference to “any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.”

⁴⁹ See Chapter 7. Particularly the UN's Model Double Taxation Convention between Developed and Developing Countries and Commentaries.

⁵⁰ Organisation for the Economic Co-operation and Development, particularly their Model Tax Convention on Income and Capital, and Commentaries.

⁵¹ The discussion at par 73 1 -7 3 3 provides an overview of the historical development of the term.

⁵² Burgstaller, E & Haslinger, K “Place of Effective Management as a Tie-Breaker-Rule – Concept Developments and Prospects” 2004 *Intertax* (32) 8/9 at 381.

17. Even the meaning the OECD's has attributed to this term has not been constant, and instead is ever evolving as is evident from the changes that occurred between 2000 and 2008. In the 2000 Commentary, the place of effective management was explained to be the place where key management and commercial decisions necessary for the conduct of the entity's business are made, with further comments placing emphasis on where the most senior person or group would meet. Whilst the 2008 Update retained the place where key management and commercial decisions are made, such further comments relating to the senior persons were deleted and an alternative tie-breaker was inserted to allow for the authorities of contracting states, to through mutual agreement resolve situations where the place of effective management was not clear and residence could not be ascertained. It therefore appears that SARS' proposed refined view will be more aligned with the OECD's approach, and our recommendation stated above that these proposals be put into effect soonest, is reiterated.
18. In a treaty setting it was found that there are a number of issues, which arise and are peculiar to trusts, such as whether they may be regarded as a person for application of the treaty, similarly whether they can be regarded as liable for taxation (which is influenced by their flow-through nature), as well as whether they can be regarded to be beneficially entitled to the income.⁵³ A last issue arises in the context of South African treaties: whether the "place of effective management" as tie-breaker must bear a different meaning than our domestic meaning, where the term is also used to determine local fiscal residence.⁵⁴
19. Unfortunately in these conventions and publications, trusts are not considered specifically. However international case law dealing with the application of the term in a treaty setting and particular in respect of trusts, provides such guidance as to the meaning and its practical treatment.
20. In our view the guidance can be extrapolated from these cases into a three tiered principle structure. This would render it capable of better application in a trust setting. It is our recommendation that such a three step approach be followed in determining the place of effective management of a trust in a practical situation:

⁵³ These four issues are discussed at par 7 4 1- 7 4 4.

⁵⁴ See in particular the discussion at par 7 4 4, the case of *Oceanic Trust Co Ltd No v Commissioner for SARS* (2011) 74 SATC 127 where the court did not consider it necessary to follow the domestic meaning as well as the Smallwood –case where such a distinction was made. See also Gutuza, T "Analysis: Has Recent UK Case Law Affected the Interplay Between 'Place of Effective Management' and 'Controlled Foreign Companies?'" (2012) 24 *SA Mercantile Law Journal* at 426

- 20.1 The case of *Wensleydale's Settlement Trustees v Inland Revenue Commissioners*⁵⁵ establishes the basic principle to be followed. It is authority that the place of effective management is the “place where the shots are called” and that “realistic positive management” is required. Generally the realistic positive management will be exercised by the trustees, as they bear the responsibility to make the key decisions of the trust. Thus where they meet to make such decisions and exercise their management functions will be important.
- 20.2 To elaborate on this basic principle, regard should also be had as to what constitutes “key” decisions and here the cases discussed also provides important guidance in deeming certain actions, such as the opening of a bank account, as insufficient to constitute effective management. The *Indofood*-cases⁵⁶ continues this theme by also reviewing the decisions which had to be made, and finding them to fall short of being “key” decisions. The *News Datacom*-case⁵⁷ is lastly effective in establishing that a distinction should be made between ministerial matters and substantive issues, with matters dealing with housekeeping inadequate in constituting effective management.
- 20.3 However in not all instances will the trustees be the real decision-makers and there are, and have been instances where such function was fulfilled by others. The case of *Wood v Holden*⁵⁸ establishes the second principle that in assessing the impact of the actions of such parties, a distinction should be made between *exercising* management and control, and *being able to influence* those who exercise the management and control, and secondly, between *ensuring* that those who are able to exercise the management and control knows one's wishes for its decisions, as opposed to *usurping* those functions. In assessing into which category the actions fall, regard should be had to the particular nature of the entity, specifically taking into account whether it has active continuing business functions or but limited functions.

⁵⁵ [1996] S.T.C. (S.C.D.)241.

⁵⁶ For example, decisions as to the keeping of the books, audit, the handling of interest and equity. Citation for the High Court case *-Indofood International Finance Ltd v JPMorgan Chase Bank, N.A London Branch* [2005] EWHC 2103 (Ch), and for the Court of Appeal *Indofood International Finance Ltd v JPMorgan Chase Bank, N.A, London Branch* [2006] EWCA Civ 158.

⁵⁷ *News Datacom Ltd & News Data Security Products Ltd v Revenue & Customs* [2006] UKSPC SPC00561 (06 September 2006).

⁵⁸ 2006 EWCA Civ 26 (Court of Appeal); 2005 EWHC 547 (High Court); 2003 Case no SPC00422 (Special Commissioners).

- 20.4 The *Laerstate*- case⁵⁹ elaborates upon this principle by also introducing a further aspect to be included for consideration– the degree of knowledge the decision-maker had, and by establishing a scale upon which the degree of influence can be measure. The scale consist out of four categories. Firstly, where the signatory simply signs mindlessly what it placed in front of him. Secondly, where the signatory knows what is placed in front of him, but signs it without any consideration as to whether to sign or not. Thirdly, where the signatory follows the wishes of an outsider, but has the absolute minimum information at his disposal which would have enabled him to make a decision, albeit an ill-informed decision it would remain a management decision. Lastly, where sufficient information to make an informed decision is available.
- 20.5 The last principle is then illustrated in the case of *Smallwood and another v HMRC*.⁶⁰ Once the above distinction has been made and it is found that the impact of the activities by such parties goes beyond mere influence and overshadows the actions of the trustees, or in the words of the court, where its managements are “carefully orchestrated” by other parties, this case is authority that the place of effective management of the trust, will no longer correlate with the place where the formal decisions were made, but instead be located from such place where such decisions were in substance made and controlled, and thus the trust’s residence will be located there accordingly.
- 20.6 Essentially then when the three principles are applied, it renders a test of firstly asking what are the key-decisions, then, who made these decisions, and where were they made, with the place of effective management located at such place. However when the degree of influence is such that the decision-making is orchestrated from another place, the substance over form will prevail, and the place of effective management will be located where the decisions were substantially made.
21. Until such time as SARS however revises its Interpretation Note as per its Discussion Paper, there is therefore a discrepancy between the local approach focusing on implementation and the international viewpoint contained in the OECD’s commentary and edified by the above cases. This may therefore lead to different conclusions being

⁵⁹ [2009] UKFTT 209 (TC).

⁶⁰ [2010] EWCA Civ 778 (Court of Appeal (Civil Division)).

reached as to an entity's place of residence, depending on which viewpoint is applied, which is not an ideal situation. Whilst the *Oceanic*-case implicitly indicates that our local courts do not regard themselves to bound by SARS' viewpoint, and will rather endeavour to apply the international meaning, it is recommended that in the interest of certainty, SARS effects these changes rather sooner than later.

22. SARS has also proposed a further alternative in its Discussion Paper – the “Mutual Agreement Procedure,”⁶¹ which is also contained in the most recent OECD Model.⁶² Whilst this is a practical solution and there is evidence to suggest that it is being utilized increasingly in local double tax agreements, it obliterates any measure of certainty for taxpayers and may be time-consuming and arbitrary. The further criticisms against such an approach was outlined when the recently renegotiated treaty between South Africa and Mauritius, was discussed.
23. It is lastly concluded that whilst the criterion of 'place of effective management' does not necessarily have a clear and consistent meaning, neither locally nor internationally, it is a fitting complimentary test to the first criterion. Its factual-based approach offers protection against those who employ artificial measures with the hope to undermine tax by concealing their true substance, whilst it also fluid, changing as the facts change, thus capturing those who have sufficient connections here but releasing them when they do not.

10 3 Findings in respect of the test for residence of a trust in other jurisdictions

Trusts are also a popular vehicle in common law countries with an ever increasing following in civil law countries. Consequently various jurisdictions were reviewed to determine their approach for ascertaining the residence of a trust. A diverse spectrum of approaches was the result:

1. In traditional civil law countries, no uniform approach could be identified. Italy follows a similar approach to South Africa and has both a legal and factual criteria, employing “place of management’ or main business, and where that latter is not ascertainable through an organisation structure, defaults to the trustee’s residence. This default

⁶¹ This mutual agreement procedure is already found in 12 of the 70 double tax agreements SARS has concluded with other countries. SARS “Discussion Paper on Interpretation Note 6” September 2011. at footnote 1 and par 8.4. It was also further discussed in Par 7 3 4 2 as SARS has recently substituted the place of effective management with this tie-breaker in its double taxation agreement with Mauritius, anticipated to come into effect on 1 January 2015.

⁶² Par 24.1 of the OECD “Model Tax Convention on Income and on Capital” (2010) as at 22 July 2010.

provision loses sight of the fact that the trustee's residence will not necessarily be the place from where they exercise their management. Belgium allows the settlor to specify the governing law upon which the residence of the trust is then based, a test which is clearly open to manipulation.

2. In low tax jurisdictions, residence is easily established by usually having at least one trustee resident in such country, thus conferring the benefits of low or (generally) no taxes being applicable to the trust. This appears to be artificial, and would only be justifiable if a substantial connection in the form of such trustee actually managing the trust were present.
3. In the USA, two criteria must be satisfied – an USA court must be able to exercise primary supervision over the trust, and secondly control over the trust must be present in the form of one or more US persons having the authority to control all substantial decisions. Thus it incorporates both a legal and factual standard, and appears to be a practical test. Australia applies a stricter test, regarding a trust to be resident should only one of its trustee be resident, alternatively if the central management and control of the trust is situated in Australia. The latter test is regarded as similar to the place of effective management.
4. The position in Canada was investigated in further detail.⁶³ Similarities to South Africa were identified: a trust is also considered be a taxable entity and thus could be resident, and as in South Africa, there is no statutory defined residence test exclusive only to trusts.
5. The residence of a trust has therefore been largely left to the judiciary to develop a meaning, although Canada's Revenue Authorities have attempted to assist by formulating an approach in their Interpretation Bulletin.⁶⁴ Again similar to South Africa, historically the judicially developed test focused on the residence of the trustee.⁶⁵ However in the recent *Fundy Settlement v Canada* case, the test has now been evolved by the Supreme Court of Appeal.⁶⁶ This case has established that the approach to be followed is to determine the trust's residence based on where its central management and control is. As stated above this test is often perceived to be similar to the place of effective management and control. Whilst the approach is to be commended for being a factual,

⁶³ See the discussion at par 8.3.

⁶⁴ Income Tax Interpretation Bulletin IT-447: Residence of a Trust or Estate Issued by the Canada Revenue Agency, date 30 May 1980. Modified 1995-01-01.

⁶⁵ *Thibodeau Family Trust v the Queen* [1978] FCJ No 607 also cited as 78 DTC 6376 sub nom *Dill v The Queen*.

⁶⁶ *Fundy Settlement v Canada* 2012 SCC 14, Judgment delivered on 12 April 2012.

substantial enquiry, therein also lies its downside as with factual investigations, increased time, compliance and costs result which would not be necessary in all instances and which could be obviated by also having a purely formal test, as is the position in South Africa.

6. Then the position in the UK was considered.⁶⁷ In the UK the trustees are by statutory definition regarded as a deemed person distinct from the persons who are the trustees of the settlement from time to time.
7. Furthermore unlike South Africa and Canada, the UK has a statutory residence particular to trusts. This residence test was introduced in 2007 following a trust modernisation programme. However it retained the historical approach to focus on the residence of the trustees. Thus it determines that the residence status of the trustees be ascertained – where all are non-resident the trust would be non-resident, and where all resident – the trust would be resident. In instances of mixed residency where at least one trustee is resident and one not resident, the residence of the settlor then becomes conclusive. At first blush therefore one would regard the test to have the benefits of simplicity, certainty and low compliance costs. However it requires that the residence of each trustee be investigated, individual or corporate which could undermine such benefits. Secondly it is open to manipulation and may not necessarily have any substance underlying it. The approaches of Canada and South Africa are therefore preferable.

10 4 Findings in respect of the various tests

In order to analyze the respective tests, it was necessary to review the underlying justification for residence based taxation as this forms an implicit measure of the effectiveness of such tests, and then to determine the further measures by which tests are to be assessed.

Having then reviewed such justification, as well as the objectives of the tax system and the optimal characteristics of the tax system, it was concluded that an optimal test for residence would therefore be one that utilizes criteria which a) justifies the tax liability based on the protection and privileges the taxable entity receives 2) requires sufficiently close connections to the jurisdiction 3) is enforceable 4) is aimed at maximising revenue and protecting the tax base and 5) aims to promote the characteristics of a good tax system, namely equity, neutrality, efficiency, ease of compliance, flexibility and certainty.⁶⁸

⁶⁷ The UK's approach was set out in par 8 4.

⁶⁸ See par 9 2 and par 9 3.

Whilst the various test reviewed the country under whose laws the trust was established (a so-called purely legal test), place of central management control or place of effective management (so-called purely factual tests) , residence of the beneficiaries, residence of the settlor, residence of the trustees, location of the assets, strongest economic nexus and the combination approach – each to a certain extent achieved some of the characteristics, all were unsuccessful in achieving all of the desired attributes.

Tests which looked to only one factor, such as assets, or to one party, be it the settlor, beneficiaries, or trustees – all tended then to have only one connecting factor, thus opening the door for manipulation, and undermining the ability of generating revenue. Test which looked to formal connections – such as the purely legal test related to the creation of an entity, was exposed to the same problem, yet held the benefit of simplicity and certainty.⁶⁹

The factual tests, such as place of effective management applied in South Africa, and place of central management and control, as well as the strongest economic nexus test, seems best equipped to achieve the optimal features by ensuring that sufficient connecting factors are present, and are by reason of their factual nature, resistant against manipulation and inherently flexible.⁷⁰

This was demonstrated by the practical example discussed in Chapter 9, where the tests utilized in the UK, South Africa and Canada were applied to a factual scenario and the factual tests applied in South Africa and Canada yielded the most appropriate results. However it was found that in some instances the application of a single factual based test would tend to result in increased compliance costs, uncertainty and be time-consuming, and therefore the approach of South Africa to combine such a test with an alternative formal legal based test is a more pragmatical approach.

It was furthermore suggested that as we enter further into a modernized world of cyberspace, increased mobility and ever developing communication mediums, the strongest economic nexus test with its ability to overcome the challenges of such an era, be applied as further alternative, although this will require further study and consideration to ensure that such a test is capable of being applied with certainty as to the factors to be taken into considerations, how they are to be quantified and that in measurement of such factors, subjectivity is minimized.

⁶⁹ See Par 9 4 2 1, as well as par 9 4 2 3 to 9 4 2 6.

⁷⁰ See Par 9 4 2 2.

10 5 Conclusion

It has aptly been remarked that -

“The recognition of the residence status of a person is a cornerstone of international taxation.”⁷¹

The basis upon which South Africa recognises the residence status of a trust has in-depth been considered in this study. This was deemed necessary as unlike the position in respect of individuals and companies, there is unfortunately a dearth of authority on this aspect. In so doing, it has been found that the basis upon which South Africa determines residency is a commendable model, and is to be preferred above the models used in countries such as the United Kingdom and Canada. That said, there are however aspects which detract from its usefulness and complicate its application. The recommendations made in the study have sought to address these so as to result in an optimal and appropriate residence test, and is in keeping, where relevant with the approach of the international community. Given the fact that trusts and tax have for centuries been intertwined, it is hoped that the resultant test addressing this relationship, will too last the test of time.

⁷¹ Russo, R et al *A Decade of Case Law* (2008) at 7.2.3.3.

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